Information Note

Changing the paradigm of concessional financing as innovation finds its way in development financing

The President of the Islamic Development Bank (IsDB), Dr. Ahmad Mohamed Ali recently launched an innovation drive at the Bank and invited staff to develop innovative ideas and projects that will better serve its member countries. In response to this call, The Vice President, Operations led a Bank-wide team to engineer an innovative *"Triple-win"* financing mechanism after months of negotiations and interactions with the Bill and Melinda Gates Foundation (Gates Foundation). This new and innovative financing mechanism, that is compliant with *the Islamic modes of financing*, holds promise for millions of people as more concessionary financing is made available to developing countries in Africa and Asia. It enables Multilateral Financial Institutions (MFIs) to increase the quantum of concessional financing they could offer to their developing member countries. This is exemplified in a pilot project in which the IsDB offered all the resources needed to close the financing gap to support national responses to Polio Eradication in Pakistan as part of the Global Polio Eradication Initiative (GPEI). Together with the Gates Foundation, the IsDB has declared their support, also for the eradication of polio in Nigeria and Afghanistan and then extend use of the financing mechanism to tackling the eradication of Malaria and overcoming Food Insecurity.

Complementing the "buy down" mechanism and the "loan conversion" model that the Gates Foundation had with the World Bank (WB) and the Japan International Cooperation Agency (JICA) respectively, this newly engineered financing mechanism also avails considerable amount of ordinary resources, softened through philanthropic contributions, to social sector programs/projects in a developing country. It enables the Bank to tap into its ordinary resources to augment its concessional pool and thereby extend a large quantum of financing to a member country to address a pressing development challenge, while the member country only pays the principal, and the Gates Foundation pays the mark-up and/or the service fee. As opposed to other MFIs, IsDB's concessional resources come from its capital base and not from member contributions as in International Development Assistance (IDA) of the World Bank, African Development Fund (AfDF) or the Asian Development Fund (AsDF).

With this financing mechanism, the responsibility to effectively implement the project remains mainly with the recipient government. This enhances national ownership and strengthens the developing country's occupation of the driver's seat for its development, in line with the aspirations of the Paris Declaration and Development Effectiveness.

A marvel of this new financing mechanism is in its *"win-win-win"* nature as all three partners stand to win. In the pilot case, Pakistan is able to obtain financing for all it needs (US$ 227 million in this case) to address a pressing development challenge (Polio Eradication in this case) and pays back only the principal. By paying the mark-up for the ordinary component and administrative service fee for the concessional component (averaging US$ 3.55 million per year), the Gates Foundation is able to pool its risks in achieving one of its philanthropic goals and at the same time, is able to finance more projects in many more countries from the resources it would have spent only on this project. The IsDB is able to provide financing with considerably more resources to a member country to enable it to address a pressing development challenge without jeopardizing the debt sustainability standing of the country.

During the signing ceremony of the IsDB-Gates Foundation MOU at the sidelines of the 2012 UN General Assembly Meeting in New York, IsDB President Dr. Ahmad Mohamed Ali said, "*if successfully implemented in Pakistan, this financing mechanism will be a ground breaking innovation that will avail considerable concessional resources for development finance, and open new opportunities for* Least Developed Member Countries *(LDMCs) to access resources for investment in social and agriculture sectors".* The financing mechanism also holds promise for mobilizing financing infrastructure deficits in Africa and Asia.

Another marvel of the "triple-win" innovative financing mechanism is its contribution to the on-going reflections on the future of concessional financing, as global circumstances change, aid budgets tighten, and the urgency for financing global public goods increase. Through the new financing mechanism, concessional funding could be increased if the grant allocation of IDA, ADFs could be used as m*ark-up subsidy funds* to leverage on the huge amount of financial resources in the market, which could end up being considerably greater than the initial grant amount. With the increased quantum of resources, many more projects, in many more countries could be financed. For example, a US$ 1 Billion market loan could be softened to a charge free loan through a stream of annual markup payment of US$ 3.7 Million for 15 years. This stream of markups has to come from sustainable sources such as: (a) net income allocation of MDB's; (b) philanthropic foundations for cause-based programs/projects; (c) sustained grant allocation from replenishable funds such as IDA and the two ADFs; (d) Investment funds with returns used as subsidy for market resources.

As a matter of fact, packaging for trading the projects financed by this debt instrument could be an attractive prospect because of its low-risk profile, hence lowering its cost. The investor could bear a sovereign risk for the principal, while the philanthropist, the MDB's replenishable fund, or MDB net income, etc., could bear the risks for the markup. This low-risk investment could be attractive to private and sovereign wealth funds.

The "triple-win" innovative financing mechanism has the potential to unleash tremendous growth in developing countries if it could be replicated in sectors such as infrastructure. For many of IsDB's LDMCs, infrastructure deficits (energy, transport and water and sanitation) are among the major binding constraints to development. The cost of addressing the infrastructure deficits is always overwhelming for many countries and the concessional financing available is not enough to address them. For example, the World Bank estimates for infrastructure development needs in Africa could cost up to US$ 93 billion a year; New Partnership for Africa's Development Agency (NEPAD)'s Programme for Infrastructure Development in Africa (PIDA) needs at least US$ 68 billion to finance regional projects in energy, transport, trans-boundary water and ICT sectors; and the IsDB estimates that for 20 of the 22 Sub-Saharan African member countries, the cost of eradicating poverty is at least US$ 17.6 billion per year for the period 2011-2015. Yet, the supply of concessional financing from the main multilateral financial institutions is dwarfed by the needs. For example, IDA 16 is US$ 49.3 billion, the AfDF-12 is US$ 9.4 billion; AsDF XI is US$ 12.4 billion; and IsDB concessional financing for a three-year period is US$ 1.25 billion. Hence by potentially expanding the pool of concessional financing, the mechanism helps add to these.

Recognizing the tremendous opportunity that this innovative financing mechanism could create for IsDB member countries, especially within the context of the Bank's special programs, The IsDB Vice President Operations said that *"extending this mechanism to infrastructure development could increase the pool of financing available to LDMCs by almost ten-fold and also help address the energy deficit, expand the inadequate road network and thereby increase the competitiveness of our member countries – all these without debt unsustainability overhang".*

In effect, the "triple-win" financing mechanism could enable the use of ordinary/non-concessional resources of MFIs coupled with market funds to finance projects in developing countries that would not, otherwise, have been possible, and in greater quantum than before – thereby changing the paradigm of concessional financing.

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