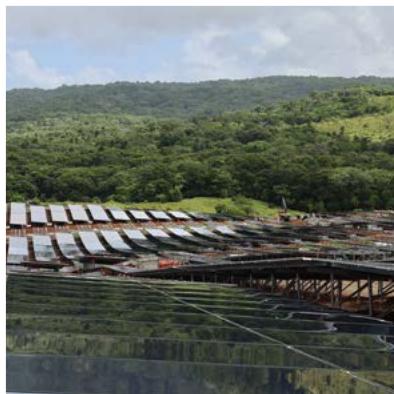
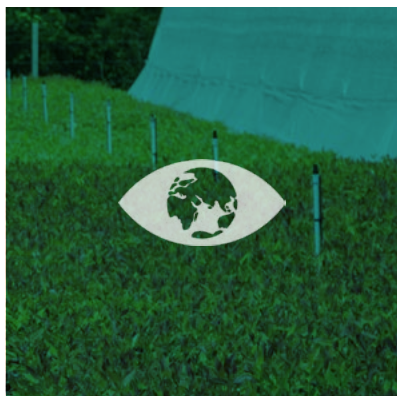




Australian Government

Department of Foreign Affairs and Trade



# Development Finance Review

NEW APPROACHES FOR A CHANGING LANDSCAPE



## Acknowledgement of Country

The Australian Government acknowledges Australia's First Nations peoples as the Traditional Custodians of Country throughout Australia and recognises and respects their continuing connections to lands, waters and communities.

The Government pays respect to Elders past and present, to emerging leaders, and to all First Nations peoples, and recognises the continuation of diverse cultural, spiritual and educational practices.

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This Review was authored by the Development Finance and Economics Branch within DFAT under the guidance of Robert Christie, Kirsty McNichol, Michelle Shepherdson, and Anthony Swan. The core report team included Wilma Gillies, Rahul Nath, James Rodda, Anthony Samson, Alexander Smith, and Amy Williams, and with significant contributions from Mark Bailey, Gordon Burns, Simon Cramp, Tess Connolly, Peta Anne Garrett, Trisha Gray, Declan Ingham, Andy Isbister, Angus Kathage, Samuel Thatcher, Abhay Madan, Julie McCallum, Joanna Pinkas, Hussain Rajwani, Esther Sainsbury, Kevin Smith, and Priyanka Sunder. The Review was overseen by the Review Advisory Panel, chaired by Natalie Cohen and Michael Crowder, and later chaired by Mathew Fox.

This Review is the product of the staff of DFAT. The findings, interpretations and conclusions expressed in this report do not necessarily reflect the views of the Australian Government. DFAT does not guarantee the accuracy of the data or graphical representations included in this Review.

# Abbreviations and acronyms

ACFID.....	Australian Council for International Development
ACFP.....	Australian Climate Finance Partnership
ADB.....	The Asian Development Bank
AIFFP .....	The Australian Infrastructure Financing Facility for the Pacific
AUD .....	Australian dollars
DFAT .....	Department of Foreign Affairs and Trade
DFI.....	Development finance institution
EFIC.....	Export Finance and Insurance Corporation
EFA.....	Export Finance Australia
EMIIF.....	The Emerging Markets Impact Investment Fund
FDI.....	Foreign direct investment
GEDSI.....	Gender equality, disability and social inclusion
GLI.....	Gender lens investing
IDA .....	International Development Association
IFC.....	International Finance Corporation
IFI .....	International financial institution
IMA .....	International Monetary Agreement
IMF .....	International Monetary Fund
MDB.....	Multilateral development bank
NGO .....	Non-governmental organisation
NIA.....	National Interest Account
ODA.....	Official Development Assistance
OECD.....	Organisation for Economic Cooperation and Development
OOF .....	Other Official Flows
PFAN.....	The Private Financing Advisory Network
PIDG.....	The Private Infrastructure Development Group
PM&C.....	Department of the Prime Minister and Cabinet
PNG.....	Papua New Guinea
RAP.....	Development Finance Review Advisory Panel
SDG.....	Sustainable Development Goals
SME.....	Small and medium-sized enterprise
UN.....	United Nations
USD.....	United States dollars

# Foreword

Australia is committed to deepening our engagement with the Indo Pacific. A peaceful, stable and prosperous Indo-Pacific is in Australia's long-term interest but poverty, vulnerability to natural disasters and inequality threaten stability.

Australia's development finance must play its part to advance the needs of our times. Our development program is critically important to meet these challenges. It saves lives, promotes economic growth, creates jobs and helps lift people out of poverty. It can address inequalities – including for women, girls, and people with disabilities. And it can make countries more resilient to shocks.

Today's global challenges are interconnected and have compounding effects. Development needs in the Indo-Pacific are large and growing. Most Pacific Island countries have emerged from the pandemic with high and growing debt, while also facing the ravages of climate change. Southeast Asia requires significant financing to meet ambitious development goals, including to transition to clean energy.

Traditional grant-based financing through the Official Development Assistance program will no longer be enough to meet the development needs of our partners.

The Government commissioned DFAT to review Australia's development finance and to identify how we can better assist partner countries achieve their development objectives by using new forms of finance.

Australia's existing development finance mechanisms are operating successfully to support countries in the region. But we can do more to respond to increasingly complex development challenges. Through these efforts the Government will focus on outcomes that impact gender equality, climate change, disability and First Nations in Australia's development finance.

The Review charts a way forward to achieve this. The Government accepts all eight recommendations of the Review.

Australia will continue to provide affordable, high quality, and climate-resilient infrastructure in the Pacific without exacerbating existing fragility and debt sustainability challenges. And our recent measures to expand the investment cap on the Emerging Market Impact Investment Fund will mobilise private sector financing for climate mitigation and adaptation.

The Government will scale up these development finance mechanisms and work more with philanthropic organisations and impact investors. This approach will provide opportunities for countries to unlock opportunities and deepen cooperation with each other, and with Australia, in the process.

We thank all stakeholders, across the region and in Australia, who engaged in consultations throughout the Review.



**The Hon Pat Conroy MP**

Minister for International Development and the Pacific





Credit: Flordeliz Ranola

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Credit: DFAT/Linda Roche

# Executive summary



## Context

**Australia's future is intertwined with the prosperity and stability of our neighbours in the Indo-Pacific region.** Cementing our place as a reliable, responsive, and trusted partner in the region requires stepping up our capability to work in genuine partnership with countries of the region to deliver solutions to the increasingly complex development challenges we face. Twenty-two of our twenty-six near neighbours are developing countries who are striving to mobilise the financing needed to meet their economic and social aspirations. This financing gap has been widened further by COVID-19 pressures, growing indebtedness, and the urgent mitigation and adaptation needs posed by the accelerating climate crisis.

**Development finance expands Australia's toolkit beyond the Official Development Assistance (ODA) grant program.<sup>1</sup>** Delivered using instruments such as loans, equity, insurance, and guarantees, it can be deployed to meet a variety of development needs at a much larger scale and with a wider array of potential financing partners. Blended finance approaches are proving very effective at attracting much-needed private finance towards development outcomes, especially in emerging markets in the region.

**Consultation has been central to this Review.** The Review, undertaken at the Government's request, consulted widely, including with partner governments, multilateral development banks (MDBs), bilateral donors, non governmental organisations (NGOs), private sector representatives, and philanthropic and civil society organisations. It complements the Government's new International Development Policy and other initiatives including those focused on Australia's increased ambition on climate.

## Development finance needs

**The gap in achieving the Sustainable Development Goals (SDGs) in the Indo-Pacific region is large and growing in many cases.** This gap has been exacerbated by COVID-19-related expenditure pressures, elevated global interest rates, rising food and energy prices, debt sustainability challenges, and urgency to support the energy transition and climate adaptation. COVID-19 also massively set back efforts to close gender gaps.

**Pacific governments have limited fiscal space and fiscal deficits are set to remain elevated well after direct COVID 19 pandemic impacts subside.** This is contributing to the Pacific's substantial deficit in critical infrastructure. Managing these fiscal gaps will require significant external finance and concurrent technical support for fiscal reform and public financial management, which will be challenging for countries that are highly indebted but also constrained in their technical capacity.

**The risk of debt distress in the Pacific threatens economic growth and the macroeconomic stability of the region.** Seven countries in the Pacific are assessed at a high risk of debt distress by the World Bank and the International Monetary Fund (IMF) and consultations suggest that further downgrades in the Pacific are a possibility.<sup>2</sup>

**The Review confirms the Pacific has an urgent need for affordable, high-quality, well maintained, and climate-resilient infrastructure.** Fiscal fragility and debt sustainability challenges mean grant aid and highly concessional sovereign finance have been, and will continue to be, an important form of development finance.

**In Southeast Asia, development finance gaps for infrastructure are most pronounced at the project development stage.** While there is an established track record of private sector investment in infrastructure, there remain significant blockages caused by policy and regulatory architecture for project approvals, governance issues, and a lack of project preparation and development, which affect the scale and quality of investment-ready projects.

<sup>1</sup> The Review defines 'development finance' as finance that both generates a development outcome and a financial return.

<sup>2</sup> Kiribati, the Republic of Marshall Islands (RMI), the Federated States of Micronesia (FSM), Papua New Guinea (PNG), Samoa, Tonga and Tuvalu are currently rated at a high risk of debt distress.

**The Review finds Southeast Asia's ability to transition to clean energy and the value chains that will support it are limited by financing constraints for small and medium-sized enterprises (SMEs).**

The SME sector is economically significant, accounting for about a 40–60 per cent share of economic growth and around 80 per cent of total employment. SME financing gaps also disproportionately impact women-led businesses and remain a long standing binding constraint on broader economic growth, job creation and innovation.

## Strengthening Australia's development finance mechanisms

**Australia has rapidly increased the use of development finance in the last five years, focusing on loans and grants, across a range of financing mechanisms.** Australia's development finance portfolio currently consists of investment commitments worth around AUD7.3 billion.<sup>3</sup> Consultations suggest that individually these mechanisms are performing well against their objectives. The growing prominence of the development finance portfolio gives it momentum to increasingly sit alongside the traditional grant-based development program.

**The Review finds that further expansion of development finance would enhance capability and support new and modern partnerships to engage meaningfully with development partner needs.** This is notably the case in more advanced economies in the region, where the private sector is looking to take on a greater share of investment in infrastructure and businesses that will support sustainable development outcomes. Continued expansion of these existing mechanisms would build on successful approaches and avoid significant establishment costs of new mechanisms.

**Multilateral development banks (MDBs) offer Australia the opportunity to pool and diversify risk globally to support the development objectives of individual countries.** The MDBs and International Monetary Fund are an important source of development finance for the Pacific and Southeast Asia. Their financing model for low-income countries and small island economies

provides a highly effective means to scale donor funds and leverage multilateral balance sheets. As global standard-bearers of the rules-based order, international financial institutions support stability in the region, as well as trade, climate change adaptation, human development, and other global challenges.

**The Review recommends Australia continue to expand its use of development finance through existing mechanisms to respond to key development challenges in Southeast Asia and the Pacific.** This approach would enable learning by doing, maximise complementarity with traditional grant aid (such as on technical assistance), and support approaches that consider both debt sustainability concerns of development partners and impacts on the Commonwealth's balance sheet. Continued expansion of development finance would also enable stress testing of existing financing architecture to enable holistic consideration of any major structural reforms, such as establishing an Australian development finance institution (DFI).

**Australia's support for affordable climate-resilient infrastructure in the Pacific will continue to be a priority.** Maintaining the ability for the Australian Infrastructure Financing Facility for the Pacific (AIFFP) to offer concessional infrastructure financing in the Pacific will be key to meeting the region's infrastructure needs. The Review finds that AIFFP is well-placed to support Pacific countries to access affordable, high quality, and climate-resilient infrastructure, including by drawing in additional financing from like-minded partners. However, the recent increase in Australia's cost of capital for lending means that AIFFP providing highly concessional sovereign loans involves a cost to the Budget.

**The Review recommends that Australia continue to build capability to deploy concessional development finance for climate-resilient infrastructure in the Pacific.** This should be accompanied by appropriate consideration of the expected achievement of foreign policy objectives, including trade-offs from using grants that would otherwise support broader Pacific development, and the impact on the Commonwealth's balance sheet.

<sup>3</sup> Investment commitments consist of budget support loans (AUD3.45 billion); the Australian Infrastructure Financing Facility for the Pacific (AIFFP) portfolio (AUD1.2 billion); blended finance through the Australian Climate Finance Program (ACFP), Emerging Markets Impact Investment Fund (EMIIIF), Investing in Women, and Private Infrastructure Development Group (PIDG) vehicles (AUD170 million); and support for the Telstra acquisition of Digicel (AUD2.5 billion package of loans and insurance).



**The Review finds that Australia's financing in Southeast Asia will always be modest compared to others and relative to the size of many of the region's economies, but it could be significantly more influential through strategic selectivity and greater mobilisation of external capital.** Expanded use of blended finance presents an important opportunity for Australia to help meet the region's development finance needs. Blended finance can play a critical role in addressing the high perceived or real risk of projects in developing countries and in turn encourage greater private investment. DFAT's Emerging Markets Impact Investment Fund (EMIIF) uses blended finance to address financing gaps faced by SMEs. EMIIF is scalable and demonstrates a strong ability to mobilise private sector financing, including from impact investors and philanthropic organisations.

**In Southeast Asia, the Review recommends that Australia should expand its use of development finance.** To support this, Australia should scale up existing blended and climate finance mechanisms. EMIIF's investment cap should be lifted to AUD250 million at the earliest opportunity and EMIIF should be renamed to strengthen its brand and reflect its increased scale.

**Australia has rapidly scaled-up its development finance in response to emerging foreign policy objectives and fiscal challenges in the Indo-Pacific, but without a commensurate strengthening in portfolio management and reporting across its financing mechanisms.** While individual financing mechanisms have their own robust governance approaches, there is opportunity to improve visibility and consideration of outcomes and risks across the portfolio of development finance mechanisms, including cumulative risks on the Commonwealth's balance sheet. Consultations suggest that Australia is yet to report publicly on its nascent development finance portfolio and impact in accordance with our transparency commitments and in line with international comparators.

**The Review recommends establishing an 'International Development Finance Advisory Committee' (the Committee) to provide advice to the Government on its portfolio of development finance investments.** Advice would focus on portfolio financial performance, opportunities, and risk and the portfolio's contribution to foreign, trade, investment, and

development policy objectives. The Committee would not make investment level decisions, which will remain with existing financing mechanisms. The Committee should consist of whole-of-government representatives. Further consultation should be undertaken on the form, mandate, and composition of the Committee.

**The Review also recommends periodic public reporting on Australia's development finance, including on development impact.**

## Opportunities to raise development impact

**The Review recommends requiring that new development finance investments have a gender equality objective and introducing a gender equality performance target for these investments, similar to DFAT's approach under the ODA grant program.** Australia's strong focus on gender equality and successful gender lens investing (GLI) track record through mechanisms such as EMIIF and the Investing in Women program provides a solid platform to embed GLI more broadly in our development finance approach. The Review also recommends supporting global approaches for gender lens investing at scale by joining 2X Global and consideration of options to incorporate a stronger focus on disability, social inclusion, and First Nations peoples, building on experience from the ODA program.

**Significant opportunity also exists to draw in finance from philanthropic foundations, charitable trusts, and impact investors to support development in the Indo-Pacific.** Globally, the philanthropic and impact investment sectors are large, with assets amounting to around USD1.5 trillion and USD1.2 trillion, respectively. Leveraging this global pool to support Australia's region, even if only to a small extent, could have a significant impact on human development. However, consultations suggest that our engagement with philanthropic and impact investors has been ad hoc and lacked strategic clarity. **The Review recommends establishing a dedicated unit within DFAT to support enhanced engagement and collaboration with philanthropic organisations and impact investors where their objectives align with Australia's interests.**

## The proposed way forward

**Australia has long considered whether it should create an Australian owned DFI.** The more pertinent issue is whether Australia is building the right functional capability to address the development challenges in our region rather than the institutional form or structure that houses that capability. The Review argues that our focus should be to continue to evolve and expand existing financing mechanisms that are performing well without incurring the establishment costs, risks, and delays involved with establishing a new DFI. Nonetheless, there may be benefits to establishing an Australian DFI in the future as the scale and sophistication of Australia's development finance increases. The reforms proposed by this Review provide a pathway for Australia to build on existing foundations. Through close monitoring of portfolio performance, the relative merits of creating a DFI should continue to be considered over the medium term.

**There is a clear opportunity for Australia to continue to position itself as a leader in the region to help tackle the growing challenge of climate change, including energy transition.**

Australia's reputation is one of being a practical and responsive development partner. As countries embark on their own net-zero transitions and continue to adapt to the impacts of climate change, they will need increasing support with their strategy and programs to develop investments that meet their specific needs. Australia should remain focused on helping partner countries build their own capability to plan and prepare projects and investments in ways that attract greater financing to meet their development needs. This is not necessarily something that a DFI is needed for, but it would require the continued build-up of expertise to help bring our traditional grant programs and new approaches to development finance into greater alignment.

**The Review recommends that DFAT periodically assess and report to the new International Development Finance Advisory Committee on the performance and gaps in Australia's development finance approach.**





Credit: New Forests

## CHAPTER 1

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# Introduction

**At the Government's request, DFAT has led a review into new forms of development finance (the Review) to support Australia's foreign policy, trade, security, and development objectives.** The Review stems from a commitment announced by the Hon Pat Conroy MP, Minister for International Development and the Pacific, on 9 May 2022. The Review commenced in August 2022 following the Government's approval of the Terms of Reference (see Annex 1).

**The Review defines 'new forms of development finance', hereby referred to as 'development finance', as finance that both generates a development outcome and a financial return.**

This definition also extends to finance that mobilises other sources of development finance. Examples of financial returns include interest payments, dividends, capital gains, guarantee fees, and insurance premiums. Development finance encompasses financing that is eligible to be reported as Official Development Assistance (ODA) under the Organisation for Economic Cooperation and Development (OECD) Development Assistance Committee (DAC) guidelines and financing that is not ODA eligible. 'Financing for development' is a broader concept that includes domestic revenue collected by partner governments, foreign direct investment (FDI), as well as conventional grant-based ODA.

**The Review into Australia's development finance comes at an important time.** Challenging economic circumstances underscore the need for Australia's Pacific and Southeast Asian partners to have trusted and sound support to meet their development needs. Access to sustainable and impactful development finance is a critical ingredient for stability and success, now and in the future. Australia already makes an important contribution but has the capacity to do more. As a trusted partner, Australia is well-positioned to deploy development finance directly and mobilise it from a wide range of public and private sources.

**The Review is forward looking.** The Review compiled Australia's current suite of development finance mechanisms and examined their capability against the ambitions and priorities of the Government. The Review has drawn conclusions about the existing capability to deliver against current and future policy and the 'toolkit' that Australia will need to respond to emerging development, climate, and foreign policy challenges.

**With over 100 individual meetings, consultation has been central to the Review.** The Review team consulted a wide range of stakeholders, including partner governments across the region, multilateral development banks (MDBs), bilateral donors, non-governmental organisations (NGOs), private sector representatives, and philanthropic and civil society organisations. Views were collected through targeted interviews, invited submissions and in-person consultations. Partner government views were sought through DFAT's diplomatic network. The list of stakeholder consultations, both within and outside of the Australian Government, is at Annex 3. The Review was guided by a Review Advisory Panel (RAP) comprised of senior officials from across Government.

**The Review provides opportunity to continue to build modern partnerships in the region.**

Australia has increasingly played a convening role, drawing in development financing to the region from the private sector, like-minded countries, MDBs, and philanthropies to support development impact at a scale that Australia could not achieve on its own. This approach plays to Australia's strengths, drawing on our strong presence, trusted relationships, and ODA program to the region. A flexible and targeted approach to Australia's future development finance will be critical to build new, and enhance existing, partnerships in support of the region.

**The Review sets out several recommendations for consideration by Government.** It comes at the same time as the release of the Government's new International Development Policy, which outlines the use of ODA and non-ODA to advance a peaceful, stable, and prosperous Indo-Pacific, alongside Australia's diplomatic, economic, defence, and security engagement. Several other government initiatives are concurrent, including initiatives focused on Australia's climate ambition, that aim to position Australia to better prioritise and implement a robust development finance agenda with our partners.

**The Review consists of this Report and four Briefing Papers.** The Briefing Papers provide deeper analysis to supplement the Report with a focus on sovereign development finance (Briefing Paper 1), blended finance (Briefing Paper 2), bilateral development finance institutions (Briefing Paper 3) and philanthropic and impact investors (Briefing Paper 4).





Credit: Sarah Friend

## CHAPTER 2

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# Development financing needs and opportunities

## 2.1 Growing needs in a challenging macroeconomic environment

**The peace, prosperity and security of Indo-Pacific countries is vital to Australia's interests.** The ability of these partner countries to reliably access sufficient development and climate finance is critical. Australia's future is deeply intertwined with the region. Our partners need the means to address pressing economic challenges and bolster their social stability and security.

**The region's large development finance needs are growing.** The COVID-19 pandemic set many economies back, leaving higher debts, high costs of living, and years of lost education. The pandemic ended three decades of consistent poverty reduction, which has been further hampered by fuel and food price shocks. Climate change is also adding new layers of economic, social, and environmental risk.

**The COVID-19 pandemic also widened gender gaps.** According to estimates by the World Economic Forum, women already faced an expected 99-year wait before reaching equality with men. The impact of COVID-19 has increased the wait to 132 years (World Economic Forum 2022).

**The estimated financing gap to meet the Sustainable Development Goals (SDGs) has greatly increased.** The estimated gap for all developing countries to meet the United Nations (UN) SDGs by 2030 was USD2.5 trillion per year before the pandemic. This estimate is now at USD3.9 trillion per year (OECD 2023). Moreover, the nature and magnitude of development challenges are evolving.<sup>4</sup>

**Macroeconomic headwinds are weakening government balance sheets, increasing the risk of debt distress in developing countries.** Central banks are raising interest rates in response to persistent and broadening inflationary pressures. Beyond increasing the cost of debt repayments, higher global interest rates increase the risk of capital flight from developing countries. Capital flight has adverse impacts on the foreign exchange rates of developing countries and increases the cost of debt repayments beyond just that of rising interest rates.

**The climate crisis is accelerating. Climate**

**finance is central to enabling economies to reach net-zero and to support adaptation and build resilience, including through investing in nature-based capital.** While technology is improving and unit costs are falling, the climate crisis is worsening and vulnerability increasing, particularly for our Pacific family.

**Climate financing needs are enormous.** Each year, emerging market and developing economies (other than China) require USD1 trillion in climate finance to keep global warming under 1.5°C and meet the goals of the Paris Agreement. This figure rises to around USD2.4 trillion by 2030 (Songwe et al 2022).

**Many countries face compound crises.** Countries with high risk of natural disasters are often also heavily burdened by debt. Debt accumulates over time as countries borrow to recover from or prepare for natural disasters. This cycle is worsened where disasters are more frequent and have a higher impact. Small island states in the Pacific are isolated from international markets and must import their food and energy, making them highly vulnerable to food and fuel price inflation.

### Key finding 1

Development needs in the Indo-Pacific region are large and growing, exacerbated by COVID-19-related expenditure pressures, debt sustainability challenges, and urgency to support the energy transition and climate adaptation.

## 2.2 Development financing approaches

**Meeting development financing needs requires a combination of types of financing that vary as countries grow and development challenges evolve.** ODA grants will always be a key source of financing, not just for the world's poorest countries but also many low- and middle-income countries that are unable to take on higher debt burdens. However, global ODA, sitting at USD186 billion in 2021, remains well below the trillions in financing needed (OECD 2023).

**Development finance can be deployed at a much larger scale than grants alone and can be self sustaining.** Finance is delivered using

<sup>4</sup> For example, in 2017 the Asian Development Bank (ADB) estimated that developing countries in Southeast Asia and the Pacific need an annual infrastructure investment of USD187 billion from 2016–30 to achieve the SDGs by 2030. Climate change is imposing significant risks and costs, adding an additional USD26 billion per year to this estimate.



instruments such as loans, equity, insurance, and guarantees. Development financiers, including MDBs, DFIs, and bilateral financiers, such as Australia, often use their balance sheet and credit rating to borrow from private capital markets to fund their development financing. In this way, development finance can be expanded until borrowing from private capital markets becomes too expensive.<sup>5</sup> Investment returns from development finance can also be reinvested, increasing the pool of development financing available over time. Expanding Australia's use of development finance must be considered in the context of the potential risk and impact on the Commonwealth's balance sheet.

**Development finance helps match the needs of financiers and recipients.** For example, large infrastructure projects are often too costly to be financed by grants alone. Development finance uses a suite of financing instruments to manage exposure to levels of financial risk and return. This can help attract a broader range of investors with differing risk appetites. Additionally, tailoring the mix of development financing instruments deployed can help minimise any further debt that countries take on to meet their development needs.

**Mobilising private sector capital is critical to meeting broad development financing needs.** Estimates suggest that blended finance could facilitate around 50 per cent of the funding required to meet the SDGs (Convergence 2022). Blended finance is a form of development finance from public or philanthropic sources that leverages additional private sector investment for development outcomes. It can include grants, loans, equity positions, and guarantees, including first loss provisions.<sup>6</sup> Blended finance seeks to address market gaps that increase risk and constrain private investment. These include the lack of collateral and/or lack of demonstrated history of investment returns, large minimum investment size, and high information asymmetry or transaction costs (see Briefing Paper 2).

**For Australia, development finance offers solutions to some challenges that cannot be solved through grants alone.** Expanding Australia's development finance through existing mechanisms leverages already successful approaches and avoids significant establishment costs of new mechanisms. This can include working closely with other sovereign DFIs, such as the US Development Finance Corporation, leveraging their capability and finance into the region. However, it brings additional costs and coordination challenges. Therefore, a stepped approach with clear performance benchmarks has merit. Unlike most other major donors, Australia has not established a DFI to deploy its development finance (see Briefing Paper 3).

### Key finding 2

Development finance expands the tools available to tailor Australia's responses and engage meaningfully with development partner needs beyond what the ODA grant program could achieve. However, it also adds financial risk to the Commonwealth by leveraging its balance sheet. Development finance institutions have become widespread among like-minded donors.

## 2.3 Addressing needs in the Pacific

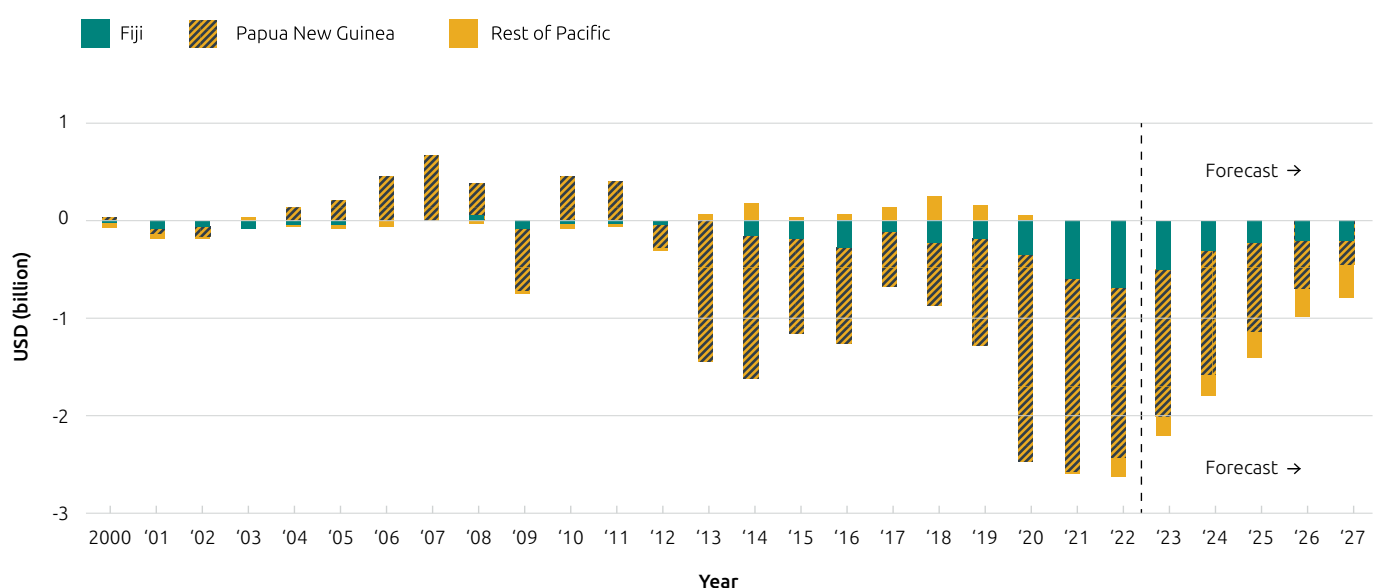
**The Pacific's development finance needs are shaped by economic, fiscal, and political fragility, high levels of indebtedness, and vulnerability to natural disasters.** Pacific Island countries' small sizes, remoteness, narrow resource base, limited climate-resilient infrastructure, and exposure to climate risks are major constraints to private sector development. As a result, governments play a disproportionately large role in economic development.

**Governments have limited fiscal space in the Pacific.** The International Monetary Fund (IMF) expects fiscal deficits to remain elevated well after direct COVID-19 pandemic impacts subside (see Figure 1). Managing these gaps will require significant external finance, which will become increasingly expensive as countries have limited capacity to increase tax revenue. For example, the IMF (2021) estimates that Pacific Island countries face an annual climate finance gap of almost USD1 billion.

<sup>5</sup> Higher credit ratings permit borrowing at lower interest rates. A limit on expanding development finance can be attributed to risk premiums demanded by the market that increase with the extent to which balance sheets are leveraged and an increased likelihood that credit downgrades will occur.

<sup>6</sup> A first loss provision by an investor implies that if the investment financially underperforms relative to some pre-specified benchmark, then that investor will incur losses before other investors. Use of first loss provisions supports de-risking the participation of other investors, thereby helping to mobilise additional investment.

**Figure 1: Fiscal balances in the Pacific**



Note: Negative values indicate fiscal deficits

Source: IMF (2022)

**Debt distress in the Pacific is a risk.** The World Bank and IMF have assessed seven countries in the Pacific as being at high risk of debt distress, and consultations suggest that further downgrades in the Pacific are a possibility.<sup>7</sup> Separately, the IMF has assessed that Fiji's debt is sustainable, albeit subject to high risks. Highly indebted countries often face a vicious cycle of high debt repayments and limited ability for further borrowing. This pushes countries towards additional and increasingly costly debt finance to meet fiscal deficits, creating a downward spiral that can take years or even decades to resolve. Debt distress stagnates economic growth and has wider implications for regional macroeconomic instability.

**Pacific-focused economic reform programs that increase fiscal space and reduce reliance on debt financing can strengthen resilience to shocks and climate risks.** Access to concessional finance, particularly highly concessional finance available from international financial institutions (IFIs), will also play a role to increase fiscal space and support reform efforts.

**Limited government fiscal space is contributing to the substantial deficit in critical infrastructure.** This impacts access to services such as water, electricity, effective supply chains

and transport infrastructure as highlighted by Review consultations with partner countries. The ADB (2017) estimates that Pacific countries require an additional USD2 billion in annual investment to meet their infrastructure needs.

**Australia is demonstrating responsible infrastructure financing through the Australian Infrastructure Financing Facility for the Pacific (AIFFP)** (see Briefing Paper 1). AIFFP's lending policy is aligned with the World Bank to ensure the lowest income and most vulnerable countries will be provided with only grant finance for infrastructure.<sup>8</sup> Elsewhere, grant financing is used by AIFFP to lower loan costs, helping to ease debt burdens, improve fiscal space, and remain competitive with other development financiers in the region.

**For Australia, sovereign finance, which encompasses lending to governments rather than private entities, will likely remain the primary way to meet the Pacific's development finance needs.** The Pacific's size, limited private sector, and remoteness will remain key constraints to mobilising private finance for development. This is particularly the case for supporting climate-resilient infrastructure. Sovereign financing is needed for construction and potentially for operation and maintenance (Pacific

<sup>7</sup> Countries with high-risk ratings in the Pacific are Papua New Guinea (PNG), Samoa, Tonga, Kiribati, Tuvalu, the Republic of Marshall Islands and the Federated States of Micronesia.

<sup>8</sup> This applies to International Development Association (IDA) member countries. IDA Blend Countries, such as PNG, can receive debt financing under AIFFP and World Bank lending policies.



Region Infrastructure Facility 2013). Nonetheless, opportunities for supporting private sector engagement in the Pacific have the potential to grow over time, including through new locally based partnerships that take advantage of market developments such as the emerging market for carbon credits (see Box 3 in Briefing Paper 2).

### Key finding 3

The Pacific has an urgent need for affordable, high quality, and climate-resilient infrastructure, together with effective and appropriately funded operations and maintenance.

### Key finding 4

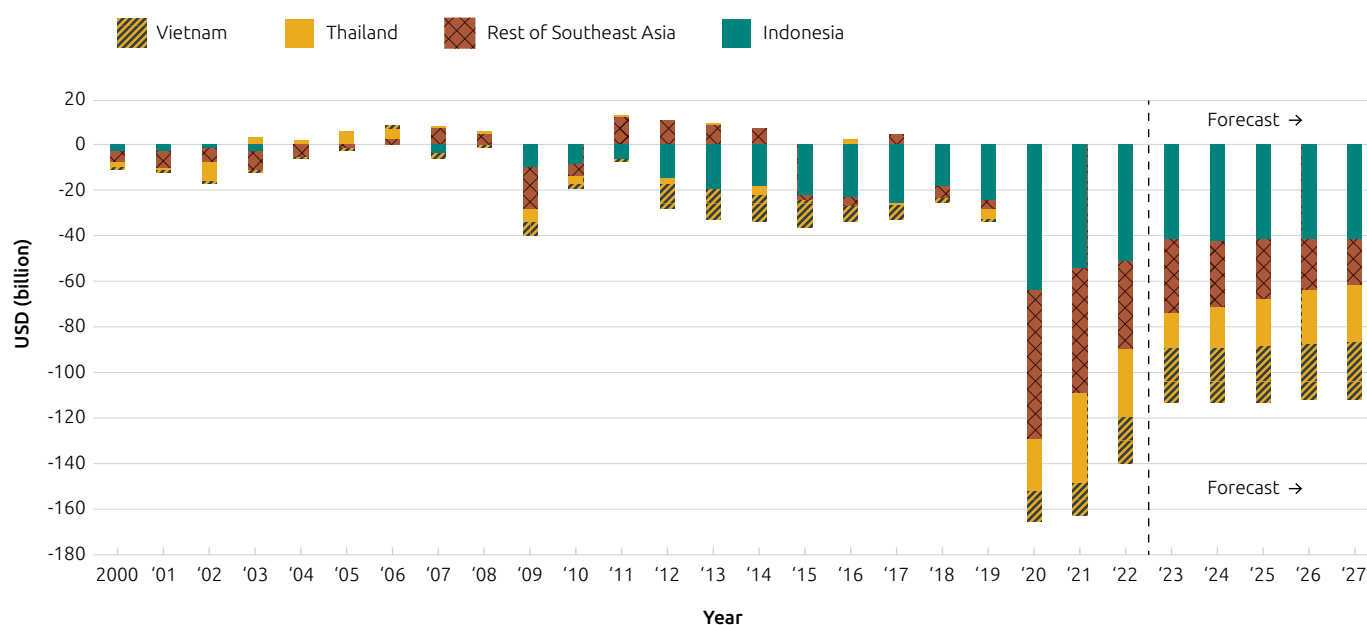
Fiscal fragility and debt sustainability challenges mean grant aid and highly concessional sovereign finance will continue to be an important form of development finance for the Pacific.

## 2.4 Addressing needs in Southeast Asia

**Southeast Asia's development finance needs are driven by market gaps affecting infrastructure supply and the small and medium enterprises (SME) sector, particularly in support of the clean energy transition and gender equality.<sup>9</sup>** Domestic public resources are limited, particularly given fiscal balances are unlikely to return to pre-pandemic levels in the next five years (Figure 2). According to the ADB (2017), Southeast Asian countries require USD157 billion annually to finance the infrastructure needed to meet the SDGs, resulting in a financing gap of USD102 billion per year.

**Australia currently offers important, albeit small in a relative sense, amounts of development finance to Southeast Asia.** Australia provided a budget support loan to Indonesia during the onset of COVID-19 (AUD1.5 billion) and has some experience in deploying blended finance via the Emerging Markets Impact Investment Fund (EMIIF) (AUD40 million), Private Infrastructure Development Group (PIDG) (AUD54 million), and Australian Climate Finance Partnership (ACFP) (AUD140 million). Since 2019, Export Finance Australia (EFA) has used its new power to support infrastructure investments in Southeast Asia and the Pacific, under a broad 'Australian benefit' test.

**Figure 2: Fiscal balances in Southeast Asia**



Note: Negative values indicate fiscal deficits

Source: IMF (2022)

9 The World Bank's International Finance Corporation defines SMEs as enterprises meeting two of the following three criteria: (1) having a number of employees between 10 and 300; (2) total assets between USD100,000 and USD15 million; and (3) total annual sales between USD100,000 and USD15 million (IFC, 2023).

**Japan, China and the MDBs provide finance to Southeast Asia at a much larger scale than Australia.** While Australian contributions make up a share of the World Bank and ADB financing, this is subject to multilateral governance and branding. In this context, careful targeting of Australia's bilateral development finance is required to maximise development impact, raise standards and terms across the board, and provide real additionality, such as that provided by blended finance approaches.<sup>10</sup>

**Early-stage project development financing is the first of two key market gaps identified by Review consultations with DFIs and other partners.** At later and less risky stages of the project lifecycle, the finance from DFIs and private sources is more readily available. DFI infrastructure investments in Southeast Asia are mostly constrained by a lack of 'bankable' projects that offer commercially acceptable returns and risks. However, while project development financing can offer relatively high expected returns, risks, including sovereign and regulatory risks, can often exceed DFI and private sector investor tolerances. Technical assistance and blended finance can play an important de-risking role to attract sufficient finance to support projects to progress from the development to commercial financing phase. This form of co-investment could be tailored to the needs of like-minded partners to support infrastructure financing at scale.

**Limited access to financing by SMEs is the second key market gap identified, particularly for women-led SMEs and SMEs focused on clean energy transitions.** The SME sector provides the backbone for value chains and is a key driver of economic growth, job creation and innovation activity in Southeast Asia, accounting for about a 40–60 per cent share of growth (SMEWG 2022) and around 80 per cent of total employment (Marsan and Sabrina 2020). Consultations highlighted the constraints imposed by limited access to SME finance. These market gaps are likely to disproportionately impact women-led SMEs and limit SME innovation. For example, there is a lack of support for the development of value chains needed for the clean energy transition. Blended finance approaches to facilitate private sector investment can play an important role in de-risking finance for SMEs.

#### Key finding 5

Development finance gaps for infrastructure in Southeast Asia are most pronounced at the project development stage. At later stages of the project lifecycle, the supply of finance from DFIs and private sources is more readily available.

#### Key finding 6

Gaps in market access for finance limit growth in the SME sector in Southeast Asia. This constrains the sector's contribution to the clean energy transition, women's economic empowerment, job creation, and innovation.

<sup>10</sup> Financial additionality refers to situations where finance is mobilised (such as from the private sector), and an investment is made that would not have materialised otherwise. Development additionality refers to development impacts that arise because of investment that otherwise would not have occurred (OECD, 2021).





Credit: Jesse Alpert/Belau Submarine Cable Company

## CHAPTER 3

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# Australia's approach to development financing

The Review has examined whether Australia's current financing mechanisms and capabilities adequately support economic development in the region, reinforce Australia's relationships with partner countries to support regional stability and prosperity, and manage risks to the Commonwealth.

The Review concludes that Australia's existing mechanisms and financing tools are likely to be sufficient to respond to most strategic objectives and foreseeable needs in the short term. However, rapid evolution over the last five years, the anticipated magnitude of challenges facing the region and Australia's standing within it, and potentially a higher level of Australian Government ambition for the role of development and climate finance, mean changes will be needed to ensure Australia's development finance tools remain fit for purpose.

### 3.1 Strategic objectives

Australia's development finance will need to align with evolving strategic objectives. The Australian Government has set an ambitious foreign policy and development agenda. The Review assesses that within the next five years, Australia's development finance will need to:

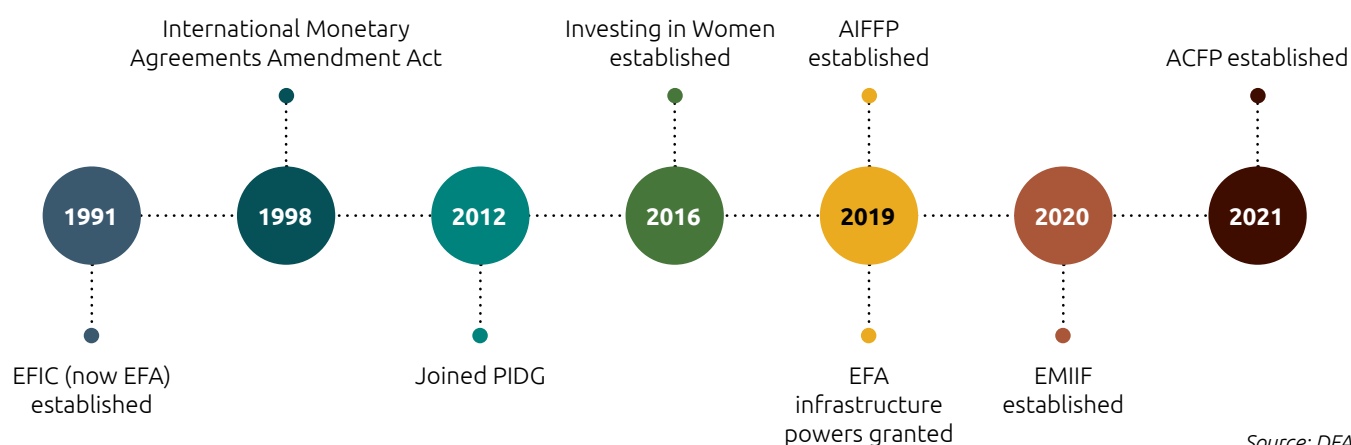
- **continue to strengthen Australia's position as partner of choice in the Pacific**, in part by ensuring financing of productive, quality assets, built and maintained with local content and labour, and offering Pacific partners a meaningful alternative to competitors without leading to unsustainable debt burdens

- **establish Australia as a reliable financing partner in Southeast Asia** with a targeted approach focused on where it can make a difference, including by drawing in co-investment with like-minded partners to offer finance at scale
- **establish Australia as a key climate change financier**, supporting the clean energy transition and climate resilience within our region and building on Australia's expertise and domestic comparative advantage in green technology
- **sustain Australia's global leadership in promoting women's economic empowerment** through its investments
- **embed a First Nations peoples focus** into investments
- **strengthen economic resilience and sustainability in the region**, particularly in the Pacific.

### 3.2 Australia's development finance mechanisms

Australia has expanded development financing over the last 30 years through several mechanisms, each with its own distinct objectives and range of financing approaches (see Figure 3). The development finance portfolio currently consists of a stock of investment commitments totalling around AUD7.3 billion.<sup>11</sup> This includes the use of the *International Monetary Agreements Act 1947* (Cth) (IMA Act) to support sovereign budget support loans and financing on

**Figure 3: Timeline of Australian development finance**



Source: DFAT

<sup>11</sup> Investment commitments consist of budget support loans (AUD3.45 billion); the AIFFP portfolio (AUD1.2 billion); blended finance through ACFP, EMIIF, Investing in Women, PIDG (AUD170 million); and EFA support for the Telstra acquisition of Digicel (AUD2.5 billion).



the Government's National Interest Account (NIA) (see Briefing Paper 1).<sup>12</sup>

**Expansion over the last five years has been particularly rapid.** Australia has:

1. established AIFFP, which combines ODA grant funding and loans for infrastructure projects. By end-2022, AIFFP had finalised financing agreements for 12 projects worth approximately AUD1.2 billion (including AUD890 million in lending) in nine countries. Most of this is concessional sovereign financing to Pacific governments, although AIFFP has also provided financing on market terms to private sector investors. EFA is the lender of record for AIFFP loans
2. renewed its use of the *IMA Act* to deliver AUD3.45 billion in budget support loans to help Indonesia (AUD1.5 billion) and Papua New Guinea (PNG) (AUD1.95 billion) deal with the fiscal impacts of the COVID-19 economic shock
3. established EMIIF (AUD40 million), which invests in early-stage SMEs through funds, such as venture capital funds. EMIIF redeploys its investment returns
4. partnered with the ADB to establish ACFP, committing AUD140 million of grant funding to support the rapidly expanding market for climate finance and help address the impacts of climate change
5. amended the *Export Finance and Insurance Corporation Act 1991* (EFIC Act) to enable EFA to invest in infrastructure under a broad 'Australian benefit' test providing Australia with direct infrastructure financing capability in Southeast Asia.

**Australia's financing approach has heavily favoured loans, particularly to sovereign governments for budget support and infrastructure in the Pacific.** Use of other financing instruments, such as equity, guarantees,

insurance and subordinated instruments, has been small scale, except for EFA's financing to support Telstra's acquisition of Digicel in PNG on the NIA (around AUD2 billion of loans and AUD429 million of insurance). Australia has AUD269.8 million in committed financing to non sovereign entities, excluding EFA's financing for Telstra's acquisition of Digicel Pacific.<sup>13</sup>

**Australia also indirectly provides development finance to the region through its contributions to IFIs, including the World Bank, ADB and IMF.** Development finance invested through core contributions to multilateral organisations allows for greater scale and efficiency of financing but is less able to be directed to visibly support Australia's national interest compared with bilateral engagement. Contributions to the World Bank have fallen over the last decade and have remained static in the case of the ADB.<sup>14</sup> There is a risk that declining contributions over time will diminish Australia's influence, which helps maintain currently high relative allocations by the World Bank to the Pacific. In 2022, Australia committed 39 per cent of its Special Drawing Rights (valued at around AUD4.6 billion) to support the IMF's Poverty Reduction and Growth Trust and Resilience and Sustainability Trust to provide highly concessional loans to low- and middle-income countries (see Briefing Paper 1).

**Individually Australia's development finance mechanisms are performing well against their objectives.** This view is consistent with independent reviews of AIFFP, EFA, Investing in Women, and of the blended finance portfolio through the Blended Finance Learning Program.<sup>15</sup> Consultation further confirmed the overall positive performance of the existing development finance portfolio. The development impact achieved through the development finance portfolio is nascent given its relatively recent scale-up.

<sup>12</sup> The National Interest Account is an account for undertaking transactions under ministerial direction where such transactions are deemed to be in the national interest. The Commonwealth receives all income on National Interest Account transactions. It also bears all risks and losses.

<sup>13</sup> This figure encompasses DFAT's AUD170 million in blended finance investments, and two executed non-sovereign transactions from the AIFFP portfolio: an Airports Fiji transaction (AUD68.4 million) and a Palau solar plant investment (AUD 31.4 million).

<sup>14</sup> Australia's contribution to the World Bank was AUD723.6 million (12<sup>th</sup> largest donor) for IDA16 (July 2011–June 2014) and was AUD488.0 million (18<sup>th</sup> largest donor) in IDA20 (July 2022 – June 2025). Australia's contribution to the ADB of AUD423 million in 2020 for the twelfth replenishment of the Asian Development Fund (ADF13), the ADB's concessional assistance arm, and the Technical Assistance Special Fund. This maintained Australia's position as the second largest contributor (behind Japan).

<sup>15</sup> The AIFFP Two-Year System-Wide review assessed the establishment phase of AIFFP (mid-2019 to end 2021) and considered whether AIFFP is well-positioned to achieve its long-term objectives. The EFA review refers to a review of the amendments to the EFIC Act in 2019 that expanded EFA's mandate to carry out infrastructure financing. Neither of these reviews considered portfolio performance given the nascent nature of AIFFP and the infrastructure powers at the time each review was conducted.

**Australia's development finance is increasing in prominence, giving it momentum to eventually sit alongside the traditional grant-based development program in terms of importance.**

Further expansion of Australia's development finance will need to consider approaches that support effective and efficient responses to meet critical partner needs in the region.

The Review finds that further expansion of development finance would enhance capability and support new and modern partnerships to engage meaningfully with development partner needs. Continued expansion through existing mechanisms would leverage already successful approaches and avoid significant establishment costs of new mechanisms. This approach would enable learning by doing, including maximising complementarity with traditional grant aid, and support approaches that consider debt sustainability concerns of development partners and impacts on the Commonwealth's balance sheet. Continued expansion of development finance would also enable stress-testing of existing financing architecture prior to considering the need for major structural reforms, such as establishing an Australian DFI. Expansion of development finance to support partners to respond to climate change impacts would also add to existing development efforts to avert, minimise, and address loss and damage.

**Recommendation 1**

Expand use of development finance through existing mechanisms to respond to key development challenges in Southeast Asia and the Pacific. This should be done without placing unsustainable debt burdens on our development partners or excessive risk on the Commonwealth's balance sheet.

### 3.3. Approach in the Pacific

**Australia's response to the Pacific's development financing needs has been to focus on climate resilient infrastructure and budget support.** This has played a critical role in sustaining Australia's position as a partner of choice

and meeting priority needs for infrastructure development, particularly in PNG. However, there is a serious threat to the viability of debt financing for infrastructure in the Pacific due to rising interest rates and ongoing fiscal and debt challenges in many countries.

**The recent considerable increase in Australia's cost of capital for lending means that AIFFP providing highly concessional sovereign loans will involve a cost to the budget.**<sup>16</sup>

Prior to 2022, Australia's ability to access a low cost of capital was an important enabler, making Australia's infrastructure and budget support loans competitive, affordable, and manageable, particularly for countries taking on sovereign debt. Rising debt in the Pacific and the increased cost of capital could blunt AIFFP's ability to achieve its objectives.

**Maintaining the ability for AIFFP to offer concessional financing will be key to Australia's ongoing responsiveness to Pacific Island governments.** This offering could be complemented by:

- taking equity positions in infrastructure, such as through private-public partnerships, to reduce the need for grants and improve affordability for partner countries
- strengthening approaches to support partner countries to better mobilise their own resources to reduce reliance on external financing
- continuing efforts to draw in like-minded and private sector co-investment, including from MDBs and through partner country access to IMF financing
- improved targeting of AIFFP financing to support assets that are critical to regional stability and security.

**However, the benefits of concessional finance will need to be balanced against the risks.**

Concessional finance is most often used for projects that cannot attract commercial finance and are inherently risky. While investments that leverage the Commonwealth's balance sheet may have a limited impact on the underlying cash balance initially, longer-term risks all need consideration.<sup>17</sup> Such investments would have

<sup>16</sup> Australia's 10-year government bond yield increased from below one per cent in 2020 to around four per cent by the end of 2022.

<sup>17</sup> The underlying cash balance is the Government's key fiscal aggregate specified in its medium-term fiscal strategy. It is derived from projections of cash inflows and outflows in the cash flow statement. The underlying cash balance shows whether the Government must borrow from financial markets to cover its activities (for example, if receipts are lower than payments, the cash balance is in deficit, meaning the Government does not have sufficient cash to cover its activities and instead borrows from financial markets).



a direct negative impact to the underlying cash balance if loans were not repaid. In addition, concessional financing options can be more complicated to establish and to monitor over time and these costs, which accrue to the Australian Government and developing nations, need to be considered alongside the benefits.

**Establishing AIFFP with EFA as the lender of record on the NIA has allowed AIFFP to operationalise rapidly and effectively, drawing on EFA's mature systems and expertise.** Over the longer term other operating models that may increase AIFFP's efficiency should be explored.

#### Key finding 7

Australian Government support for climate-resilient infrastructure in the Pacific will continue to be a priority. Recent considerable increases in Australia's cost of capital for lending means that AIFFP providing affordable and competitive loans will come at an increasing cost to the budget.

#### Recommendation 2

Australia should continue to have the capability to deploy concessional development finance for climate-resilient infrastructure in the Pacific. This should be accompanied by appropriate consideration of the expected achievement of foreign policy objectives and the impact on the Commonwealth's budget and balance sheet.

### 3.4 Approach in Southeast Asia

**Australia has been increasing its development finance to Southeast Asia, but Australia's financing will always be modest compared to overall needs.** Beyond Australia's budget support loan to Indonesia (AUD1.5 billion), Australia's development financing in Southeast Asia is currently at a small scale, focused on infrastructure, climate projects, and support for SMEs.

**Australia's financing in Southeast Asia could be more influential through strategic selectivity and greater mobilisation of external capital.** Australia's approach to deploy relatively

small-scale financing in flexible and highly targeted ways has crowded-in private and like-minded financing and enhances Australia's influence over projects that are too big for Australia to fund alone. In addition, technical assistance is playing a key role in supporting countries' efforts to improve infrastructure policy, planning and procurement standards, and reducing key regulatory risks facing investors, including processes for approvals and permits. While this approach plays to Australia's strengths, in part reflecting our presence and strong relationships in the region, opportunities exist to extend Australia's influence and provide more options to the region to meet financing needs.

#### Infrastructure in Southeast Asia

**There is opportunity to further support the region's infrastructure needs.** This could be achieved by expanding and improving capability and coordination in diplomatic posts, infrastructure-focused technical assistance mechanisms, and infrastructure financing mechanisms to support line of sight across the infrastructure lifecycle. Achieving this does not mean Australia must have the capability to deliver support across all stages of the lifecycle. Rather, it means having a strategy and building capability to draw in technical assistance or financing from Australian and international private sources, like-minded partners, and MDBs, particularly at the large-scale commercial financing phase of projects. This approach would support building EFA's pipeline of infrastructure investments in Southeast Asia, where Australia does not have in-country deal origination capability, unlike in the Pacific where AIFFP provides this function.

**Scaling-up Australia's use of blended finance to support project development would help to fill a key gap in the infrastructure market** (see Briefing Paper 2). Australia's contributions to PIDG have allowed it to expand into Southeast Asia, bringing with it the full range of financing instruments to de-risk private and like-minded financing and enable project proposals to be taken forward to commercial financing. Likewise, ACFP is designed to de-risk projects to catalyse private sector financing for climate adaptation and mitigation. Few deals have been approved to date given its recent establishment. Nonetheless, infrastructure needs in Southeast Asia remain unmet due to an undersupply of early-stage project development finance. In contrast, Review consultations suggest a relative abundance of

later-stage or more commercial return-oriented financing from DFIs.

**EFA could deploy blended finance for infrastructure in Southeast Asia.** EFA has demonstrated capability to use its tools to deliver a transaction with blended finance characteristics through large-scale support for Telstra's acquisition of Digicel Pacific. However, new capability within EFA may be needed for it to deploy repeated and smaller scale blended finance transactions for infrastructure in Southeast Asia.

### Support for SMEs in Southeast Asia

**DFAT has developed a modest portfolio of SME-focused blended finance mechanisms aimed at strengthening gender equality and supporting climate mitigation and adaptation** (see Briefing Paper 2). These include EMIIF, the Investing in Women program, and ACFP. These mechanisms are also complemented by partnerships with technical assistance mechanisms supporting engagement with the private sector, such as Convergence and the Private Financing Advisory Network (PFAN).

**Review consultations highlighted that Australia is world leading in gender lens investing, in part reflecting its success through EMIIF, the Investing in Women program, and the Women's Livelihood Bond.** For example, EMIIF has demonstrated an ability to mobilise private sector financing for gender lens investments, with evidence suggesting a private sector finance mobilisation ratio of 1:5, including with impact investors and philanthropic organisations. It is expected that the next phase of the Investing in Women program will use EMIIF, in part reflecting its ability to accept and deploy investment returns, thereby growing the pool of investments over time.

**There is opportunity for Australia to pivot DFAT's SME financing mechanisms more directly towards climate action and increase their scale.** Private sector finance mobilised to support the clean energy transition and women-led SMEs through EMIIF could contribute significantly to Australia's international climate finance commitments. DFAT has conducted market testing on EMIIF's potential to boost climate finance mobilisation in the Indo-Pacific. It shows strong investment demand and a growing pool of high-quality investments suitable for EMIIF's investment approach. However, maximising EMIIF as a development finance tool is constrained by

its small scale. EMIIF's pilot phase was launched in July 2020 with a financing cap of AUD40 million. A recent impact study found that the pilot has performed above expectations and unlike traditional grant-based ODA programs, EMIIF generates returns which can be re-invested (Alinea International 2023). This allows the Australian government to stretch the impact of the ODA budget further by investing the same allocation multiple times. DFAT projections show that with a total capitalisation of AUD250 million, EMIIF would become cashflow positive and potentially self-sustaining by 2030.

**Renaming EMIIF would strengthen brand recognition and ties to Australia.** EMIIF was the name used for the pilot phase. Review consultations indicated this had limited brand awareness. To reflect the recommendation (below) for Government to take this pilot to scale, consideration should be given to renaming EMIIF, such as to Australian Development Investments (ADI).

### Key finding 8

Australian Government blended and climate finance mechanisms operating in Southeast Asia are performing well, although currently at small scale. Project development stage financing for infrastructure and SME financing should continue to be a priority for development reasons.

### Recommendation 3

In Southeast Asia, Australia should expand its use of development finance and strengthen connections with private investors, like-minded agencies and MDBs. To support this, Australia should scale up existing blended and climate finance mechanisms, including lifting EMIIF's investment cap to AUD250 million at the earliest opportunity, with a focus on climate finance and gender impact investment. EMIIF should be renamed to strengthen its brand recognition and support public diplomacy.



### 3.5 Portfolio insights and lessons

**Australia has rapidly scaled-up its development finance in response to emerging foreign policy objectives and fiscal challenges in the Indo-Pacific, but without commensurate strengthening in portfolio management across financing mechanisms.** While individual financing mechanisms have their own robust governance approaches, there is opportunity to improve visibility and consideration of outcomes and risks across the portfolio of development finance mechanisms, including cumulative risks on the Commonwealth's balance sheet.

**Australia's sovereign lending to ODA eligible countries has increasingly utilised the NIA which now constitutes the bulk of Australia's non-ODA development finance.** This places unique and correlated risks on the Commonwealth's balance sheet. Adoption of approaches that strengthen management of such risks would support increased utilisation of the NIA within prudent limits.

**A whole-of-government approach to support portfolio management could strengthen advice to ministers on achieving foreign policy objectives, monitoring financial performance, and managing risks across the development finance portfolio.** This would better manage the risk of cumulative lending across financing mechanisms negatively impacting the debt profiles of borrowing countries. It could also deliver efficiency gains by identifying and reducing duplication of functions across mechanisms, and allocating scarce resources according to need, including staff with financial and other technical expertise. This could also strengthen early and whole-of-government visibility on potential transactions on the NIA that advance Australia's development objectives.

**A new 'International Development Finance Advisory Committee' (the Committee) should be established to support advice to Government on its portfolio of finance that advances Australia's development objectives.** Advice would focus on portfolio financial performance, opportunities, and risk, as well as the portfolio's contribution to foreign, trade, investment, and development policy objectives. The Committee would not make investment level decisions, which will remain with each financing mechanism. The Committee would provide early-stage guidance to support alignment of potential finance that advances

Australia's development objectives with broader foreign policy objectives. The Committee should include whole-of-government representation. An alternative is having its functions incorporated within an expanded AIFFP Board. Further consultation should be undertaken on the form, mandate, and composition of the Committee.

**The Committee could support alignment with broader strategies, targeted engagement with like minded partners, and longer-term reforms.**

The Committee could consider how financing strategies align with geographic engagement strategies at a portfolio level; the relative merits of bilateral versus multilateral engagement; optimal portfolio allocation across financing modalities, instruments and mechanisms; and strategies to sustainably increase the scale of the development finance portfolio. The Committee could support targeted engagement with like-minded partners to enhance visibility of their financing in our region and strengthen the complementarity of Australia's development financing. Finally, the Committee could identify longer-term reforms to governance, financing efficiency, capability gaps, improvements to transparency, and portfolio-wide consideration of climate risks.

#### Key finding 9

While Australia's mechanisms individually appear to be performing well against their own objectives, current decentralised governance arrangements limit visibility of interdependencies between their activities and other mechanisms, increasing portfolio level risk and potentially undermining foreign policy alignment and financial performance.

#### Recommendation 4

Establish an 'International Development Finance Advisory Committee' consisting of whole-of-government representatives to provide advice to Government on its portfolio of development finance investments, including financial performance, opportunities, and risk and portfolio contribution to foreign, trade, investment and development policy objectives.

### 3.6 Transparency and reporting on development impact

#### **Best practice for reporting on development finance and impact suggests that Australia has an opportunity to improve transparency.**

The relatively recent scale-up of Australia's development finance and decentralised approach for its deployment has meant a common framework for reporting on investments and their impact, particularly at a portfolio level, is yet to be developed. A consistent approach to assessment and reporting of expected and actual achievement of development, climate and gender equality, disability and social inclusion (GEDSI) outcomes across financing mechanisms would support more coherent investment decision-making processes. It would also enable more effective accountability across the program and draw on evidence from relevant evaluations. This approach would strengthen whole-of-government understanding of development impacts, financing risks (particularly debt sustainability), and interdependencies between mechanisms. Periodic public reporting could be supported by the Committee and leverage existing but specialised reporting frameworks.

**All DFIs report on their development finance portfolio and development impact, albeit with different approaches and varying levels of transparency.** The DFI Transparency Initiative finds that while DFIs are still insufficiently transparent, progress is being made (James et al 2023). Examples of progress include adoption of harmonised indicators of development impact aligned to the SDGs, increased publication of disaggregated data on mobilisation of private finance, and adoption of disclosure policies on environmental and social risks.

**Submissions to the Review suggest strong demand among stakeholders for Australia to improve transparency of its development finance and reporting of impact.** Public reporting would improve transparency, accountability, and ministerial engagement with external stakeholders. For Australia's financing mechanisms, PIDG appears to be at the forefront of applying best practice on transparency and development impact reporting. PIDG aligns its investments with the SDGs and publishes a detailed project impact database and annual

reports on the contribution of its financing to greenhouse gas emissions. EFA does not report on development impact, consistent with it not having a development mandate, but does publish a transaction register which notes whether projects will have potential adverse environmental impacts. Neither AIFFP, EMIIIF, nor ACFP routinely report on development impact but are subject to evaluations as well as environmental and social safeguard policies.<sup>18</sup>

#### **Key finding 10**

Australia is yet to publicly report on its nascent development finance portfolio and impact, which is inconsistent with best practice of international comparators.

#### **Recommendation 5**

Support greater transparency of Australia's development financing through a periodic public development finance portfolio update that includes reporting on development impact.

<sup>18</sup> Evaluations include the AIFFP two-year system-wide review, EMIIIF Impact Study 2021–22, and DFAT's ongoing Blended Finance Learning Program which is a portfolio evaluation of 12 blended finance programs.





Credit: New Forests

## CHAPTER 4

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# Opportunities for Australia to lift development impact



#### 4.1 Gender equality, disability, social inclusion, and First Nations peoples

**Australia has recently stepped-up its commitment on gender equality in the ODA program.** The new commitment ensures that all new ODA grants over AUD3 million include an objective relating to gender equality, as measured by reporting to the OECD. This commitment is alongside a reintroduced performance target, which aims for 80 per cent of ODA grants to effectively address gender equality in implementation.

**Australia is already a recognised global leader in gender lens investing, which promotes women's economic empowerment.** Blended finance approaches used by EMIF, the Investing in Women program, and the Women's Livelihood Bond have successfully attracted finance from private and philanthropic investors to support this objective. Australia's position as a global leader could be further enhanced by joining 2X Global, an initiative to support gender lens investing by sharing practices, pipeline opportunities, and co-investment opportunities at scale.

**Expanding the focus on gender equality and women's economic empowerment across all of Australia's development financing would support our standing in the region.** It would do this by increasing development impact, raising the bar on best practice compared to many other financiers, and providing a point of difference to other donors.

**Reporting on the extent to which Australia's development finance investments have a gender equality objective would support transparency.** Australia does not report on the extent to which its non-ODA development finance has a gender equality objective. However, some development banks, DFIs, and private foundations do provide this reporting (OECD 2022). According to the OECD, DAC members, including Australia, should aim to screen all their 'other official flows' (OOF) against the OECD DAC gender equality policy marker and report these data to the OECD where feasible (OECD, 2022).<sup>19</sup>

**There is opportunity for Australia to introduce an approach to require new (non-ODA) development finance to include a gender equality objective, similar to its commitment**

#### **on gender equality in the ODA program.**

Australia has already made significant progress on expanding the gender focus of its development finance through mechanisms such as AIFFP, EMIF, ACFP, and PIDG. However, further progress could be made, including by improving the gender focus of Australia's budget support financing.

**Increasing the gender focus of Australia's development finance will support raising its performance to effectively address gender equality.** However, further consideration of measurement and data collection options is needed to ensure consistent and timely reporting of gender equality performance across Australia's development finance investments.

**Australia can explore approaches to embed considerations for disability inclusion, social inclusion, and First Nations peoples into all development financing approaches.** This may provide new spaces for Australian innovation and leadership. Understanding how to embed these considerations should leverage approaches and learnings from the ODA program.

#### **Key finding 11**

Australia's success with supporting gender equality positions it well to expand the gender focus and achieve effective performance on gender equality across all development financing. Opportunity also exists to extend Australia's focus on disability, social inclusion, and First Nations peoples considerations in its ODA programs to all its development finance.

#### **Recommendation 6**

Commit to introduce a requirement that new development finance investments have a gender equality objective. Commit to introduce a gender equality performance target that 80 per cent of new development finance investments effectively address gender equality in implementation. Support global approaches for gender lens investing at scale by joining 2X Global and consider options to incorporate a stronger focus on disability, social inclusion, and First Nations peoples.

<sup>19</sup> The OECD DAC gender policy marker is a statistical tool to record aid activities that target gender equality as a policy objective. The gender marker is based on donor intentions at the design stage (OECD, 2016).

**The International Development Finance Advisory Committee could advise government on how to take forward a requirement for Australia's development finance to have a gender equality objective.** The Committee could also advise government on an appropriate framework to support measurement of gender equality performance.

**Resourcing and capability implications of Recommendation 6 would be minimal for several financing mechanisms.** These includes EMIF, AIFP, PIDG and ACFP, all of which already focus on supporting gender equality and the empowerment of women and girls. EFA could draw on DFAT expertise to support gender mainstreaming, or capability could be built in-house, for any development finance it deploys. Capability already exists within DFAT to support joining 2X Global. Capability and resourcing to support consideration of options to incorporate a stronger focus on disability, social inclusion, and First Nations peoples could be drawn from on-going parallel processes to include this focus in the ODA program.

## **4.2 Engagement with philanthropy and impact investors**

**Despite their diverse interests and approaches to financing, significant opportunity exists to draw in finance from philanthropic foundations, charitable trusts, and impact investors to support development in the Indo-Pacific.** In Australia, annual financing from these sources amounted to around AUD2 billion in 2021. Were all of this directed to financing development it would be equivalent to almost a half of Australia's ODA program.<sup>20</sup> Growth is also significant, with philanthropic and impact investor financing increasing by an average of 28 per cent and 50 per cent per year, respectively, in the three years to 2021 (Coates 2019–2021; RIAA 2019–2021).

**Globally, impact and philanthropic investment sectors are large, with assets amounting to around USD1.2 trillion and USD1.5 trillion, respectively** (Johnson 2018; Hand et al 2022). Leveraging this global pool to support Australia's region, even if only to a small extent, could have a significant impact on human development.

**There is potential to engage in a more sophisticated and curated way with Australian philanthropies and impact investors in blended finance deals.** DFAT has typically partnered with philanthropic foundations through pooling grants (for example with the Bill and Melinda Gates Foundation through the Global Polio Eradication Initiative and Gavi, the Vaccine Alliance) or direct partnering, but rarely in blended finance investment structures. The deployment of philanthropic finance is closely monitored by other private investors and can trigger subsequent investment from these participants.

**Submissions and stakeholder interviews suggest that Australia's engagement with development focused private finance representatives, including philanthropic organisations and impact investors, has been ad hoc and lacks strategic clarity** (see Briefing Paper 4). DFAT's expanded use of, and comfort with, blended finance tools provide an ideal avenue for a step-up in engagement. However, the lack of a dedicated point of contact and capability within DFAT are key constraints on improving meaningful engagement with philanthropies and impact investors.

**DFAT should establish a new dedicated unit to engage with the private finance community.** This would need to draw on specific financing expertise not generally found within DFAT. The role of the new unit would be to develop and implement a strategy for enhanced engagement and collaboration to support development and climate impact, highlighting the value proposition of new partnerships, including by leveraging Australia's blended finance mechanisms and particularly through an expanded EMIF.

**DFAT's initiatives to engage with the private finance community for development should link to domestic efforts.** In recent years, the Department of the Prime Minister and Cabinet (PM&C) and the Treasury have been leading work on how the Government can better engage with philanthropic organisations and social impact investors to identify ways forward for Commonwealth financing of social impact investments. This work is undertaken by the Social Impact Investing Taskforce ('the Taskforce'), established following the 2019–20 Budget, to examine the Government's role in the social

<sup>20</sup> In Australia, grant financing from the top 50 philanthropists was AUD942 million in 2020–2021 (Coates 2022). Total impact investment assets under management in Australia reached AUD30 billion in 2021, up from AUD29 billion in 2020 (RIAA 2022). The total investment value is for all investments by philanthropic and impact investors, including domestic and international investments.



impact investment market.<sup>21</sup> DFAT's prospective work should continue to draw on the Taskforce's lessons learned, research and extensive consultations, including with the private sector, philanthropies and NGOs.

#### Key finding 12

While there is opportunity to mobilise significant financing from philanthropic organisations and impact investors to respond to development and climate challenges in our region, DFAT needs to build its capability to engage with the private finance community more meaningfully.

#### Recommendation 7

Establish a dedicated unit within DFAT to support enhanced engagement and collaboration with the private finance community, including philanthropic organisations and impact investors.

### 4.3 Considerations for an Australian development finance institution

**Bilateral DFIs provide donors who own them with the tools, capability, and branding that support financing at a scale often beyond the reach of in-house development financing approaches used by governments.** DFIs are typically at arm's length from government albeit with close oversight and strategic direction. DFIs often manage their own staffing and balance sheet, drawing on financial markets to raise capital. They often have the backing of a government guarantee or capital injection and redeploy investment returns to enable capital growth over time. DFIs use a combination of financing tools and expertise to deploy financing instruments tailored to transaction needs. They can often be more efficient through scale, reduced overheads, and diversified risk. Most major donors other than Australia own a DFI (see Briefing Paper 3).

**Australia has long faced calls to establish a standalone DFI.**<sup>22</sup> Key factors for why Australia

has not established a DFI to date include a lack of need given the relatively small scale of Australia's development finance, large establishment costs, and the time required to build capability, expertise, and investment pipeline. However, there may be benefits to an Australian DFI as the scale of Australia's development finance increases and potential effectiveness and efficiency limits of our current development financing architecture are reached.

**There are several DFI models that could inform a potential future Australian DFI.** Each model has its own advantages and disadvantages, both across model types and compared to Australia's current multi-mechanism financing approach.

**Australia could establish a purely non-sovereign DFI, similar to like-minded DFIs, focused on blended and climate financing and achievement of the SDGs.** This type of DFI could be built out of EFA, leveraging its existing capability in international finance. However, it would also require new capability to support building an investment pipeline, including by investing in new partnerships and close relations with partner countries, and engaging on project preparation, as well as carrying out project monitoring, evaluation, and reporting on development outcomes in line with international development standards. This would likely duplicate functions of mechanisms such as the International Finance Corporation (IFC), PIDG, EMIF and ACPF in the region to which Australia contributes. It would also take significant resourcing, and if part of EFA it would require a major addition to its mandate. Unless a non-sovereign Australian DFI had a higher risk tolerance than existing DFIs, it would likely be competing with other DFIs for the limited pool of investible projects.

**Alternatively, a purely non-sovereign financing institution could be built out of EMIF.** Such an institution could focus on climate financing, much like the Clean Energy Finance Corporation's domestic financing approach but in an international context, alongside support for gender equality. EMIF's blended finance capability brings a relatively high risk tolerance, enabling it to directly address financing gaps, thereby bringing additionality rather than potentially crowding out existing DFIs. Lessons and experience from a

21 PM&C has released an Interim Report summarising the Taskforce's findings to date (PM&C 2020).

22 In 2018, DFAT commissioned a Feasibility Study into Expanding the Australian Aid Program's Development Finance Options (the 'Eyers Review') which considered the merits of establishing an Australian DFI.

potentially expanded EMIF (Recommendation 3) could inform future consideration for a regional 'green bank' approach.

**Australia could establish a DFI built out of existing mechanisms to provide both sovereign and non-sovereign finance.** A DFI with such a broad mandate, including for development and export financing, would support operational efficiency and management of financial risks albeit with significant complexity given the breadth of objectives and financing approaches. The Review has found no precedent for a consolidated sovereign and non-sovereign focused DFI among Australia's like-minded donors.

**The Review finds that the benefits of establishing an Australian DFI do not outweigh potential costs at this time.** In contrast, the Review finds clear benefits to enhancing Australia's existing development finance approach through improved portfolio and risk management, increased transparency, strengthening of DFAT's capability, and an expanded focus on blended and climate finance using existing mechanisms. This would support strengthening of Australia's existing suite of financing mechanisms that together bring DFI-like capabilities, but with greater flexibility. These reforms nonetheless provide a pathway for Australia to establish a DFI over the medium term once Australia's development finance has reached sufficient scale and should the relative benefits become clear at that time.

#### **Key finding 13**

Enhancing Australia's existing development finance approach through improved portfolio and risk management, increased transparency, strengthening of DFAT's capability, and an expanded focus on blended and climate finance would provide many of the benefits that a new Australian DFI could provide without the establishment costs and time delays of a new DFI.



Credit: Amartha

## CHAPTER 5

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### Proposed way forward



**The Review has found that existing development finance mechanisms are achieving results and appear to be addressing gaps in both the Pacific and Southeast Asia.** Nonetheless,

there is opportunity for further improvement. Recommendations 1–7 in this report aim to strengthen the effectiveness, efficiency, visibility, and risk management of Australia's development finance without undermining the ongoing pursuit of foreign, trade and development objectives.

**The Review has not established that an Australian DFI would generate material benefits for Australia that clearly outweigh potential costs at this time.** This is particularly the case

once the expected benefits from the reform recommendations of this Review are realised. Establishing a new DFI would divert attention from addressing critical and time sensitive development and climate challenges in our region.

**Australia should scale up existing mechanisms to respond to the immediacy of development challenges.** To the extent they can, these

mechanisms should work closely and continue to collaborate with DFIs of like-minded partners. This allows Australia to retain flexibility and capitalise on the experience and networks it has already built in the region and avoid duplicating the mechanisms of others. Periodic assessment against performance criteria and the state of the market as it develops will ensure this approach remains fit-for-purpose.

**Over time, Australia should build capability to broker deals in the region that draw in complementary project preparation support and financing from like-minded donors and private sources to meet the critical needs of our development partners.** This does not necessarily need to be supported by a DFI.

#### **Recommendation 8**

Australia should position itself in the region to help tackle the climate challenge and broader infrastructure needs by building capability to draw in complementary project preparation support and financing to meet critical partner needs in the region. DFAT should periodically assess and report to the International Development Finance Advisory Committee on the performance and gaps in Australia's development finance approach.

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# Annex 1: Development Finance Review – Terms of Reference

## I. Background and Rationale for the Review

At the request of Government, DFAT will lead a review into new forms of development finance (the Review).

As the development needs of the Indo-Pacific region grow, countries face a widening financing gap, and many are at risk of debt distress. Innovative financing instruments can be a valuable tool to pursue Australia's foreign policy, trade, climate, and development interests. Different development financing approaches can support new and modern partnerships to address increasing challenges facing the Pacific and Southeast Asia, and help Australia remain a relevant partner of choice.

## II. Scope of the Review

DFAT will examine how different development financing approaches can complement Australia's grant financing and enhance the effectiveness of current financing arrangements in the Pacific and Southeast Asia. DFAT will look at existing sovereign and non-sovereign financing mechanisms being used by the Australian Government and the potential to improve their effectiveness, functionality, coherence, and scale.

DFAT will draw on best practice from around the world and evaluate the opportunities and costs of reshaping existing mechanisms or creating new entities as an effective means of providing development financing. DFAT will consider options to better leverage and blend investment from bilateral donors and multilateral organisations, as well as private, philanthropic, and other sources of financing. Based on this analysis, DFAT will provide advice on policy options to the Minister for Foreign Affairs. DFAT will also examine the potential for greater use of blended finance mechanisms where government financing instruments such as grants and loans are used in combination with and to leverage private sector and philanthropic investment in development.

## III. Timing, Format, Consultation and Resourcing

The Review will be led by DFAT's Development Policy Division in consultation with relevant areas of DFAT and other agencies, notably Treasury and Export Finance Australia (EFA). DFAT will aim to present the final Review report to the Minister in November 2022. DFAT officials undertaking the Review will report to a Review Advisory Panel, which will be led by a senior DFAT official and include representatives from key agencies of Government. Public consultation will be targeted and include round tables, invited submissions, and in-person consultation with partner governments, bilateral donors, multilateral organisations, the private sector, ACFID, and philanthropic and civil society organisations. The Review will be resourced through existing departmental funding.

## IV. Key Review Questions

DFAT will provide recommendations to the Minister based on the following Key Review Questions:

What are the unmet demands for development finance in the Pacific and Southeast Asia and their relevance to Australia?

1. What are the different development financing needs and to what extent are they being filled, including by partner governments in the region, bilateral donors, multilateral organisations, as well as private, philanthropic, and other sources of financing?
  - a. What innovative forms of development financing could Australia use to draw on private, philanthropic, and other sources of financing to meet development financing needs beyond what is available from like-minded bilateral donors and multilateral organisations? What is best practice around the world, including for blended finance? What are relevant international comparators to inform Australia's future use of development finance?
  - b. How might changing global economic circumstances and characteristics of domestic markets and financial sectors in the region impact the availability or suitability of certain kinds of development financing, including blended finance?
  - c. What is the opportunity to strengthen gender equality and women's empowerment in the region through development finance?
2. How has Australia's current suite of development finance mechanisms supported strengthening stability, prosperity, peace, and security in the Pacific and Southeast Asia?
  - a. How have existing Australia's development financing mechanisms complemented broader development financing to deliver on Australia's international development, climate change, and gender equality objectives?
  - b. How have Australia's development financing mechanisms provided support that is consistent with best practice from around the world, including debt management?
  - c. How have Australia's development financing mechanisms supported Australia's position as a partner of choice in the region?
  - d. How have Australia's development financing mechanisms utilised blended finance to leverage private, philanthropic, and other sources of financing to help fill the development financing gap, and support trade, investment, and technology transfer?
  - e. What challenges have been encountered and what insights can we draw through the use of Australia's current development financing mechanisms? What is the potential for greater use of blended finance?
3. Drawing on evidence from responses to Key Review Questions 1 and 2 above, what are the key options to utilise new forms of development finance and/or reshape existing financing mechanisms that Government should consider?
  - a. For each key option, what are the:
    - i. opportunities, risks, and policy trade-offs;
    - ii. resource and capability implications; and
    - iii. regulatory and legislative requirements and budget management considerations?
  - b. What measurement, evaluation, and learning approaches should government consider to support achievement of development, climate and gender equality objectives through development finance?

## Annex 2:

# Recommendations and key findings

Recommendations	Key findings
<p><b>Recommendation 1</b></p> <p>Expand use of development finance through existing mechanisms to respond to key development challenges in Southeast Asia and the Pacific. This should be done without placing unsustainable debt burdens on our development partners or excessive risk on the Commonwealth's balance sheet.</p>	<p><b>Key finding 1</b></p> <p>Development needs to achieve the Sustainable Development Goals in the Indo Pacific region are large and growing, exacerbated by COVID-19-related expenditure pressures, debt sustainability challenges, and urgency to support the energy transition and climate adaptation.</p> <p><b>Key finding 2</b></p> <p>Development finance expands the tools available to tailor Australia's responses and engage meaningfully with development partner needs beyond what the ODA grant program could achieve. However, it also adds financial risk to the Commonwealth by leveraging its balance sheet. Development finance institutions have become widespread among like-minded donors.</p> <p><b>Key finding 9</b></p> <p>While Australia's mechanisms individually appear to be performing well against their own objectives, current decentralised governance arrangements limit visibility of interdependencies between their activities and other mechanisms, increasing portfolio level risk and potentially undermining foreign policy alignment and financial performance.</p>
<p><b>Recommendation 2</b></p> <p>Australia should continue to have the capability to deploy concessional development finance for climate resilient infrastructure in the Pacific. This should be accompanied by appropriate consideration of the expected achievement of foreign policy objectives and the impact on the Commonwealth's budget and balance sheet.</p>	<p><b>Key finding 3</b></p> <p>The Pacific has an urgent need for affordable, high quality, and climate-resilient infrastructure, together with effective and appropriately funded operations and maintenance.</p> <p><b>Key finding 4</b></p> <p>Fiscal fragility and debt sustainability challenges mean grant aid and highly concessional sovereign finance will continue to be an important form of development finance for the Pacific.</p> <p><b>Key finding 7</b></p> <p>Australian Government support for climate-resilient infrastructure in the Pacific will continue to be a priority. Recent considerable increases in Australia's cost of capital for lending means that the AIFFP providing affordable and competitive loans will come at an increasing cost to the budget.</p>



## Recommendations

### Recommendation 3

In Southeast Asia, Australia should expand its use of development finance and strengthen connections with private investors, like-minded agencies and MDBs. To support this, Australia should scale up existing blended and climate finance mechanisms, including lifting EMIF's investment cap to AUD250 million at the earliest opportunity, with a focus on climate finance and gender impact investment. EMIF should be renamed to strengthen its brand recognition and support public diplomacy.

### Recommendation 4

Establish an 'International Development Finance Advisory Committee' consisting of whole-of-government representatives to provide advice to Government on its portfolio of development finance investments, including financial performance, opportunities, and risk and portfolio contribution to foreign, trade, investment and development policy objectives.

### Recommendation 5

Support greater transparency of Australia's development financing through a periodic public development finance portfolio update that includes reporting on development impact.

## Key findings

### Key finding 5

Development finance gaps for infrastructure in Southeast Asia are most pronounced at the project development stage. At later stages of the project lifecycle, the supply of finance from DFIs and private sources is more readily available.

### Key finding 6

Gaps in market access for finance limit growth in the SME sector in Southeast Asia. This constrains the sector's contribution to the clean energy transition, women's economic empowerment, job creation, and innovation.

### Key finding 8

Australian Government blended and climate finance mechanisms operating in Southeast Asia are performing well, although currently at small scale. Project development stage financing for infrastructure and SME financing should continue to be a priority for development reasons.

### Key finding 9

While Australia's mechanisms individually appear to be performing well against their own objectives, current decentralised governance arrangements limit visibility of interdependencies between their activities and other mechanisms, increasing portfolio level risk and potentially undermining foreign policy alignment and financial performance.

### Key finding 13

Enhancing Australia's existing development finance approach through improved portfolio and risk management, increased transparency, strengthening of DFAT's capability, and an expanded focus on blended and climate finance would provide many of the benefits that a new Australian DFI could provide without the establishment costs and time delays of a new DFI.

### Key finding 10

Australia is yet to publicly report on its nascent development finance portfolio and impact, which is inconsistent with best practice of international comparators.

## Recommendations

### Recommendation 6

Commit to introduce a requirement that new development finance investments have a gender equality objective. Commit to introduce a gender equality performance target that 80 per cent of new development finance investments effectively address gender equality in implementation. Support global approaches for gender lens investing at scale by joining 2X Global and consider options to incorporate a stronger focus on disability, social inclusion, and First Nations peoples.

### Recommendation 7

Establish a dedicated unit within DFAT to support enhanced engagement and collaboration with the private finance community, including philanthropic organisations and impact investors.

### Recommendation 8

Australia should position itself in the region to help tackle the climate challenge and broader infrastructure needs by building capability to draw in complementary project preparation support and financing to meet critical partner needs in the region. DFAT should periodically assess and report to the International Development Finance Advisory Committee on the performance and gaps in Australia's development finance approach.

## Key findings

### Key finding 11

Australia's success with supporting gender equality positions it well to expand the gender focus and achieve effective performance on gender equality across all development financing. Opportunity also exists to extend Australia's focus on disability, social inclusion, and First Nations peoples considerations in its ODA programs to all its development finance.

### Key finding 12

While there is opportunity to mobilise significant financing from philanthropic organisations and impact investors to respond to development and climate challenges in our region, DFAT needs to build its capability to engage with the private finance community more meaningfully.

### Key finding 13

Enhancing Australia's existing development finance approach through improved portfolio and risk management, increased transparency, strengthening of DFAT's capability, and an expanded focus on blended and climate finance would provide many of the benefits that a new Australian DFI could provide without the establishment costs and time delays of a new DFI.

## Annex 3:

# List of stakeholder consultations

The Review received cables from Australian missions, who consulted host governments and organisations, in the following locations: Alofi, Apia, Bandar Seri Begawan, Berlin, Brussels, Cairo, Colombo, Dhaka, Dili, The Hague, Hanoi, Jakarta, Kuala Lumpur, Madrid, Manila, Nuku'alofa, Noumea, Paris, Paris OECD, Port Moresby, Rome, Seoul, Singapore, Suva, Tokyo, UN Geneva, UN New York, Washington, and Wellington.

The Review was guided by the Review Advisory Panel, which included representatives from the Department of Finance, the Department of Foreign Affairs and Trade, the Department of Prime Minister and Cabinet, the Department of the Treasury, and Export Finance Australia.

The Review received 14 external written submissions: a joint submission from ActionAid Australia, Jubilee Australia Research Centre, Oxfam Australia and Dr Susan Engel; and submissions from August Group, Australian Council for International Development (ACFID), Australian National University Development Policy Centre, Australian Sustainable Finance Institute (ASFI), Center for Global Development, Clay O'Brien and Jenni Henderson, Cross Sector Development Partnerships Initiative (XSPI), Dalberg Global Development Advisors, Good Return, Ian Anderson, John Eysers, Professor Rosemary Addis, and Save the Children.

The Review consulted representatives from philanthropies, impact funds, NGOs and related organisations, including Act for Peace, ActionAid Australia, Asia Pacific 4 Development Diplomacy and Defence Dialogue, Atlassian Foundation, August Group, ACFID and various other members of ACFID via a roundtable, Australian International Development Network, Bill and Melinda Gates Foundation, Bridges Australia, Criterion Institute, Dalberg Advisors, Fred Hollows Foundation, Good Return, Ian Anderson, International SOS, Interpeace, John Eysers, Jubilee Australia Research Centre, Minderoo Foundation, Mondiale Impact, Oxfam International, Save the Children, and World Vision.

The Review consulted representatives from think tanks and academia, including Australian National University Centre for Social Research and Methods, Australian National University Coral Bell School of Asia Pacific Affairs, Australian National University Crawford School of Public Policy, Australian National University Development Policy Centre, Center for Global Development, Center for Strategic and International Studies, Cross Sector Development Partnerships Initiative, Development Intelligence Lab, Lowy Institute, and University of Wollongong Future of Rights Centre.

The Review consulted representatives from development finance institutions, donor governments and international financial institutions, including: the Asian Development Bank, Asian Infrastructure Investment Bank, Association of Bilateral European Development Finance Institutions, British Investment International, Dutch Entrepreneurial Development Bank, FinDev Canada, International Finance Corporation, Japan Bank for International Cooperation, Japan International Cooperation Agency, Korean Economic Development Cooperation Fund, Nippon Export and Investment Insurance, US Agency for International Development, US Development Finance Corporation, US State Department, and the World Bank.

The Review consulted representatives from the following Australian corporations: AMP Capital, Association of Superannuation Funds of Australia, Australian Sustainable Finance Institute, Bloomberg, Construction and Building Unions Superannuation Fund, Ernst & Young, HSBC Group, IFM Investors, Insurance Australia Group, Metrics Credit Partners, Moody's Corporation, National Australia Bank, Point Advisory, QBE Insurance Group, Queensland Investment Corporation, State Super, Australia and New Zealand Banking Group, Vanguard Investments Australia, and Westpac Banking Corporation.



## Annex 4:

# Glossary of key terms

**Additionality** – a development finance principle that public investments should contribute beyond what is available in the market and not ‘crowd out’ the private sector.

**Asian Development Bank (ADB)** – a multilateral development bank focused the Asia-Pacific region. The ADB defines itself as a social development organisation dedicated to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

**Australian Infrastructure Financing Facility for the Pacific (AIFFP)** – an Australian Government owned facility providing grant and loan financing in the Pacific and Timor-Leste for energy, water, transport, telecommunications, and other infrastructure needs.

**Blended finance** – using development finance to mobilise additional finance towards sustainable development.

**Budget support** – a method of financing a recipient country’s budget through the transfer of resources directly from an external financing agency to the recipient.

**Concessional loans** – loans made on more favourable terms than the borrower could obtain in the market. The concessional terms may be one or more of the following: a lower interest rate (the most common); deferred repayments; or income-contingent repayments.

**‘Crowding out’** – a situation in which public investment (or spending) leads to a decrease in private investment (or spending).

**Development finance** – for the purposes of the Review, any form of finance that is both: (a) finance that generates a development outcome (even if it is not the primary objective); and (b) finance that generates a financial return or mobilises another source of finance. This broad definition includes loans, guarantees, equity, insurance, budget support, and a range of grant financing instruments that seek to mobilise other sources of finance or generate a return.

**Development finance institutions (DFIs)** – specialised investment vehicles supported by governments to make investments with development outcomes. DFIs can be bilateral (the focus of the Review – see Briefing Paper 3), serving to implement their government’s foreign development and cooperation policy, or multilateral, acting as private sector arms of international financial institutions established by more than one country.

**Emerging market economy** – an economy transitioning into a developed market economy. Developed market economies refer to the 39 countries classified as ‘advanced’ by the IMF World Economic Outlook.

**Equity financing** – a form of financing that leads to an ownership share in an enterprise, as opposed to non-equity investments (for example, loans and guarantees) that do not lead to ownership rights.

**Export Finance Australia (EFA, previously EFIC)** – Australia’s export credit agency established under the Export Finance and Insurance Corporation Act 1991 (EFIC Act) as a statutory corporation wholly owned by Government. EFA delivers its functions using two main accounts: the Commercial Account (the primary operating account for transactions entered into by EFA) and the National Interest Account (NIA) (an account for undertaking transactions under ministerial direction deemed to be in the national interest).

**‘Financing for development’** – all funding streams and finance instruments that generate positive development outcomes. This broad definition includes domestic revenue collected by partner governments, FDI, as well as conventional grant-based ODA.

**Foreign direct investment (FDI)** – refers to the inflow of foreign capital in the form of investment that earns interest in enterprises where it is deployed. FDI is driven by private sector investment. FDI is categorised as non-ODA flows and represents one of the largest sources of developing countries' external financing.

**Gender equality, disability and social inclusion (GEDSI)** – a framework integrated into Australia's development policy. DFAT is committed to ensuring all its investments and diplomatic activities progress GEDSI outcomes, in line with the Australian Government's international commitments to sustainable development, gender equality and disability rights.

**Gender lens investing (GLI)** – involves consideration of gender biases, patterns, power dynamics, opportunities, and risks in investments. At its core, gender lens investment incorporates a gender analysis alongside impact and financial analysis to make better decisions that lead to better gender equality and economic outcomes.

**Grant financing** – a type of development finance in which financial resources are provided to developing countries with no expectation of repayment.

**Guarantee** – a contractual undertaking in which one party assumes responsibility for the debt or performance obligations of another party should that other party default in some way.

**Impact investing** – an investment strategy that aims to generate specific social or environmental effects in addition to financial gains.

**International Development Policy** – Australia's new development policy that sets the long-term direction for Australia's international development engagement.

**International financial institutions (IFIs)** – financial institutions established by more than one country and subject to international law. These institutions include the IMF and the MDBs.

**International Monetary Agreements Act 1947 (IMA Act)** – administers Australia's relationship with the IFIs and allows Australia to provide financial assistance (such as loans) to recipient countries under certain conditions.

**International Monetary Fund (IMF)** – a major financial agency and an IFI, with over 190 member countries, working to achieve sustainable growth and prosperity for all member countries. The IMF provides broad support to developing countries through surveillance and capacity-building activities, as well as concessional finance to help achieve, maintain, or restore stable and sustainable macroeconomic positions consistent with strong and durable poverty reduction and growth.

**Investing in Women** – an Australian Government initiative established to catalyse inclusive economic growth through women's economic empowerment in Southeast Asia.

**Mobilisation** – a causal link between private finance made available for a specific project in a developing country and the official flows provided that were used to incentivise them.

**Multilateral development banks (MDBs)** – international financial institutions that provide financial assistance to developing countries to promote economic and social development.

**Official development assistance (ODA)** – government development assistance in the form of grants and concessional loans that promote and target the economic development and welfare of developing countries.

**Organisation for Economic Cooperation and Development (OECD)** – an intergovernmental organisation with 38 member countries (including Australia) that operates to stimulate economic progress and world trade. The OECD partners with governments and private actors in developing countries.

**Other Official Flows (OOF)** – official sector transactions that do not meet ODA criteria. OOF include: grants to developing countries for representational or commercial purposes; official bilateral transactions intended to promote development, but not reaching the minimum grant element for a given recipient; and official bilateral transactions, whatever their grant element, that are primarily export-facilitating in purpose.

**Pacific Island countries** – refers to the following group of Pacific Island nations: Cook Islands, Federated States of Micronesia, Fiji, French Polynesia, Kiribati, Nauru, New Caledonia, Niue, Papua New Guinea, Republic of Palau, Republic of the Marshall Islands, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, Vanuatu, and Wallis and Fortuna.

**Philanthropic organisations** – non-profit, non-governmental organisations that often have a clear mandate and offer grant capital to provide development assistance.

**Southeast Asia** – refers to the following group of Asian nations: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Timor-Leste, and Vietnam.

**Sovereign debt distress** – a situation in which a country is unable to fulfill its financial obligations, and which may lead to debt restructuring or default. This raises the risk of the country facing higher borrowing costs and losing access to international markets.

**Technical assistance** – a form of development assistance that facilitates the preparation, financing and execution of development projects and programs.

**The World Bank** – a multilateral development bank that provides financial and technical assistance to developing countries. The World Bank generally refers to just the IBRD and IDA (see below definition of The World Bank Group).

**The World Bank Group** is Australia's largest multilateral partner. This term refers to the following institutions collectively:

- the **International Bank for Reconstruction and Development (IBRD)**, which lends to governments of middle-income and creditworthy low-income and most vulnerable countries
- the **International Development Association (IDA)**, which provides concessional loans – called credits – and grants to governments of the world's poorest countries
- the **International Finance Corporation (IFC)**, which provides loans, equity and advisory services to stimulate private sector investment in developing countries
- the **Multilateral Investment Guarantee Agency (MIGA)**, which offers political risk insurance (guarantees) to investors and lenders
- the **International Centre for Settlement of Investment Disputes (ICSID)**, which provides international facilities for conciliation and arbitration of investment disputes.





## Briefing Paper 1:

# Sovereign development finance

**Sovereign development finance is an important source of finance for the Indo-Pacific.** Sovereign development finance includes grants or loans provided to sovereign governments and sovereign owned entities. Partner governments often borrow from sovereign governments and international financial institutions (IFIs) to meet budget shortfalls or finance infrastructure they are unable to finance from tax revenue or private borrowing. Sovereign finance can be counter-cyclical and is increasingly important to mitigate current shocks (COVID-19, food and energy price shocks) and attendant historically high fiscal deficits. Australia provides sovereign development financing through budget support, infrastructure financing, and contributions to international financial institutions.

**Sovereign development finance is characterised by the degree of 'concessionality'.** Concessional loans are made on more favourable terms than the borrower could obtain in the market. The concessional terms may be one or more of the following: a lower interest rate, deferred repayments or income-contingent repayments.

**The capability to manage the unique and correlated risks associated with sovereign lending will play a large role in driving Australia's sovereign development financing engagement in the future.** While individual financing mechanisms include robust governance, arrangements lack visibility of the interdependencies with other financing mechanisms. There is opportunity to bring a portfolio view of lending made on the Commonwealth balance sheet. This will enhance portfolio level management of financial performance, risk, and alignment

across mechanisms to advance development and foreign policy objectives. Improving portfolio management would also improve coordination of loan objectives with grant-based bilateral aid programs, manage responses to partner country debt challenges, and support engagement with IFIs.

## Budget support

**Budget support assists partner countries to respond to crises and generate economic reforms and sustainable recovery.** The ability to deploy resources quickly in a crisis is a key advantage, while also providing an entry point for policy dialogue between donors and recipients.

**Well-designed budget support can be a useful tool to achieve policy reform.** Budget support can provide partner governments with cost effective loan or grant financing that avoids unsustainable debt while maintaining critical levels of service delivery. Budget support financing is often provided to partner governments to undertake policy reforms and is usually complemented by non-financial elements, including technical assistance to support the reform process.

**Australia's budget support has increased sharply in recent years providing finance to key partners during the COVID-19 pandemic.** This has occurred through budget support grants and, more recently, budget support loans deployed through the *International Monetary Agreement Act 1947* (IMA Act). Since 2019, Australia has provided four loans to PNG (2019, 2020, 2021 and 2022, totaling approximately AUD2 billion) and one loan to Indonesia (2020, AUD1.5 billion) using the IMA Act.

**To date, budget support loans have been highly affordable from the perspective of borrowing countries.** The fixed interest rates of these loans were only marginally above Australia's cost of capital but for borrowing countries were much lower than their cost of borrowing from other sources. Australia's increasing cost of capital will have implications for the affordability of any new budget support loans.

## Infrastructure financing

**Inadequate infrastructure is a constraint on economic growth and development, leaving vulnerable communities with substandard access to basic services and impeding efforts to achieve broad based poverty reduction.** Total infrastructure costs, including operations and maintenance over the lifecycle of the investment, are often under-provisioned. Many forms of infrastructure that are critical for development are provided by sovereign governments, such as healthcare, water, roads, and power. Limited private sector involvement in infrastructure provision may reflect regulatory barriers, low expected risk-adjusted returns, and technology characteristics which support provision at a scale that is too large for the private sector.

### **Infrastructure provision in the Pacific and Southeast Asia falls well short of needs.**

Estimates place the infrastructure need to sustain expected rates of growth at 5.7 per cent of GDP in Southeast Asia (USD210 billion) each year to 2030, and at 9.1 per cent of GDP in the Pacific (USD3.1 billion) (ADB 2017).

**Australia's sovereign financing for infrastructure supports more sophisticated and sustained partnerships with governments than can be achieved solely through grants.** Historically, Australia's development program has provided grants to fund infrastructure, predominantly through technical assistance and upstream project preparation. This has enabled Australia to influence the design of projects. However, grants present limited opportunities to influence the financing, procurement, construction, operation, and maintenance of key infrastructure assets.

**Ongoing project finance in the form of loans and guarantees enables Australia to sustain relationships with partner governments and their state-owned enterprises (SOEs) based on mutual responsibility and shared risk.** It

provides Australia with additional influence to raise asset quality, such as improving climate resilience, and improving development outcomes, including through a focus on gender equality and environmental and social safeguards. In addition, there is potential to deploy equity and insurance, albeit constrained, that could further deepen relationships.

### **Australia has become a significant infrastructure financier in the Pacific through the Australian Infrastructure Financing Facility for the Pacific (AIFFP).**

AIFFP offers loans and grants to support investment in infrastructure assets across the Pacific. Most financing is to sovereign governments, reflecting the constraints on the ability of the private sector to provide infrastructure in the region. To date, AIFFP has committed financing of AUD1.2 billion for 12 infrastructure investments across nine countries to support roads, ports, airports, telecommunication cables, and other critical infrastructure. The majority of AIFFP financing has been in the form of loans (AUD890 million).

### **Through AIFFP, Australia has fostered long-term relationships with governments and like-minded financiers across the Pacific and Timor-Leste.**

AIFFP is helping Australia remain an infrastructure partner of choice through its financing for productive and climate resilient assets. Australia is also using its infrastructure financing capabilities to encourage like-minded investment in the Pacific. AIFFP works closely with donors such as the US and Japan to increase their engagement in the Pacific, particularly in critical sectors. For example, Australia is partnering with the US and Japan to finance the USD30 million Palau Submarine Cable Branch System Project.

**Australia's concessional financing is a driver of AIFFP's success in the Pacific but rising interest rates increase the cost to Australia of providing such finance.** Policies of the IMF and World Bank to support sustainable debt in developing countries may result in limits on non-concessional borrowing being imposed on countries in our region. AIFFP provides only grant financing for infrastructure projects in the lowest income and most vulnerable countries, considering risks of debt distress. For other countries in the Pacific, such as Papua New Guinea, AIFFP may soften its loan terms, including using grants, to enable affordability and competitiveness with other development financiers. High risk of debt distress

in many Pacific Island countries challenge the long-term sustainability of AIFFP's financing approach as the gap between funding and lending rates continue to grow.

**Australia currently provides limited financing for infrastructure in Southeast Asia.** Like the Pacific, SOEs in Southeast Asia are critical providers of infrastructure-based services. However, the infrastructure financing landscape in Southeast Asia is fundamentally different to the Pacific as capital markets are generally more developed, sovereign borrowing capacity is greater, and the scale of project financing can be larger than what Australia is able to finance.

**There are opportunities to further expand support for sovereign funded infrastructure in Southeast Asia through technical assistance.**

Australia's funding of technical assistance programs like Partnerships for Infrastructure (P4I) and the Global Infrastructure Facility helps countries identify and develop priority infrastructure and enables Australia to influence the upstream design of projects. Engagement with partner governments through technical assistance may also present sovereign infrastructure financing opportunities for Australia as countries in the region seek to strengthen their climate resilience using new technology which supports smaller scale investments.

## International financial institutions

**International financial institutions (IFIs) are an important source of development finance for the Pacific and Southeast Asia** (see Figure 1).

IFIs is the collective term for the multilateral development banks (MDBs) and the International Monetary Fund (IMF). IFIs bring expertise and technical knowledge, engaging with countries to implement difficult economic and social reforms, with scale and expertise potentially beyond Australia's capabilities. The MDBs can also undertake large scale projects, leveraging finance through innovative financing models. In 2021, the Asian Development Bank (ADB) and the World Bank provided USD850 million to the Pacific and USD11.2 billion to Southeast Asia.

**In July 2022, Australia announced it would reallocate approximately AUD4.6 billion (SDR2.5 billion) to support IMF initiatives that provide low-income countries increased access to concessional financing.** Initiatives such as the Poverty Reduction and Growth Trust (PRGT) and the Resilience and Sustainability Trust (RST) allow the IMF to expand its role beyond short-term financial stability.<sup>1</sup> Eligible countries can access these trust funds to support stability, poverty reduction and growth, as well as potential longer-term balance of payments needs due to climate change or pandemic preparedness. Papua New Guinea, Samoa, Solomon Islands and Tonga have accessed PRGT financing since the beginning of the pandemic. Countries must have an IMF program to access the RST, providing an opportunity for Australian technical assistance to influence economic governance reforms through IMF engagement and support partner country access to IMF trust funds.

**MDBs offer Australia the opportunity to pool and diversify risk globally to support the development objectives of individual countries.** Around one-fifth of Australia's Official Development Assistance is provided through the ADB and the World Bank in the form of core funding to their concessional finance arms, trust funds and project co-financing. Their financing model for low-income countries and small island economies provides a highly effective means to scale donor funds and leverage multilateral balance sheets. Australia can also encourage MDBs to further leverage their balance sheets to create additional loan-based resources for developing countries, particularly middle-income countries, to access additional finance.

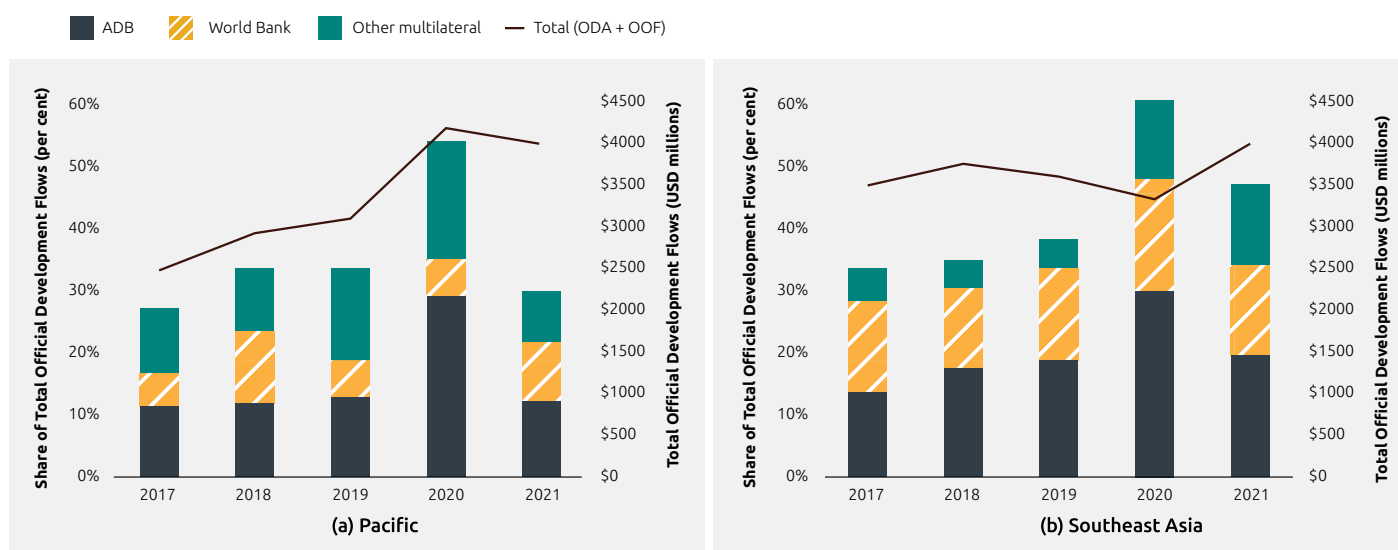
**IFIs have a comparative advantage in mobilising highly concessional sovereign finance at scale.** Strong credit ratings driven by balance sheet depth, diversified portfolios, and preferred creditor status allow the IFIs to raise capital at low cost and hence offer highly concessional finance.<sup>2</sup> These low-cost funds can be deployed at scale and speed to support countries recovering from external shocks. Most recently this has been seen by the support provided in response to the COVID-19 pandemic in 2020 driven by the ADB (see Figure 1).

1 Nine Pacific countries (Federated States of Micronesia, Kiribati, Marshall Islands, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu) and Timor-Leste are eligible for financing under the PRGT. RST eligibility is broad and includes middle-income and vulnerable small states which are not PRGT eligible, such as Fiji, Nauru and Palau.

2 For example, the World Bank International Development Assistance (IDA) interest rates stood at 1.33 per cent on USD borrowing with a 10-year grace period and 40-year repayment period effective as of January 1, 2023. The ADB's policy-based loans stood at an interest rate of 1 per cent during the grace period and 1.5 per cent during the amortisation period with an 8-year grace period and 24-year repayment period. These rates are variable to the extent that they are reset periodically but are smoothed over time.



**Figure 1: Multilateral share of total official development flows (LHS) and total official development flows (RHS)**



Note: Total Official Development Flows refers to the sum of Official Development Assistance (ODA) and Other Official Flows (OOF)

Source: OECD Development and Assistance Committee (DAC)

**IFI membership provides Australia with the opportunity to influence policies and priorities, including to increase development resources for the Indo-Pacific region.** As global standard-bearers of the rules-based order, IFIs support stability in the region, as well as trade, climate change adaptation, human development, and other global challenges. Australia has had success in influencing the World Bank and ADB to align more closely with Australia's interests. Australia has been instrumental in increasing IFI presence in the Pacific from an 11 per cent share in 2012 to a 29.5 per cent share in 2021 of total Official Development Assistance and Other Official Flows. However, donor funds to some concessional financing arms of MDBs are pooled and cannot be directed to specific transactions.<sup>3</sup>

**Beyond the provision of donor capital, co-financing at the project level can be an efficient approach to influence MDB presence and operations.** Australian Government support can crowd-in MDB financing for development projects that further improve alignment with Australian objectives. There are also opportunities for greater cooperation with like-minded bilateral donors, including the US, Japan and India, to further draw in MDB financing into the Indo-Pacific.

**Co-financing with IFIs also allows Australia to engage with sovereign governments on transformational development investments that would otherwise not be feasible due to complexity and scale.** Transformational development projects require bespoke solutions given their complexity both in terms of scale of financing and risk. IFIs have expertise deploying a range of financial instruments at a scale potentially beyond Australia's current capability that can address the various risks associated with large-scale financing. For example, the Multilateral Investment Guarantee Agency (MIGA) promotes cross-border investment in developing countries through political risk insurance. Furthermore, co-financing with IFIs can help develop markets in the Indo-Pacific by mobilising private capital in addition to IFI capital (see Briefing Paper 2).

**MDB procurement provides opportunities for Australian firms as contractors.** Australian businesses are recognised as contractors that deliver high-quality goods and services. Participation of Australian companies in these projects can help shift norms towards the provision of high-quality, value-for-money goods and services.

**Coordinating Australia's financing efforts with IFIs will become increasingly complex**

<sup>3</sup> Concessional financing arms of MDBs include the International Development Association (IDA) of the World Bank and the Asian Development Fund (ADF) of the ADB.

**with future climate finance commitments.** A whole-of-government portfolio management and coordination approach for Australia's development finance would strengthen coherence to Australia's relationship with the IFIs.

## Opportunities

**As the development finance portfolio matures, Australia will need to consider the relative merits of core finance through IFIs against finance through bilateral engagement.**

Investment in the IFIs allows for greater scale and efficiency of financing but is less able to be directed to visibly support Australia's national interest compared with bilateral engagement.

**IFIs are coordinating contingent debt clause initiatives to support debt sustainability, with implications for the terms of Australia's future lending, including for budget support.**

Contingent debt clauses embed contractual debt relief triggers into loans, thereby minimising complications that may arise from renegotiations. These contingent clauses will become increasingly important as the impacts of climate change add to fiscal stress in developing countries. Climate resilient debt clauses automatically support deferral of debt servicing for a specified period following a severe shock, allowing governments to direct limited resources to respond to the disaster and lowering the risk of default.

**Australia can engage in innovative forms of budget support like debt buybacks to reduce**

**debt burdens and improve development**

**outcomes.** Debt buybacks involve buying back part or all sovereign outstanding debt from creditors, usually at a discount to its face value reflecting risks of sovereign debt default. Donor participation in debt buyback programs can support partner countries to reallocate revenue towards other critical uses that would otherwise be used to meet debt service obligations.

**Donor guarantees for MDB sovereign lending are a cost-effective alternative to direct bilateral sovereign lending.**

These guarantees enable MDBs to lend to countries beyond normal exposure limits. Guarantees are cost effective due to lower risk of sovereign default in recipient countries arising from MDB preferred creditor status and concessional lending terms.

**There are also opportunities to support partner countries through technical assistance and de-risking approaches to structure and issue development impact bonds, such as green bonds.**

Financing through this type of sovereign issued bonds enables mobilisation of private sector finance to support the development objectives of governments. Donor support could be achieved directly through grant financing the structuring and issuance process, or by purchase of the bond issuance itself. Support could be offered indirectly through a first loss guarantee indemnifying the sovereign up to some level to de-risk the bond payments with the aim of catalysing greater private capital.

### Opportunities for budget support through green bonds

Sovereign green bonds are a financing instrument that allows countries to demonstrate a commitment to a green financing agenda. Fiji was the first developing country to issue a green bond, in 2017. The Fiji Green Bond was issued for FJD100 million with proceeds being used to fund projects in line with the World Bank IFC Green Bond Principles. This supports the Fijian Government's commitment to achieve 100 per cent renewable energy and reduce its carbon emissions in the energy sector by 30 per cent by 2030.

The green bond is structured in two tranches, (i) FJD20 million with tenor of 5 years and 4 per cent coupon, and (ii) FJD80 million with tenor of 13 years and 6.3 per cent coupon. This structure allows Fiji to better manage its sovereign debt repayments as the interest rates are fixed and the repayments are in local currency. The Fiji Green Bond was supported by technical assistance from IFC and the World Bank in the structuring and issuing of the bond.

The green bond market size was USD1.6 trillion in 2021, with USD522.7 billion in new (Climate Bonds Initiative 2021). While issuances are at record highs, only USD1.6 billion of new issuances in 2021 were by emerging economy countries in the Indo-Pacific region (Climate Bonds Initiative 2022). Given the extent of the climate financing needed in the region and the challenging macroeconomic environment, green bonds provide an effective way to raise private capital for climate finance.

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## Briefing Paper 2:

# Blended finance

**Blended finance is a form of development finance from public or philanthropic sources that leverages additional private sector investment towards development outcomes** (OECD 2022). It allows organisations with different objectives to invest alongside each other while meeting their individual objectives (Convergence 2022).

**Blended finance helps to bridge market gaps where risks prevent potential investment by other actors, particularly the private sector.**

Market gaps include the lack of collateral, lack of demonstrated history of investment returns, large minimum investment size, long investment time horizons, and high information asymmetry, risk, or transaction costs. Blended finance can address these gaps by using grants, loans, equity positions, and guarantees, including the use of first-loss provisions, to de-risk and mobilise additional investment.

**The guiding principle is to crowd-in additional finance rather than crowd-out private finance that would otherwise have taken place.** Such 'financial additionality' is defined as a contribution that is beyond what is available were the market left to its own devices, or that is otherwise absent, and should not crowd out the private sector (DFI Working Group 2018).

**Technical assistance (TA) is an important part of blended finance transactions.** TA is a form of aid that supports the preparation, financing and execution of development projects and programs. TA can occur at the design stage to improve the impact or the investment readiness of a business or fund, for example, a grant for a feasibility study. TA can also be used at the implementation phase in the form of capacity building and advisory services to enhance the development impact of an investment.

## Why is blended finance used?

**Additional private sector finance is needed to meet large and growing development financing needs.** Official development assistance (ODA) and other official flows (OOF) reached a combined high of USD307.7 billion in 2020 but remains well short of the trillions in financing needed. Before the COVID-19 pandemic, it was estimated that developing countries faced a financing gap of USD2.5 trillion to meet the Sustainable Development Goals (SDGs). This estimate is now USD3.9 trillion per year (OECD 2023).

**Blended finance can catalyse significant outcomes by supporting inclusive economic growth.** Inclusive growth is arguably the most powerful instrument for reducing poverty and improving quality of life in developing countries. De-risking projects can attract additional private sector financing, enabling more quality infrastructure to be built, and developing and deepening inclusive value chains and markets, which are critical contributors to economic growth.

**Private finance can reduce pressure on domestic public sector resources.** This enables donor countries to use ODA towards projects best delivered using grants. Over time, blended finance approaches can reduce reliance on concessional finance. The concessional financing required to attract private capital can be phased down or out when market viability is demonstrated to private investors. In this way, blended finance can support the creation and development of viable markets for impact-focused commercial finance, further adding to its catalytic potential.

## Australia's blended finance

**Table 1: Australia's mechanisms and programs that have blended finance characteristics**

Program	Type	Australia's commitment (AUD million)	Instruments	Purpose	Geography
Emerging Markets Impact Investment Fund (EMIIF)	Australian owned	40 (250 as at 9 May 2023)	TA, loans, guarantees, equity	Early-stage investments in small and medium-sized enterprises (SMEs)	Indo-Pacific (currently Southeast Asia)
Australian Climate Finance Program (ACFP)	Multilateral	Up to 140	TA, loans, guarantees, grants	Medium to large scale investments through equity in funds.	Indo-Pacific
Investing in Women – Gender lens investment component	Australian owned	82	TA, loans, equity, grants	Investment in women-led SMEs	Indonesia, Philippines, Vietnam
Private Infrastructure Development Group (PIDG)	Multilateral	54	TA, loans, guarantees, equity	Early-stage investments catalyse private finance in infrastructure	Indo-Pacific (currently Southeast Asia)
Women's Livelihood Bond (WLB)	Innovative financing structure	2.32	Bond	Gender lens investing	Southeast Asia
Partnerships for Infrastructure (P4I)	Australian owned	120	TA	Project preparation for infrastructure	Southeast Asia
Global Infrastructure Facility (GIF)	Multilateral	18.6	TA	Project preparation for infrastructure	Global
Convergence Blended Finance Design Window	Multilateral	3.5	TA	Project preparation for blended finance	Indo-Pacific (currently Southeast Asia)
Private Financing Advisory Network (PFAN)	Multilateral	8.8	TA	Early-stage business advisory support to catalyse investment.	Indo-Pacific (currently Southeast Asia)
Australian infrastructure Financing Facility for the Pacific (AIFFP)	Australian owned	3,000 loans 1,000 grants	TA, loans, guarantees, equity, grants	Infrastructure financing	Pacific and Timor-Leste
Export Finance Australia (EFA) <sup>1</sup>	Australian government support for private transaction	2,500	Guarantees, loans, insurance	Telstra's acquisition of Digicel Pacific, the leading mobile telecommunications and network services provider in the Pacific.	Papua New Guinea, Vanuatu, Fiji, Samoa, Tonga, and Nauru

Source: DFAT (2022)

<sup>1</sup> While EFA is not a dedicated blended finance program, the Telstra-Digicel acquisition had blended finance characteristics.

**Australia has developed a portfolio of blended finance mechanisms that support development objectives.** These include multilateral investment vehicles, via wholly Australian-owned entities, direct government support for private transactions, and innovative financing structures. Additionally, Australia provides upstream technical assistance to help prepare projects.

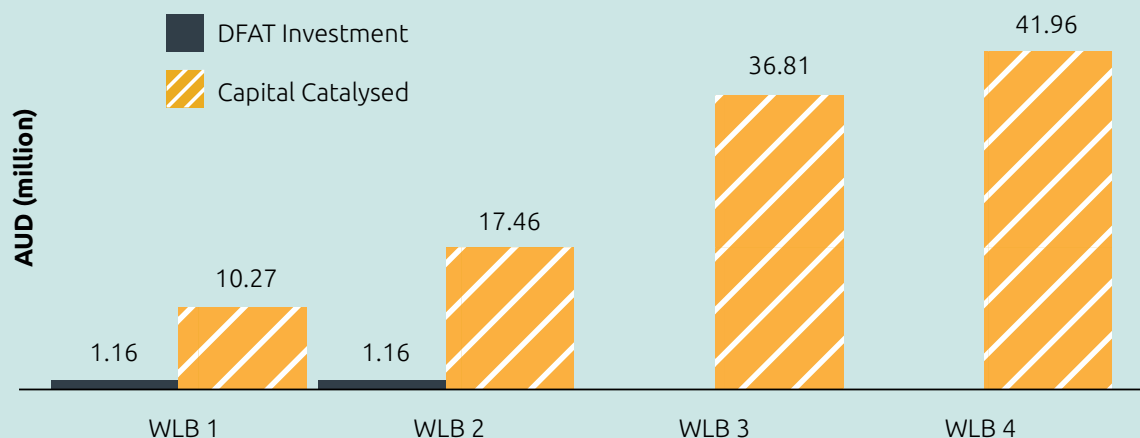
**Australia's mechanisms are predominantly grant capitalised reflecting their genesis in the Australian aid program.** Most mechanisms can deploy a wide range of financing instruments. For example, the Women's Livelihood Bond (WLB) was grant capitalised but can deploy financing through innovative bond structures (see Box 1).

### Box 1: Australia supporting women's livelihoods

The Women's Livelihood Bond (WLB) series are an innovative bond structure developed by the Impact Investment Exchange (IIX) to improve women's livelihoods, access to finance, essential goods, and income-generating assets.

Australia's participation in WLB has been through grant financing for the structuring of WLB1 and WLB2, and support for a first loss guarantee on the bond provided by the US International Development Finance Corporation (DFC). The first loss guarantee helped the WLB series mobilise private capital. To date there have been no defaults on interest payments received by bondholders, meaning that the guarantee has never been utilised, despite the challenges presented by COVID-19.

DFAT's initial investment was AUD1.16 million in both WLB1 and WLB2. WLB1 to WLB4 raised AUD106.5 million in total private capital and impacted over one million women and girls in South and Southeast Asia. IIX is now spearheading the 'Orange Bond Initiative' (OBI) with the support of Australia and DFC. The OBI aims to create a recognised asset class for gender bonds and mobilise USD10 billion in investment that empowers 100 million women and girls by 2030.



Source: DFAT

## Performance

**Australia has successfully mobilised finance from a range of sources,** including commercial finance, multilateral development banks (MDBs), development finance institutions (DFIs), and other bilateral partners. Projects range from large-scale infrastructure investments to small-scale financing that supports local value chains.

**Australia's portfolio has achieved good development outcomes through highly catalytic investments, despite its relatively small size.**

EMIIF's relatively high-risk tolerance enables it to directly address financing gaps, avoiding crowding-out existing investors (see Box 2). Australia has mobilised five dollars of private investment for every dollar invested through its SME finance portfolio.<sup>2</sup> Alongside this private finance, AUD100 million has been co-invested from like-minded donors, DFIs and MDBs.

<sup>2</sup> Since 2016, DFAT has invested around AUD50 million through SME blended financing mechanisms. This investment, using OECD methodology, has mobilised AUD270 million in private sector co-investment.



## Box 2: Emerging Markets Impact Investment Fund (EMIIF)

EMIIF is DFAT's flagship AUD40 million financing program for value chain development. It makes early and concessional impact investments into small firms in the Indo-Pacific through intermediary funds. Since its launch, EMIIF has made three investments: a Southeast Asia fintech fund, a Vietnamese venture capital fund, and a Southeast Asia gender-focused private equity fund. These have mobilised over AUD70 million in private finance, including from Australian private and philanthropic investors. EMIIF can reinvest investment returns, giving it the potential to become financially self-sustaining, freeing up grant resources for other purposes.

Other donors and philanthropic investors recognise that EMIIF fills an unmet financing need in the Indo-Pacific. It provides early and concessional finance to intermediary funds that would not otherwise receive financing, such as first-time fund managers and women-led funds.

**Australia's blended finance focuses mainly on SME investments through a 'fund-of-funds' approach in Southeast Asia.** Such funds have consistently accounted for the largest share of blended finance transactions (Convergence 2021). Funds are attractive to donors because they can offer greater diversification and leverage specialised on-the-ground market expertise to monitor portfolio companies. Investment through funds is particularly important for donors without a dedicated development finance capability. However, without direct engagement, donors using a fund approach risk having limited ability to direct the investments and gain donor-specific recognition.

**Blended finance can crowd-in private capital for infrastructure.** Australia used blended finance approaches at scale to support Telstra to acquire Digicel Pacific, the leading mobile telecommunications and network services provider in the Pacific. The deal allowed Telstra to enter the Pacific marketplace, bringing strong capabilities to ensure secure, reliable, and high-quality services are provided to Pacific communities, including in Papua New Guinea, Vanuatu, Fiji, Samoa, Tonga, and Nauru.

**Australia is considered a world leader in applying and promoting gender lens investing (GLI) through blended finance.** Review consultations highlighted that DFIs, donors, philanthropies and impact investors all recognise DFAT as a GLI leader.

**Australia's track record of quality investments and awareness-raising activities has helped influence and expand GLI in the Indo-Pacific.** DFAT's Investing in Women program is achieving

significant improvements in the gender finance ecosystem. The Investing in Women program has had a significant effect on the gender finance ecosystem, supporting established impact investors to expand their gender focus and demonstrate effectiveness. The Investing in Women program has since extended support to local impact investors, mobilising even higher ratios of private capital for SME finance. EMIIF is building on this success with a targeted gender investment strategy and by providing catalytic gender technical assistance. Australia has also worked with the US DFC to design a gender strategy for the Indonesia Resilience Fund, an investment vehicle supporting SMEs in the healthcare and essential goods transportation sectors during the COVID-19 pandemic.

## Opportunities

**Expanding current mechanisms would deepen economic engagement and increase Australia's influence while mobilising additional finance from the private sector, like minded DFIs, and MDBs.** While Australia's current blended finance mechanisms in Southeast Asia are small in terms of portfolio size and transaction volume and size, results demonstrate the transactions are addressing market gaps.

**EMIIF could be expanded. DFAT's bilateral programs, particularly in Southeast Asia, have signaled interest to invest bilateral funds in EMIIF using existing appropriations.** Raising EMIIF's investment cap is a key priority as it is the only Australian blended finance mechanism that can accept reflows and reinvest these according to Government priorities. DFAT projections show that with a total capitalisation of AUD250 million, EMIIF

would become cash flow-positive and potentially financially self-sustaining by 2030.

**Renaming EMIF would enhance brand recognition and indicate its connection to Australia.** Review consultations have highlighted that EMIF has limited brand awareness, which is partly due to its relatively small size. Renaming it to 'Australian Development Investments' (ADI) would enhance public diplomacy efforts.

**Australia's technical assistance programs could be used to facilitate increased commercial participation in blended transactions.** In Southeast Asia, programs such as P4I and the Global Infrastructure Facility support countries to identify and develop priority infrastructure. Through Convergence, the global network for blended finance, Australia is developing the pipeline of investible blended finance vehicles that bring scale and diversity for private investors. Expanding these investments provides further opportunities for Australia to influence the upstream design of projects and project pipeline.

**Scaling-up Australia's use of blended finance to support project development and early-stage project finance in Southeast Asia would help fill a key market gap.** PIDG is a market leader specialising in investments that de-risk pre-financial-close infrastructure through grants, early-stage equity, and guarantees. Expanding Australia's current investment in PIDG, including its subsidiary InfraCo Asia, would enhance Australia's influence inside infrastructure deals in Southeast Asia beyond the initial stages we usually support.

**There is an opportunity for Australia to scale up catalytic blended finance for climate-resilient and clean energy infrastructure.** Southeast Asia's ambitions to transition to clean energy, improve connectivity, and raise standards of living across the board require enormous investment in infrastructure. Current estimates place the need at USD3 trillion in cumulative investment to close the emission gap by 2030 to keep global warming below 1.5°C. Less than one per cent (or less than USD20 billion) has been invested to date (Bain, et al 2022). Australia could support the net-zero transition in Southeast Asia by drawing on Australia's expertise in clean and climate adaptive technologies and domestic climate financing experience through the Clean Energy Finance Corporation (CEFC). Supporting public financial management and mobilising private climate finance both count towards Australia's climate finance targets.

**The nascent market for carbon credits provides opportunities to support greater private sector engagement in the region through locally based partnerships** (see Box 3). While the market is still in its infancy, Australia can leverage its experience with the Women's Livelihood Bond to support market development through technical assistance and mobilising private sector investments to provide proof of market viability. Opportunities for supporting private sector engagement, particularly in the Pacific, have the potential to grow over time. This could have significant development impacts, particularly if investments are through new locally based partnerships.

### **Box 3: Attracting private financing to the region through carbon credit markets**

Signatories to the Paris Agreement have agreed to rules for cooperative approaches to mitigation under Article 6. The Paris Agreement and the United Nations Framework Convention on Climate Change (UNFCCC) recognise that carbon markets are a legitimate tool to catalyse global emissions reduction in the fight against climate change.

It is expected that both compliance and voluntary carbon markets could grow by up to 15 times their current size by 2030 to USD50 billion (TSVCM, 2021). The private sector is also sourcing carbon credits to support their own voluntary net-zero pledges. There is a role that Australia's blended finance could play to attract private sector financing for the next generation of carbon credits as the market develops. Australia is delivering technical capacity building and on-the-ground projects with Pacific neighbours to support carbon credit generation and the development of a high integrity carbon credit market.

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## Briefing Paper 3:

# Bilateral development finance institutions

## What are development finance institutions?

**Bilateral development finance institutions (DFIs) are commonly used by donor countries to invest in development projects at scale, often beyond the reach of grant-based development programs.** DFIs generate returns that can be used to grow investable capital over time to further support development outcomes. DFIs invest across a wide range of sectors including infrastructure, energy, finance (particularly fintech), and healthcare.

**As standalone financing institutions, DFIs have potential advantages compared to other financing approaches within Government, including stronger capability, more flexible financing instruments, and a distinct brand.**

DFIs can effectively develop capability as they can attract staff through competitive remuneration outside government pay structures. DFIs usually manage their own balance sheet allowing them to flexibly deploy a range of financing instruments and potentially manage risk more effectively, usually with oversight by government central agencies. DFIs can also operate autonomously and visibly to the public, which helps build recognition with their strategic partners, albeit with reputational risks to their government owners.

### Box 1: BII provides cornerstone capital for Ayana Renewable Power in India

The UK's DFI, British International Investment (BII), founded Ayana Renewable Power (Ayana) in 2018, injecting USD100 million in cornerstone equity capital. BII established Ayana to develop renewable energy generation capacity to support India's energy transition. BII selected an independent board and management team with experience in the Indian power sector to run the business.

By financing Ayana's inception, BII sufficiently de-risked the investment to mobilise over USD230 million in 2019 from third parties: India's National Investment and Infrastructure Fund (NIIF) and Lightsource BP (BII 2019). In 2020, Ayana's shareholders collectively committed USD390 million in additional funding (BII 2020), off the back of Ayana's demonstrated success and future growth plans. BII maintains a minority position in the company.

**Many modern DFIs began as government-owned private sector development vehicles established in the post-war era but have evolved in recent years to meet changing needs.** For example, in 2019 the US Government established the US International Development Finance Corporation (DFC) out of the Overseas Private Investment

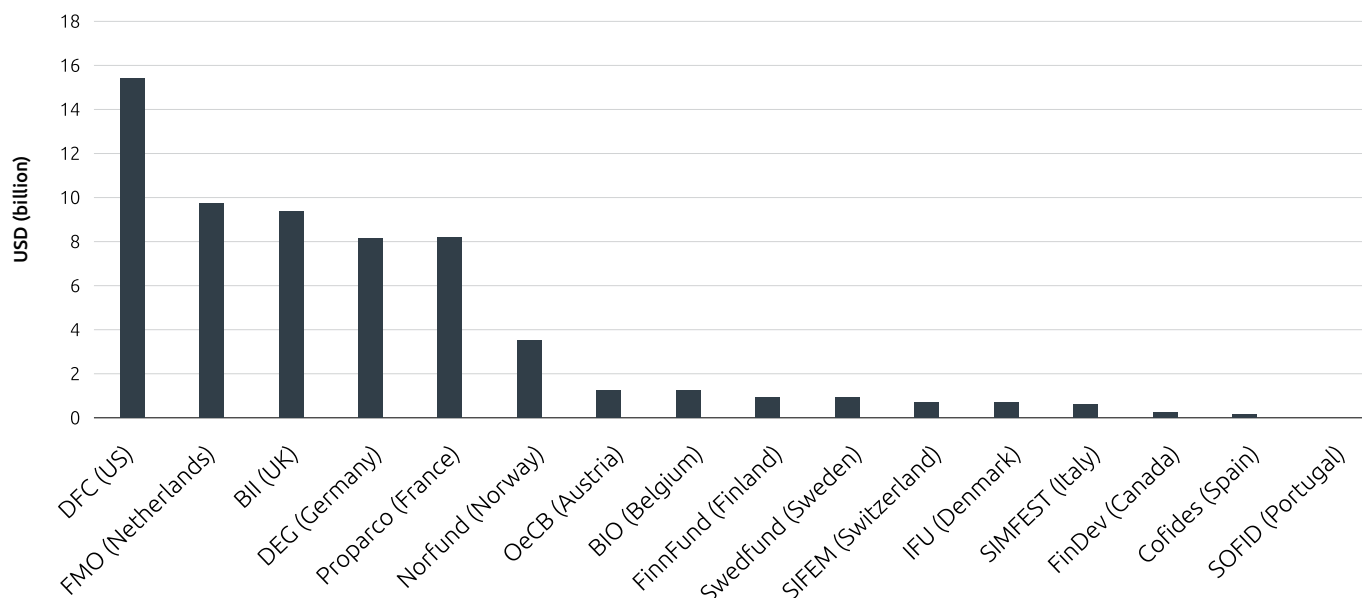
Corporation (OPIC) to expand the flexibility and reach of US development finance. Similarly, British International Investment (BII) was established in 2021 by rebranding the UK's Commonwealth Development Corporation and enabling it to directly invest in equity to support development.



**The ability to scale DFIs is a highly attractive feature for donor governments, and DFIs vary greatly in size.** For example, total investment by DFC is currently around USD15 billion but its

investment mandate has recently been increased to USD60 billion. There also exists significant heterogeneity across the actual investment size of DFIs (see Figure 1).

**Figure 1: Development finance institutions by total investment portfolio in 2021**



Source: DFI websites

## Features of development finance institutions

**The financial structure and source of funding are instrumental in determining the risk appetite and return requirements of a DFI.**

Debt-capitalised institutions (even those with sovereign guarantees) must generate returns at least equal to their cost of capital, potentially leaving them exposed to fluctuations in global interest rate markets. Equity-capitalised DFIs, particularly those that are grant financed, may not be subject to the same return constraints. BII is funded solely from equity capital, with the UK Government its only shareholder. In contrast, the US DFC does not have substantial equity, but finances individual transactions by borrowing from the US Treasury at rates determined on an agreed formula that accounts for the US Government-determined borrowing country sovereign risk rating. Both DFIs are required to make a positive return. The profiles of DFI portfolios provide an insight into their relative

risk tolerance, with equity investments generally considered higher risk than loans. For example, the portfolio of the Development Finance Institute Canada (FinDev Canada) is 60 per cent equity and 30 per cent loans; this differs from BII which is 82 per cent equity and 17 per cent loans; which in turn is different from the US DFC (95 per cent loans) (Palladium, 2022).<sup>1</sup>

**Regulation is an important factor in determining the risk tolerance of DFIs.** DFIs that are regulated like banks must conform to capital adequacy requirements (such as Basel III standards). This requires a portion of their capital base to be held in safe, liquid assets, limiting their ability to fully deploy capital to riskier investments. This is the case for the Dutch Entrepreneurial Development Bank (FMO).

**By focusing on projects that generate financial returns, DFIs are useful models for mobilising other sources of finance, particularly when they can tolerate a higher level of risk than private sources.** DFIs can de-risk transactions to mobilise private sources of finance that otherwise

<sup>1</sup> DFC's mandate was only expanded to allow equity investment at the end of 2019, with total equity exposure capped at 35 percent of their portfolio.

would not invest, such as through guarantees (see Box 2). More broadly, de-risking approaches can involve providing a demonstration effect, the use of first loss provisions (junior debt or equity), the provision of guarantees or insurance, or cornerstone equity.

**Many DFIs have not demonstrated significant success in mobilising private finance.** The Center for Global Development (CGD) argues that a mobilisation ratio upwards of 4:1 is achievable, yet existing DFIs only mobilise between USD0.6–2.6

of private finance for every dollar DFIs deploy (Lee and Preston 2019). CGD also highlight that the risk tolerance of DFIs is comparable to commercial financiers. Despite their potential to mobilise capital, few DFIs have mobilisation targets. Instead, CGD notes that most DFIs have organisational cultures backed by performance incentive schemes designed to reward transaction volume. To maximise opportunities for total capital flows, DFIs could prioritise mobilisation over transaction volume and use their capital base to leverage private sector investment.

### **Box 2: USAID DCA provides partial guarantee for Tropical Landscapes Bond in Indonesia**

The US Agency for International Development's (USAID) Development Credit Authority (DCA) historically provided partial guarantees to borrowers to encourage financial institutions to provide loans to businesses and sectors important to development. This function has now been absorbed by US DFC.

In 2018, USAID provided a partial credit guarantee early in the development of the Tropical Landscapes Bond. The guarantee offered institutional investors the opportunity to invest in a bond with high environmental returns and an investible risk-return profile. BNP Paribas led fundraising efforts and successfully secured USD95 million.

Some proceeds of the bond funded PT Royal Lestari Utama, a joint venture between the Michelin Group (France) and the Barito Pacific Group (Indonesia), to encourage production of climate-smart natural rubber. PT Royal Lestari Utama operates three licenses in Indonesia covering 88,000 hectares of land which have been heavily deforested. The company also provided USD15 million in subordinate debt towards the bond, as well as USD3.5 million in first loss capital.

The rubber industry in Indonesia carries high financial and reputational risks for investors. The DCA guarantee was a critical piece in de-risking the structure for private investors (Palladium 2022).

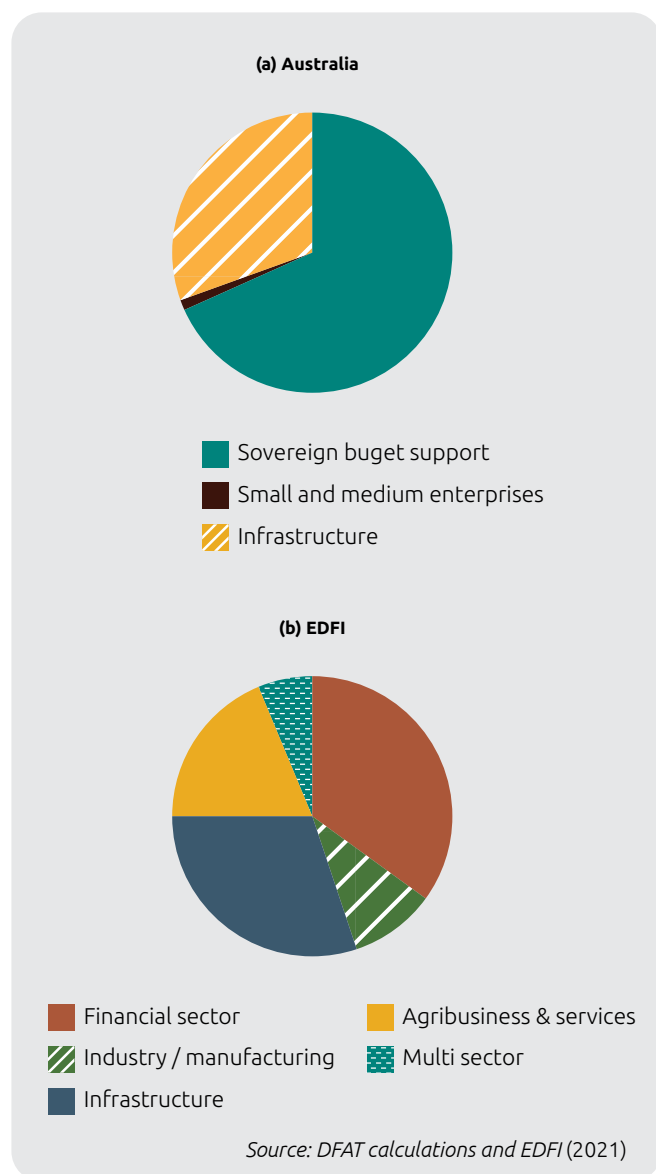
**Donor governments shape DFIs to meet their own objectives.** DFIs have their own mandates, cultures, priorities, capabilities, finance sources and degrees of independence. Projects and transactions that are suitable for one DFI may not be suitable for another. However, many transactions are financed by more than one DFI, with each bringing their own experience, expertise, priorities, and instruments to transactions. DFIs often refer deals to one another where they lack an in country presence in the host country or are unfamiliar with the asset type.

**Currently, most major DFIs have very different investment priorities to Australia.** Figure 2 highlights the differences in Australia's development finance portfolio allocation compared with European DFIs, although direct comparisons are made difficult by differing nomenclature conventions. In general, DFIs do not

provide sovereign finance, a major distinction from Australia's current offerings.

**All DFIs report on their development finance portfolio and development impact, albeit with different approaches and varying levels of transparency.** According to James, et al (2023), the multilateral development banks (MDBs) represent best practice in transparency, while DFC is the strongest amongst bilateral donor DFIs. DFC performs well due to its quarterly publication of detailed investment-level data, including details of environmental and social risks. Other DFIs, such as BII and FinDev Canada, publish development impact using a harmonised measurement approach, the Joint Impact Model, which identifies the impact of investments on a range of indicators, including the economy, employment, and carbon emissions.

**Figure 2: Breakdown of development finance allocations**



## The experience of DFIs in Southeast Asia and the Pacific

**Other than Japan, bilateral DFIs currently have a limited footprint in Southeast Asia and are even smaller in the Pacific.** Most DFIs have geographic mandates that align with their government's foreign and development policy priorities. For European and North American DFIs, this is typically in South Asia, Latin America and Sub-Saharan Africa, and these regions attract approximately two-thirds of all finance from European DFIs. In contrast, only one per cent of BII's portfolio is in Southeast Asia and it has virtually no presence in the Pacific. Most DFIs focus on commercially (or near commercially) viable non-sovereign finance which precludes

many potential deals in the Pacific due to weak risk adjusted returns and the presence of state-owned enterprises (SOEs) and government in most deals. In addition, investing in a new region requires building up capability and involves taking on new risks or accepting lower returns. Some DFIs have national content requirements, potentially restricting DFI investments if their country's businesses do not have a presence. The Pacific has the additional burdens of remoteness and small size, contributing to high costs of doing business, and making it difficult for projects to achieve economies of scale.

**Australia has demonstrated success in mobilising like-minded DFI finance to support deals in the Pacific and Southeast Asia by structuring deals compatible with their risk tolerance.** Australia's existing cooperation with DFIs has been through individual bilateral grant programs (for example with DFC in Indonesia, see Box 3), Export Finance Australia (EFA), and the Australian Infrastructure Financing Facility for the Pacific (AIFFP) (for example, the Trilateral Infrastructure Partnership and the Palau Submarine Cable).

### Box 3: Partnering with DFIs using grants – Indonesia Resilience Fund

COVID-19 created significant working capital shortages across Indonesia as supply chain constraints and lockdowns put pressure on payment systems. Traditional and alternate lenders faced their own credit crunch, limiting the extent to which they could provide short-term working capital loans for small and medium-sized enterprises (SMEs).

To improve liquidity for SMEs, DFC provided a 70 per cent partial credit guarantee (equivalent to USD28 million) for loans made by the Indonesia Resilience Fund, managed by Impact Credit Solutions. The guarantee helped mobilise USD40 million from Bank Central Asia (BCA) into the Fund, which on-lends to financing platforms that support SMEs in the healthcare and essential goods transportation sectors (EWS 2021).

Australia contributed USD315,000 to DFC to secure a guarantee. Australia's contribution, alongside grant finance from USAID, sufficiently improved the financial viability to enable DFC to provide a guarantee.

## Considerations for an Australian DFI

**Australia has long faced calls to establish a DFI, particularly as most other major donors have DFIs.** In 2018, DFAT commissioned a Feasibility Study into Expanding the Australian Aid Program's Development Finance Options referred to as the 'Eyers Review' (DFAT 2019). While the Eyers Review did not specifically recommend establishing a DFI, it identified several institutional models for scaling up development finance, including establishing a standalone institution. However, Australia's suite of mechanisms has evolved significantly since 2019, including the expansion of EFA's infrastructure powers and the establishment of AIFFP and the Emerging Markets Impact Investment Fund (EMIIF).

**The regions of focus for Australia's development program have historically been less well-suited for development finance.** The Pacific lacks the scale to make use of finance usually oriented at private markets. Other major donors (particularly the UK, Eurozone countries and the US) issue loans in major currencies, making them less appealing to recipients. With a relatively small financial sector, Australia lacks the large pool of international finance professionals that are critical to the functioning of a DFI.

**Australia already has many of the tools of a DFI at its disposal through existing mechanisms.** Australia's decentralised suite of mechanisms has grown organically in response to evolving strategic imperatives, each managed and

governed by independent processes. Despite lacking distinct 'DFI' branding, Australia retains many DFI-like functions; for example, deploying non-grant financing instruments, recycling capital, and housing strong investment expertise within EMIIF, AIFFP and EFA. EFA has the financial toolkit and ability to manage staffing capability effectively and sustainably but does not have an explicit development mandate of a DFI. AIFFP's infrastructure mandate and EFA's infrastructure powers provide these mechanisms with functions similar to DFIs.

**Australia can achieve many of the benefits of a DFI (and retain a pathway to a DFI in the future) through a gradual expansion and evolution of existing mechanisms, consistent with the recommendations in the Review.** Establishing new institutions is time consuming and requires several years before reaching maturity. This can undermine the urgency of development finance needs and impose significant establishment costs. At this time, Australia can achieve many of the benefits of a DFI without incurring establishment costs of a new institution by scaling up existing mechanisms, such as EMIIF, improving governance across mechanisms, and enhancing coordinated public reporting. Scaling up mechanisms within DFAT would also provide the experience and learnings from operating development mechanisms at a scale commensurate with DFIs. In time, Australia can review the effectiveness of these measures and reassess the case for deeper structural changes, including an Australian DFI.

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## Briefing Paper 4:

# Philanthropic and impact investors

### Philanthropic and impact investors offer Australia the potential to leverage private finance for development outcomes in the Indo-Pacific, despite their diverse interests and approaches to financing.

Globally, philanthropic and impact investment sectors are large, with assets amounting to around USD1.5 trillion and USD1.2 trillion, respectively (Johnson, 2018; Hand, et al, 2022). Despite the size of the market these investors are comparatively less active in Southeast Asia and the Pacific (GIIN, 2020).<sup>1</sup> Leveraging this global pool to support Australia's region, even at the margins, could have a significant impact on human development.

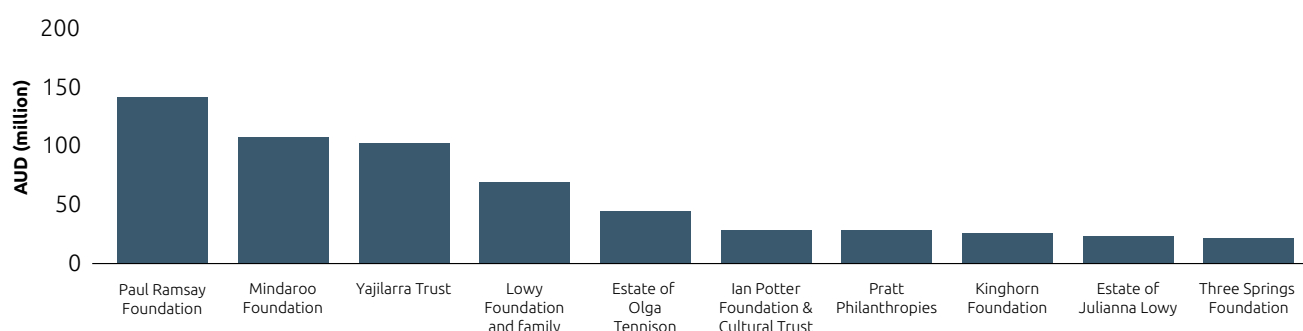
**The Australian philanthropic and impact investing markets are growing but remain relatively small compared to the global (mainly US) market.** Annual financing from these sources amounted to around AUD2 billion in 2021; were

this all directed to financing development it would be equivalent to almost a half of Australia's Official Development Assistance (ODA) program.<sup>2</sup> The three-year average growth rate (2019–2021) of the impact investing market in Australia was 50 per cent (RIAA, 2019; 2020; 2021) while it was 28 per cent for the top 50 Australian philanthropists (AFR, 2019; 2020; 2021).

### Flows of finance from Australian philanthropies and impact investors to emerging markets are modest.

That said, philanthropies can be highly catalytic in mobilising private investment. They can deploy concessional finance to de-risk high development impact projects in emerging markets which in turn crowds in private or commercial investment.

**Figure 1: Top 10 Australian philanthropies<sup>3</sup> (2020–21)**



Source: AFR (2022)

- <sup>1</sup> According the 2020 Impact Investor Survey the United States and Canada constitute the largest share by assets under management (AUM) at 30 per cent while Southeast Asia constituted at 3 per cent AUM. Oceania (including Australia and New Zealand) constituted 5 per cent AUM.
- <sup>2</sup> In Australia, grant financing from the top 50 Philanthropists was AUD942m in 2020–2021 (AFR, 2022). Total impact investment assets under management in Australia reached AUD30 billion in 2021, up from AUD29 billion in 2020 (RIAA, 2022). The total investment value is for all investments by philanthropic and impact investors, both domestic and international investments.
- <sup>3</sup> This has been constructed as the total capitalisation of philanthropies in the AFR Top 50 that state they have an international mandate, that being total investment capital available for all investment, and provides an estimate of the maximum contemporaneous market size.

## Philanthropic investors

**Philanthropic capital can invest alongside ODA in the riskiest, and most catalytic, aspects of development projects.** Philanthropic capital tends to focus on private grants to achieve social, environmental, or humanitarian outcomes. Philanthropic grant funding is most often generated by investing an endowment and disbursing a portion of returns each year as grants to charitable activities. While philanthropic

foundations generally target sub-commercial returns, many are increasingly carving out larger portions of their investment endowment for impact investment, seeking measurable social or environmental outcomes alongside market returns. Since they are highly geared towards social impact, philanthropies can be more flexible and experimental than other private capital providers subject to their legal structure and mandate (see Box 1).

### Box 1: Rockefeller Foundation and the IIX Women's Livelihood Bond Series

The Women's Livelihood Bond (WLB) Series is the world's first gender-lens impact investing security listed on a stock exchange (the Singapore Exchange) (see Box 1, Briefing Paper 2).

For the second WLB issuance, the Rockefeller Foundation provided USD1.5 million first loss subordinate debt to complement a 50 per cent partial credit guarantee from USAID. Rockefeller's subordinate position combined with USAID's guarantee lowered the risk profile of the bond to crowd-in USD12 million private investment (seeking market rate returns) for affordable loans for women-led businesses in Southeast Asia.

Australia provided AUD1.16 million in grants for proof of concept, and to cover costs associated with guarantees provided by the US. Building on the success of the WLB Series and gaining inspiration from the success of green bonds, the IIX (a women-led Southeast Asian based organisation) has gone on to establish the Orange Bond Initiative (Orange being the colour of SDG5 Gender Equality). With the support of Australia, the US, ANZ and others, it is setting principles and standards for gender equality investment bonds. The early backing provided by the Rockefeller Foundation has helped catalyse a new women's economic empowerment asset class for private sector investment.

**Despite the relatively small size of the global philanthropic market, their grants can dwarf those of ODA providers on certain issues.** For example, the Bill & Melinda Gates Foundation committed USD1.2 billion of the USD2.6 billion currently pledged for the Global Polio Eradication Initiative 2022–26 strategy, while Bloomberg Philanthropies pledged USD70 million. The USA and Australia committed USD114.25 million and USD28.1 million respectively.

**Philanthropies have dedicated expertise and experience in their specialist areas of interest that can be leveraged through meaningful engagement and collaboration for better development outcomes.** The role of philanthropy includes advocating and supporting global change, supporting local solutions at a small scale, addressing gaps that neither government or existing markets occupy, and empowering people to engage in a variety of social issues

(Bellegy et al 2019). They can also be highly catalytic, including through the personal influence of the high-net-worth individuals that back them. The market signals philanthropies provide can have a powerful impact on financial and commercial practices, and investment focus well beyond the direct work of the philanthropic enterprise.

**Philanthropy for development is more than just a source of financing.** A narrow focus on financial scale instead of the wider scope of philanthropy in development, misses the role these organisations play. In reaching those sections of markets and populations which governments, donors and private sector investors often cannot philanthropies play a vital role from the deployment of capital, through to promotion of human rights and democracy.

## Impact Investors

**Impact investors participate in investments with the explicit intention to generate positive, measurable social and environmental impact alongside a financial return.** Ideally, impact investment also provides additionality so that there are benefits beyond those that would have occurred in the absence of the investment (RIAA, 2022). The focus on measurable impact can also improve the reporting of development impact through building capability across other investor classes.

**Impact investments target a range of returns from below market to market rates, depending on investors' strategic goals (GIIN, 2019).** Most impact investments target a risk-adjusted market rate of return (GIIN, 2020).<sup>4</sup> Impact investors also deploy a range of financial instruments including private debt, public debt, private equity and equity-like debt (GIIN, 2020).<sup>5</sup> Together this means that impact investors can engage with development finance across a range of risk-return profiles and through a range of instruments making impact investors a very flexible source of co-financing.

**There is a high level of interest amongst Australian impact investors in Indo-Pacific investment opportunities, particularly in climate and gender equality.** Investors involved in a DFAT commissioned study by Ecotone Partners described themselves as either 'Quite interested but needing to understand the market more' (57 per cent) or 'Very interested and actively evaluating deals' (19 per cent) (Ecotone Partners, 2022). Both climate and gender equality are significant areas of interest for impact investors. With increasing experience and actual impact investment deals to bring to the table, DFAT can act as a bridge for Australian impact investors who are interested to collaborate, engage and invest in the region.

## Australia's engagement and opportunities

**Submissions to the Review, and stakeholder interviews have emphasised Australia's engagement with the private finance community, including philanthropies and impact investors, has been ad hoc and lacks strategic clarity.** For example, engagement with philanthropies has been through individual teams within DFAT, or through outreach by individual DFAT posts for humanitarian and development support.

**There is an opportunity for DFAT to engage in a more meaningful and scalable way with Australian and international philanthropies.** DFAT has typically partnered with philanthropic foundations through pooling grants; for example, through the Global Polio Eradication Initiative (GPEI) and Gavi, the Vaccine Alliance, or direct partnering, for example, with the Bloomberg Foundation bringing their Data for Health initiative to the Indo-Pacific, but almost never in blended finance investments. As private and commercial investors often closely follow the deployment of finance by philanthropies, such investments can trigger subsequent investments by those investors. Similarly, by taking leadership in early-stage finance, governments can act as path finders for private investors, including philanthropic finance, providing confidence in the viability of projects before more risk averse sources are prepared to invest.

**Several barriers to working with philanthropies highlight opportunities to improve engagement between DFAT and philanthropies.** These barriers include finding partners who have aligned interests; the administrative costs of managing resources from multiple organisations; and formalising a collaborative contractual agreement. Considering these, DFAT's current engagement with philanthropies highlights two clear gaps. First, there is currently no central point in DFAT for philanthropic foundations to engage with, so outreach is either sectoral, country, or specific issue based. Second, there is no clear statement of intent from Government to development philanthropy, and a general

<sup>4</sup> The Annual Impact Investor Survey 2020 finds 67 per cent of impact investors target risk-adjusted, market-rate returns, 18 per cent target below market rate returns closer to market rates, and 15 per cent target below market rate returns to ensure capital preservation.

<sup>5</sup> The Annual Impact Investor Survey 2020 finds private debt investments constituted 37 per cent of capital (61 per cent of investments); public debt constituted 24 per cent of capital (16 per cent of investments); private equity 10 per cent of capital (2 per cent of transaction).

lack of understanding of Government's value proposition to philanthropy. This means mutually supportive opportunities to engage, be it financial, or through knowledge or network sharing, are likely being missed.

**DFAT has a growing portfolio of impact investments and engagement with impact investors, however barriers remain to greater mobilisation.** Through DFAT's blended finance, impact investment and gender lens investment (GLI) programs DFAT has increased its engagement

with Australian and regional impact investors (see Box 2).<sup>6</sup> The Ecotone study into the impact investing landscape commissioned by DFAT emphasised that while impact investing is growing rapidly, interest is limited in emerging markets. This is driven mainly by a lack of familiarity investing in emerging markets leading to higher perceived riskiness of these markets and ultimately under allocation to emerging markets (Ecotone Partners, 2022).

### **Box 2: EMIIF equity investment into Southeast Asian Women's Economic Empowerment Fund**

In October 2022 DFAT's Emerging Markets Impact Investment Fund (EMIIF) made a landmark equity investment of AUD5.6 million into the Southeast Asian Women's Economic Empowerment Fund (SWEEF). EMIIF's investment was instrumental in catalysing additional private finance needed to reach its second financial close of USD23 million. This included investment from Australia investors: Tattarang (one of Australia's largest private investment groups owned by the Forrest family); the Scalzo Family Office; and an Australian high-net-worth individual.

SWEEF targets businesses that are led by women entrepreneurs; operating in sectors which generate employment for women; and providing vital products and services for women and girls.

SWEEF's sectoral focus includes healthcare (29 per cent), education (16 per cent) and food processing (39 per cent) in Vietnam, Indonesia and the Philippines. Businesses in SWEEF's advanced pipeline include medical devices manufacturer, after school education business and a food manufacturer.

The Australian investors were given access to EMIIF's extensive due diligence and EMIIF Investment Committee findings to help their investment processes. One of the investors provided the quote:

'The Emerging Markets Impact Investment Fund's support for SWEEF was influential in our decision to invest.'

**DFAT can build on its deep knowledge of developing markets and gender lens investing to mobilise impact investors in greater scale into the Indo-Pacific through blended finance structures.** DFAT can use its deep knowledge of investing in developing markets through its blended finance mechanisms and its post networks to help overcome existing barriers to impact investor mobilisation. This could include DFAT facilitating familiarity and relationship building between impact investors and other market participants in the region; supporting due diligence for investor decision making, particularly in new emerging market funds; leveraging DFAT's GLI leadership to mobilise impact investors into gender focused investments; and co-investment

opportunities alongside DFAT to encourage investment through de-risking.

**A central point of contact focused on the philanthropic sector would improve collaboration and engagement and ensure cohesion with central and domestic agencies working with philanthropies.** Establishing a dedicated unit with the expertise to engage in a more sophisticated and curated way with the philanthropic community is a common solution internationally. For example, USAID recently established a Philanthropic Engagement Unit in its Partnerships, Policy and Learning Division to improve its coordination with philanthropies. While the US philanthropic landscape is significantly different from

<sup>6</sup> DFAT has been an early adopter of GLI, which is a form of impact investment that builds the consideration of gender (for example, gender biases, gender patterns, risks related to gendered behaviour) into the investment process. This allows investors to achieve better gender equality outcomes. All DFAT's blended finance and impact investments take a GLI approach.



Australia's, the Government could consider a similar approach.<sup>7</sup> This would send a clear signal that the Government is open to explore the potential to partner for mutual benefit in regional development and climate action. Any unit would need to draw on specific financing experience and expertise not generally found within DFAT to ensure it can best unlock the full suite of resources the private finance community offers.

**The new unit would develop and implement a strategy for enhanced engagement and collaboration with the private finance community to highlight the value proposition of new partnerships, including by leveraging Australia's blended finance mechanisms.**

Strategy implementation would include the unit supporting the development of co-investments through technical assistance, pipeline scoping and analytical work. Implementation could also involve small-scale catalytic finance for individual investments to further overcome the barriers to greater private finance participation in development and climate investments. The development and implementation of an engagement strategy will provide pathways for philanthropies to co-invest in DFAT's larger blended finance, such as through an expanded and renamed EMIF. The resource implications for the engagement unit would be minimal and its activities funded through reprioritisation of existing allocations.

**DFAT should ensure that any initiative set up to improve engagement with the private finance community is aligned with domestic efforts.** Through the Social Impact Investing Taskforce (Taskforce), the Department of Prime Minister and Cabinet (PM&C) and the Department of the Treasury have been leading work to develop recommendations on a strategy for the Government's role in the social impact investing market and a way forward for Commonwealth social impact investments. The Taskforce has consulted widely (including with the private sector, philanthropies, and NGOs) and undertaken commissioned research on social impact investing interventions, social impact reporting frameworks and potential opportunities in Australia for large scale social impact investments (PM&C 2020). The Taskforce has released an Interim Report that identifies key initiatives for immediate implementation and key action areas to develop a mature and sustainable social impact investing market (PM&C 2020). Looking forward, DFAT should draw on the Taskforce's review and recommendations, and ensure it is aligned to any new DFAT-led initiative designed to improve engagement with the private finance community.

<sup>7</sup> US philanthropies provide more than half of global philanthropic funding and their global and US political influence is commensurate with their size.

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