Herman Bril: "We need to build a bridge between the world of development finance and private investors"

Amsterdam, February 2016. *By Cardano Development.*

The recently agreed UN Sustainable Development Goals (SDGs) require in the order of USD 2-3 trillion per year additional funding for emerging markets and developing economies (EMDEs). The biggest sums are required for infrastructure, climate change, and agriculture. Herman Bril, Managing Director at Cardano Risk Management Limited in London, researches the role of Multilateral Development Banks "MDBs" and Development Finance Institutions "DFIs" as financial intermediaries operating in financial markets. His aim is to understand how these institutions can better leverage their role and mobilize private investors. The research is part of the dissertation of his Masters of Studies in Sustainability Leadership at the University of Cambridge and serves as a feasibility study for Cardano Development. We've asked Herman to tell us more about his motivations for the study, and to give us an insight into the initial findings of his research.

Herman: "In recent years it has become obvious that we all need to work together on creating opportunities and solutions for billions of people living in EMDEs to improve their lives in the broadest sense. The SDGs are very ambitious targets to achieve these much needed improvements. But this requires big investments from both public and private, national and international sources for the next decennia. So this is not about solving a 'one million dollar' question but a multiple trillions of dollars challenge. These amounts of money may be overwhelming, but when you note that global savings are at around USD 22 trillion per year, there should be ways to bridge the finance gap."

On bridging the sustainable development finance gap

Herman has worked as Managing Director of Cardano Risk Management for 7 years now. The company helps pension funds, insurance companies and other organisations to become more resilient, and apply this approach across a range of fiduciary management, risk management and investment advisory services. There is a growing pressure on institutional investors, such as pension funds, to include SRI and ESG in their investment portfolio. We seek Herman's opinion on what constitutes the right balance between public and private finance to fund the SDGs in Emerging Markets and Developing Economies?

> *"Developing and promoting private entrepreneurship and implementing market based solutions or financial risk mitigating solutions, is the only sustainable way for economic growth and development."*

Herman: "We literally need to build a bridge between the world of Development Finance and private investors, such as institutional investors, in OECD countries trying to improve to match global demand and supply in finance. These two different finance worlds hardly know each other and are not connected sufficiently. The right balance does not exists and is very different per country depending on GDP per capita, institutions, macro-economic and monetary policy and a whole range of factors. The poorest countries are really dependent on Official Development Aid (ODA). Ultimately every country need the bulk of the finance coming from local private and public sources – like the tax base – but supplemented with private international funds like Foreign Direct Investments (FDI). To get there, MDBs and DFIs can play a catalyst role to provide what they call Other Financial Flows (OFF) and mobilize private investors."

On the realism to assume that these large sums of money will be invested

Financing of the UN SDGs requires 2-3 trillion dollars every year, with additional financing for infrastructure estimated between 5 and 7 trillion dollars annually. Your research covers the role of MDBs and DFIs in the mobilization of private finance, is the current volatility in international markets a threat to the feasibility of this? How realistic do you think it is that these trillions will be sourced and sufficiently allocated?

Herman: "In reality this will be extremely challenging for many reasons. Market stress and volatility always leads to risk aversion, especially by private investors. Moreover, many projects are not bankable, the safeguard requirements are not always achievable, too much country risk or perceived risk, corruption, lag of legal and institutional framework; and many other obstacles. There is a central role for MDBs and DFIs to create the demand by providing TA and other forms of expertise to make projects bankable. It is extremely important that MDBs and DFIs provide additionality through the cycle of booms and busts and sometimes have to act as lenders of last resort in some countries."

How to crowd in new investors and private capital

Based on your experience with advising institutional investors in The Netherlands and the UK, can you elaborate more on potential financing mechanisms to tap capital markets, institutional investors? What is needed to crowd in their commitment and capital? Especially for infrastructure finance?

Herman: "MDBs and DFIs can be more active as 'originate and distribute' financial intermediaries instead of 'asset gatherers'. They could become more active in syndicated loans, co-financing, parallel loans or securitizations and recycle their assets to the institutional investors. These techniques can potentially be blended with guarantees if institutional investors have issues with the perceived risk/return. Another technique is tranching for different type of risk / return rated notes in case of securitization."

Herman: "Regarding infrastructure, the biggest challenge is the initial development phase. This is the most risky part for investors. Once the project is ready and operational it starts to produce a more steady cash flow stream which institutional investors are willing to pre-finance. So MDBs and DFIs can provide additionality in the initial phase dealing with stakeholders, safeguard requirements, and documentation before institutional investors step in the second phase of the project. Moody's did a very interesting long term study on the risk of infrastructure and it clearly showed the sharp risk reduction after the first years of the project."

On the role of innovative financing mechanisms

In 2010 Cardano Development was initiated to broaden the philosophy of providing stability and resilience through financial risk management techniques to frontier markets where access to these services is limited. Under the leading role of Cardano Development new initiatives like BIX Capital, Coin Re and Impact Loan Exchange are created, and funds such as FrontClear and TCX have been established. At the beginning of 2016, Cardano Development and its initiatives have become a company with over USD 800 million assets under management, 30 employees. As the former Director of Cardano Development, you have experience in developing innovative financial risk management solutions and setting up funds to mitigate financial risks in frontier markets. We wonder how significant the role of financial innovation will be.

Herman: "Financial innovation is crucial in my mind. And the reason is that this massive funding gap requires scale to make a meaningful impact. Scale can only be realized if institutional investors are stepping up. But they will only invest at scale if they can invest in rated, liquid and market risk/return bonds. A good example is the mortgage bond markets in OECD countries were banks originate the loans but fund this in the capital markets. But we have to do this in a responsible and sustainable way and clearly avoid what happened in the US subprime mortgage market."

When it comes to innovative projects, failure rates are high. We ask Herman if he can elaborate on the key success factors and challenges for a pioneering organization like Cardano Development, that plays an incubator role for new initiatives.

Herman: "Cardano Development is incorporated as an incubator with the objective to design and implement scalable and sustainable risk- and investment solutions for frontier markets. Cardano Development has the managerial and organizational structure to explore new opportunities. Second, the people involved share the same DNA, expertise and passion to build and offer these much needed solutions. We can leverage our technological and quantitative expertise to new markets. Third, patience is required and mistakes are allowed in a not for profit maximizing environment. It is really hard to launch a successful new initiative. It takes persistence, dedication and hard work to get there and you need to accept that it can fail. Learning from failure is a very powerful process in trial and error progression. Finally projects need to have an autonomous structure, and be able to depend on sustainable resources."

> *"Cardano Development is fully committed to support innovative financial risk management business models with the goal to developing scalable sustainable finance markets."*

Concluding remarks

Herman: "In general, I see two trends: 1) to finance development objectives private funding is targeted, and 2) commercial investments are more often made with specific impact targets. Institutional investors are becoming more interested in sustainable finance. A good example is the success of Green Bonds. Impact reporting is important to avoid green washing. Linking it to the new SDGs could be a catalyst to grow the market for sustainable finance. During my research, I use my practical knowledge to uncover new innovative approaches to bridge the development finance gap. I wish to use the insights that are gained to develop new tools and projects, which help to connect the development finance and private finance worlds."

The final results of the study will be published before the summer of 2016. People who are interested to read the full dissertation can always contact Herman Bril: H.Bril@cardano.com.

Additional information:

https://brilherman.wordpress.com/
http://www.cardanodevelopment.com