Cuban Integrated Financing Framework (CIFFRA)

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Innovative Financing Mechanisms

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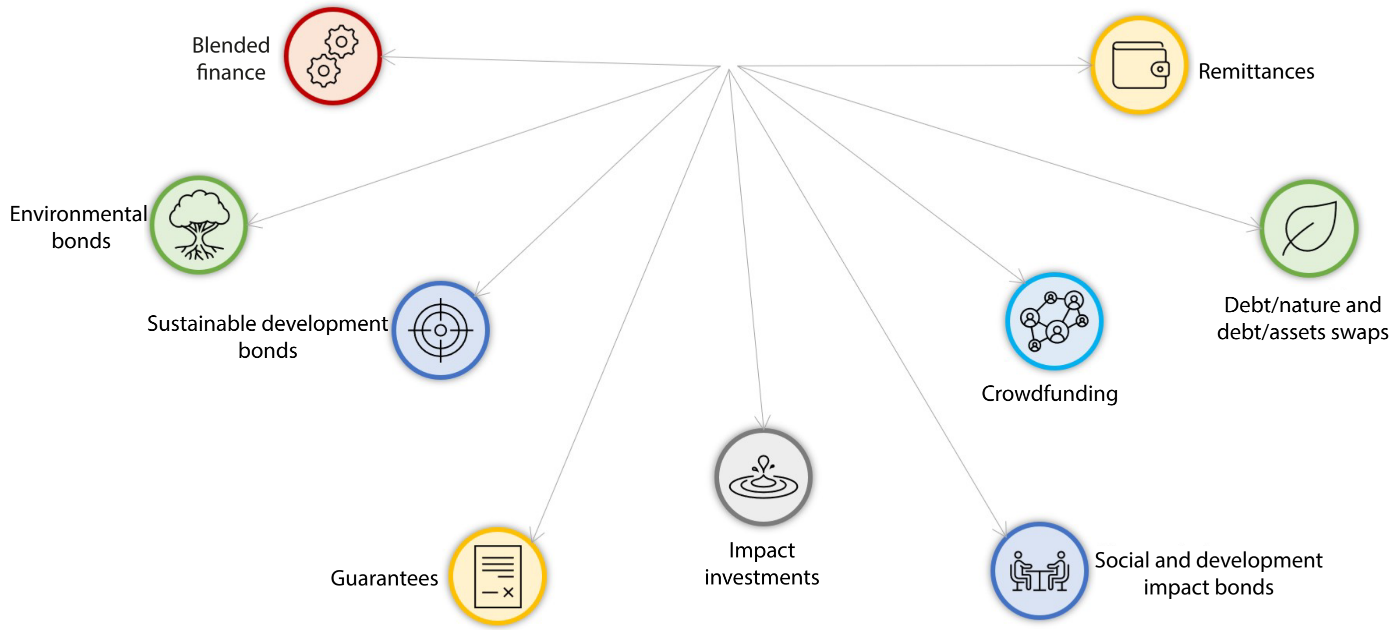
Innovative financing mechanisms

As part of the activities of the Joint Program "Support for the development of an Integrated National Framework for Financing the Sustainable Development Goals (SDGs) in Cuba" (CIFFRA), research was carried out to identify a list or "menu" of innovative financing mechanisms that could be useful in the particular context of Cuba.

The research was conducted by Ramón Lecuona Valenzuela, an international expert on financing for development, under the coordination of the Economic Commission for Latin America and the Caribbean (ECLAC) and was validated through meetings and workshops with national counterparts. The exercise took into account the most recent international and regional trends, as well as others that may not be new in the international context but are new in the Cuban case. This "menu" (see diagram 1) represents a fundamental input to be taken into consideration for the final phase of CIFFRA, focused on policy recommendations.

Diagram 1
Menu of innovative financing mechanisms studied



Source: Author.

Given the insufficiency of financing for the SDGs through traditional development financing instruments, the international development community (governments, multilateral agencies, international development banks, foundations, non-governmental organizations (NGOs) and academic institutions) has creatively generated new mechanisms.

These innovative instruments recognize the institutional peculiarities and constraints faced by many countries and seek to provide access to more abundant and stable funds to accelerate the achievement of the SDGs. The instruments also mitigate risk conditions and offer attractive costs for users and reasonable returns for investors. The purpose is to increase the volume of funding along with more focused and efficient use. For this exercise, nine (9) innovative mechanisms were studied:

(i) **Blended finance.** It consists of a mechanism for using catalytic capital, either from public or philanthropic sources, aimed at increasing private sector investment in low- and middle-income countries to achieve the SDGs. Its most common forms are:

- official investors (governments or international agencies) or philanthropic institutions providing concessional funds;
- official investors or philanthropic entities providing guarantees or insurance at below-market costs;
- institutions providing grants for technical assistance purposes.

The direct beneficiaries of blended financing are mainly micro, small and medium-sized enterprises operating in a wide range of sectors. Priority is given to low-income groups and vulnerable sectors at the bottom of the financial pyramid.

(ii) **Environmental bonds (green and blue).** These are typical fixed-income instruments, but with explicit and clearly defined environmental objectives (the resources mobilized are labeled to be used for specific projects). The social-environmental impact of these securities and the market returns they generate make them very attractive to a wide range of investors, including institutional investors. The innovative characteristics of these instruments are the destination of the resources, the rigor of their execution and the evaluation of their impact.

There is a wide variety of issuers, including: governments (both developed and emerging markets), multilateral banks and private companies.

(iii) **Sustainable development bonds.** These can be considered a thematic extension of green bonds, in terms of objective. They are traditional bonds, with the peculiarity that the funds raised are used, most certainly, for achieving any of the SDGs, not only environmental ones. The World Bank has been a pioneer in this field, issuing in December 2018 the first of these instruments, initially in Italy and then in Singapore and Hong Kong (China).

(iv) **Guarantees.** Risk mitigation is the central objective of this innovative mechanism, which consists in transferring the risk from one party to another, who is better equipped to assume it. Their coverage may vary substantially, from schemes that protect up to a certain value or proportion of losses (regardless of the cause), to coverage of commercial, political or regulatory risks.

They are legally, financially and operationally complex instruments, and can give rise to problems of adverse selection and moral damage. In practice, they have played a marginal role as a development financing instrument.

(v) **Impact investments.** This is a fund allocation strategy that seeks to generate positive and verifiable social and/or environmental impacts, as well as financial returns for investors. It has been applied in sectors such as sustainable agriculture, renewable energy, microfinance and the provision of essential services at the base of the pyramid.

Impact investment has demonstrated that solving social and environmental problems can be done profitably and is not the exclusive domain of the world's limited philanthropic funds. Thus, this approach has attracted a wide range of institutions and investors such as: multilateral development organizations, commercial financial intermediaries, pension funds and insurance companies, private foundations, NGOs and religious congregations.

(vi) **Social and development impact bonds (results-based).** These are public-private partnerships in which the private investor provides resources to finance public projects with a social or environmental orientation, executed by intermediaries selected by the government or a development or philanthropic organization. These are contractual results-based payment schemes and are not associated with traditional or sustainable development bonds.

They are contractual results-based payment schemes and have nothing to do with commercial bonds or sustainable development bonds (the term "bonds" may be misleading). They have hardly been used.

(vii) **Crowdfunding.** Microfinance schemes link -through digital platforms- projects of a very different nature with investors, lenders and donors, who participate in large numbers by contributing relatively modest amounts. There are four distinct types of crowdfunding: donation, reward, debt and equity.

The consolidation of these platforms requires adequate regulatory frameworks and basic macroeconomic stability, as well as an efficient legal system to contain fraudulent activity, which is a major threat to the development of these mechanisms.

(viii) **Debt/nature swaps.** Debt/nature swaps generate partial write-offs or discounts on the international liabilities of developing countries by some creditor governments. In exchange, the beneficiary government commits to contribute a certain amount in local currency to be used for nature conservation.

In addition to these bilateral government-to-government swaps, there are also commercial debt/nature swaps involving private financial institutions, NGOs and/or multilateral development organizations. In these cases, the NGO or multilateral agency takes on the debt of the target country as a commercial intermediary, at discounts determined by the secondary market. It then exchanges it with the government of the country in question for funds in local currency, to be used in nature conservation programs implemented by the same government under international supervision.

In both government-to-government and commercial exchanges, the debtor government is able to reduce its foreign debt by redeeming it for a fraction of its nominal value and in local currency. The creditor government or intermediary gets rid of a problematic asset, in the first case to contribute to the protection of the environment, in the second to improve its balance sheet and results. In the latter case, the NGO or development institution is the provider of funds in accordance with its mandate.

(ix) **Remittances.** To make productive use of remittances and translate them into sustainable improvements in welfare, it is essential to create a legal-regulatory and incentive framework in the recipient country. Some of the instruments that have facilitated the channeling of remittances for development are:

- Diaspora bonds. Placement of sovereign debt in the country of origin or destination.
- Investment funds, insurance products and pension plans. Established by governments or financial institutions, they allow the diaspora to invest in their countries and make retirement plans.
- Venture capital. Structured programs to attract funding to SMEs, primarily active in sectors such as health, education, clean energy and agriculture (impact investment).
- Insurance funds. Life, health and property insurance products, among others, are purchased by emigrants to protect their families back home.
- Diaspora direct investment. Especially for FDI attraction, companies in which members of the diaspora hold senior positions, invest in the countries of origin

Innovative development financing instruments, which have emerged in the last decade, aim to scale up the flow of funds to support the 2030 Agenda for Sustainable Development and to ensure the use of these resources in a more precise and efficient manner.

In the case of Cuba, it is important to highlight that access to these mechanisms requires a favorable environment for attracting a wide range of public, multilateral, philanthropic and commercial institutions committed to financing development and interested in advancing the SDGs in their various aspects. In this regard, taking advantage of this opportunity will require progress in debt negotiations with key suppliers in the financing of recent years and the calibration of domestic productive and monetary overhaul measures.

Likewise, a series of institutional strengthening steps are recommended for the study, design and implementation of these mechanisms, namely: (i) preparation of a catalog of projects clearly linked to the SDG goals (ensuring that the presentation of the projects covers the requirements and practices of the entities providing the funding); (ii) selection of innovative instruments (keep up to date with the evolution of these mechanisms to maximize their use); (iii) identification of new potential sources of funds, especially multilateral institutions that could serve as providers of technical advice and assistance, as well as contacts and guidance; (iv) selective initiation of institutional contacts; and (v) creation of specialized inter-institutional and permanent teams that require high institutional capacities, both in economic-financial and legal and operational terms.

CIFFRA Technical Committee
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ECLAC

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