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Optimizing Development Finance Levers to Meet the 2030 SDGs:

SCOPING REPORT

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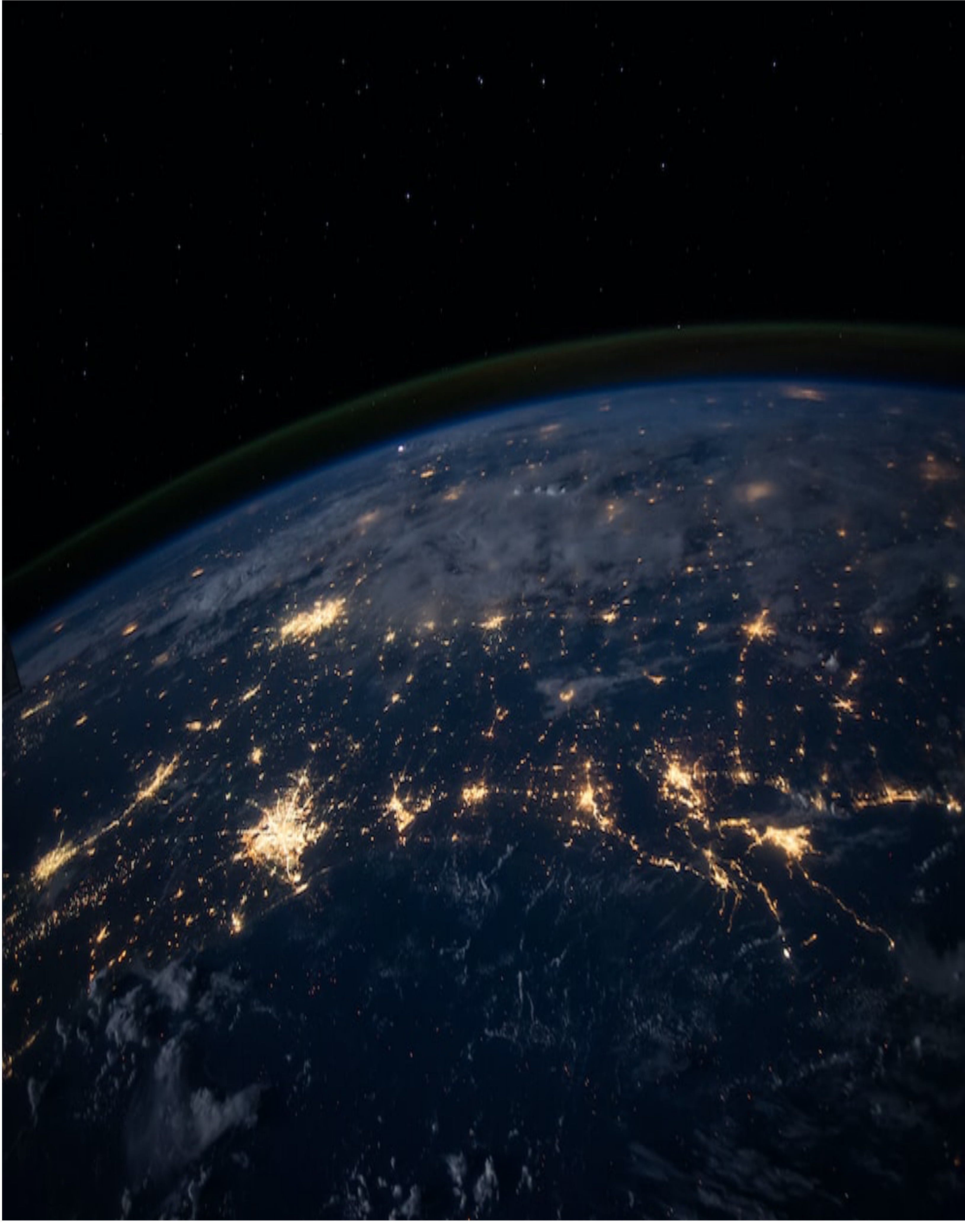

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LIST OF ACRONYMS

AAAA	Addis Ababa Action Agenda	INFF	Integrated National Financing Framework
ADB	Asian Development Bank	JBIC	Japan Bank for International Co-operation
ATI	Africa Trade Insurance Agency	MDBs	Multilateral Development Bank
AUM	Assets Under Management	MIGA	Multilateral Investment Guarantee Agency
BII	British Investment International (former CDC)	MLT	Medium and Long-term
DAC	Development Assistance Committee	MPTF	Multi-Partner Trust Fund
DCA	Development Credit Authority (USAID)	MSME	Micro, Small and Medium-sized Enterprise
DFC	Development Finance Corporation	NDB	National Development Bank
DFI	Development Finance Institution	NDP	National Development Plan
ECA	Export Credit Agency	NGOs	Non-Governmental Organization
EIB	European Investment Bank	ODA	Official Development Assistance
ESG	Environment, Social and Governance	OECD	Organisation for Economic Cooperation and Development
EU	European Union	PE	Private Equity
FCAS	Fragile and Conflict-Affected Countries	PRG	Partial Risk Guarantee
FX	Foreign Exchange	SDG	Sustainable Development Goals
GEMS	Global Emerging Markets Risk Database	TA	Technical Assistance
GFANZ	Glasgow Financial Alliance for Net Zero	UNDP	United Nations Development Program
GIIN	Global Impact Investors Network	USEXIM	United States Export-Import Bank

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EXECUTIVE SUMMARY

In order to meet the Sustainable Development Goals by 2030, more financial resources need to be directed to developing countries to close the financing gap, which currently stands at over USD 4 trillion a year. Developing country public budgets alone cannot meet these financing needs; nor can Official Development Assistance (ODA).

While there are opportunities to expand a country's domestic sources of capital through public sector reforms, including tax reforms that maximize tax revenue, and more efficient budgeting and spending, international sources of capital are vital to meeting the SDGs.

Improved coherence and alignment of development finance instruments and players within the global development financing architecture are required to optimize and increase the flow of development capital. The international private sector provides a wide range of financial resources that could be channeled towards the SDGs. From the capital markets to impact investors, philanthropic foundations, and diaspora remittances, the options are numerous and large-scale. Exploring these sources so that more of it can be tapped and deployed with greater alignment with SDGs may require policy changes and regulatory reforms but the benefits could be significant. Effort to combat illicit financial flows leaving the country, a better business enabling environment, and incentives to tap long-term domestic markets will go a long way to strengthen the flow of capital to developing countries.

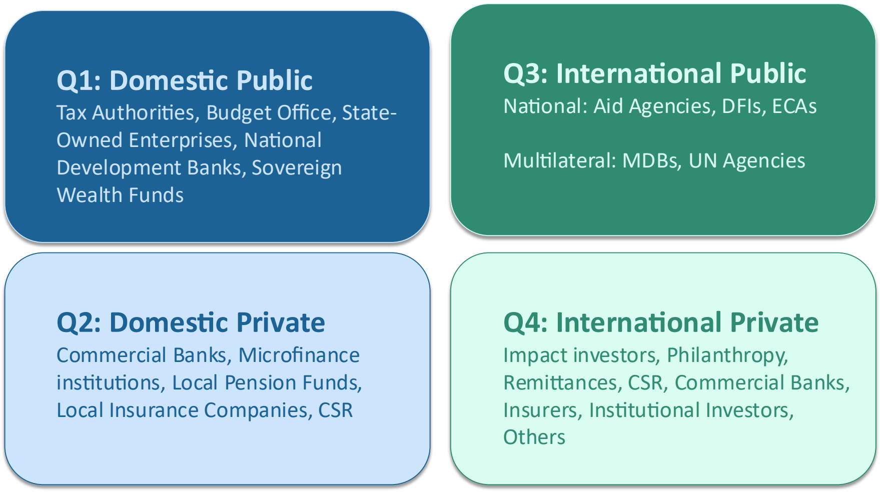
This paper provides an analysis of the providers of capital and the financial instruments that can be deployed to offer insights into how best to leverage capital sources to enhance achievement of the SDGs. Improving the coordination of capital usage would deliver efficiencies in the development finance ecosystem and serve to attract new capital to better scale up funding to meet the SDGs.

The levers in the hands of donor countries include financial instruments (grants, loans, equity and de-risking), all of which can be brought to bear in optimizing the development finance flows that can be channeled towards meeting the SDGs. However, other levers within donor countries' control, such as influence, awareness and the powers to collaborate with other partners, are also crucial to unlocking private sector flows. By nudging private capital – via de-risking or incenting through regulation – to invest in SDG-aligned opportunities, the SDG funding gap can be narrowed.

By presenting the global landscape for development finance as a "balance sheet" this paper aims to illuminate the levers at work in the financial system. By discussing the "liability" side of the equation, in which the needs of developing countries are defined through the framework of the Integrated National Financing Frameworks (INFFs), it is possible to better understand how to shift the many "assets" of the financial systems towards accomplishing the SDG agenda. There are several interlinked aspects of the development finance landscape - where are the financial gaps associated with the SDGs, how can these gaps be addressed by the financial markets, which financial products can be used most effectively, and who will create and distribute these products – all of these questions are tackled in this report in a descriptive and comprehensive way.

Within the INFF, there are four quadrants from which incremental development resources could be harnessed to meet the SDG financing requirements.

Figure 1: INFF Four Quadrants of Sources of Development Finance



Source: Adapted from www.inff.org for this Report

How these four quadrants interact is critical to understand. For example, international private capital is attracted by an enabling business environment that the government in a developing country must seek to actively create through better, more favorable and more reliable policy frameworks with fewer bureaucratic processes. Better public sector financial management and identifiable success at combatting illicit financing flows gives international public sources more confidence in providing additional concessional resources. Domestic private capital, such as from local financial institutions, can be more engaged with additional capital from international sources, as well as incentives to shift focus from buying government paper to finance the fiscal deficit to lending to the real economy.

This paper also identifies five key features of successful donor country development finance systems, which are approaches and organizational strategies that can optimize the use of existing financial envelopes and potentially grow the development finance resources available to meet the SDGs.

As noted by Global Outlook on Financing for Sustainable Development 2021, "….shifting 1.1 percent of the total financial assets held by banks, institutional investors or asset managers would be enough to fill the growing financing for sustainable development gap." The report provides an overview of the key building blocks and levers a government has to help facilitate this shift.

1. INTRODUCTION

Before the COVID-19 pandemic, the financing gap to achieve Sustainable Development Goals (SDGs) for developing countries stood at an estimated USD 2.5 trn annually.[1] The pandemic, further exacerbated by the war in Ukraine, has left many developing countries with an increased risk of stunted economic growth, a challenging fiscal atmosphere, and debt distress. It is estimated that by the end of 2021, 77 million more people had fallen into extreme poverty due to shocks from the pandemic, and the financing gap has grown to USD 4.2 trn per year. More troubling is the fact that it is estimated that the GDP per capita of one out of five developing economies would not return to the pre-pandemic levels until the end of 2023, and this is without considering the impact of the war in Ukraine.[2] The window to meet the SDGs by 2030 is closing.

The **SDG financing gap** stands at an estimated USD 4.2 trn per year, according to the OECD.

The agenda for achieving the SDGs by 2030 is broad, complex, and spreads beyond the capacity of any government or donor. It requires enhanced mobilization of both public and private funds, in collaboration. Moreover, the financing gap is not a static figure. Developing countries are facing increasing debt burdens created by pandemic recovery efforts and the higher costs of debt service caused by the appreciation of the US dollar (in which much of their external debt is denominated, sometimes overwhelming the entire health and education budgets).[3] Further strain results from macroeconomic dislocation and inflationary pressures created by international events such as the Russian invasion of Ukraine.

The financial resources to close the gaps cannot be met domestically or solely by public resources. For developing countries, domestic public resources available for development can and should be enhanced through better tax discipline and revenue generation. At the same time, the potential capital to finance SDG-aligned projects from non-state actors such as local pension funds, insurance companies, mutual funds, and other institutional investors could also be tapped with the right enabling incentives. If properly set up and managed, national development banks (NDBs) can play a central role as government-owned/backed financing partners serve as robust and reliable channels of financial resources for SDG-aligned investments.

International sources of capital are vital to meeting the SDGs. From donor countries, development finance flows via bilateral Development Finance Institutions (DFIs) and Official Development Assistance (ODA) from aid agencies and other bilateral financial support. Donor countries also provide indirect financing via ownership of and contributions to Multilateral Development Banks (MDBs) and associated Trust Funds through which donor funds are earmarked for specific purposes.

ODA today is under pressure and cannot be expected to address the SDG financing gap. Nor can debt or equity finance from DFIs. The development finance ecosystem must include all capital providers and stakeholders, collaborating across the public, private, and non-profit sectors – both domestic and international – using various financial instruments and techniques for funding development initiatives around the world.

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[1] https://www.oecd-ilibrary.org/sites/6ea613f4-en/index.html?itemId=/content/component/6ea613f4-en
[2] https://advocacy.thp.org/wp-content/uploads/2015/01/2013-06-hlp_p2015_report.pdf
[3] https://www.tcxfund.com/hear/

Improved coherence and alignment of development finance instruments and players within the global development financing architecture are required to optimize and increase the flow of development capital to the highest impact areas in a low-income country as set out in their National Development Plan.

Due to differing mandates, return expectations and lack of experience, there are sources of capital that do not easily or naturally collaborate. For example, there are DFIs that have never coordinated their investment targets with their country's Export Credit Agencies (ECAs) as a result of how these financing agencies are organized within donor countries. Private capital sources, such as pension funds in high-income countries, have little interest or incentive to focus on developing country investment opportunities.

Development finance is normally defined as the use of public sector resources to facilitate private sector investment in low- and middle-income countries where the commercial or political risks are too high to attract purely private capital, and where the investment is expected to have a positive developmental impact on the host country. *The Brookings Institute*.

In this paper, development finance includes all sources of finance – public and private / domestic and international – which can be mobilized towards financing the SDGs.

IFCL has been commissioned to study the global development finance landscape, particularly emphasizing the post-pandemic context. This paper presents the sources of international capital and types of financial instruments that are being used. The broad categories have different financial return expectations and mandates as to how to deploy their capital, from 100 percent financial return-maximizing to 100 percent grant-based giving. The paper seeks to clarify where money comes from and how more of it can be tapped and deployed with greater alignment with SDGs.

A deeper analysis of the providers of capital serves to offer insights into how best to leverage capital sources to enhance achievement of the SDGs. Improving the coordination of capital usage would deliver efficiencies in the development finance ecosystem and serve to attract new capital to better scale up funding to meet the SDGs.

2. GLOBAL LANDSCAPE FOR DEVELOPMENT FINANCE

2.1. Introduction

Framing the development finance ecosystem by "demand side" for capital investment and the "supply side" of sources of capital is useful.

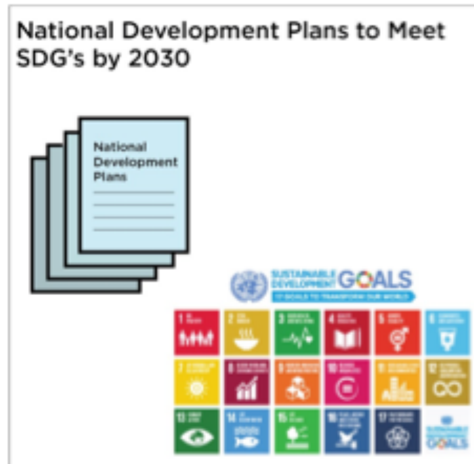
"Supply" refers to the financial sources – both domestic and international – that enable developing countries to achieve their SDGs as defined in their National Development Plans. "Demand" refers to the estimated project costs associated with achieving those objectives. With the SDG financing gap exceeding USD 4 trn per year, new ways of closing the gap in the balance sheet are needed through (a) increasing the efficient use of existing capital flows for the SDGs and (b) identifying opportunities to expand capital flows for this purpose.

2.2. Development Finance Needs

The "**demand side"** of the balance sheet details the need for capital to finance the SDGs expressed in National Development Plans (NDPs) prepared by individual countries. The UNDP notes that many national development plans and strategies lack clear steps for financing these actions – a critical missing link that leaves many SDGs underfunded.[4]

How these NDPs are to be financed is the main focus of UNDP efforts to support the development of Integrated National Financing Frameworks (INFF)[5]. At the developing country level, INFFs spell out how a country's national strategy can be financed and implemented, relying on various public and private financing sources. INFFs represent country ownership at the highest levels of government.[6]

Figure 2: **Development Finance Needs**



2.3. Development Finance Sources

To consider the **"supply side"** of the balance sheet**,** the INFFs consider potential sources of capital that can bridge the financing gap. These are represented in four quadrants of potential financing providers -- domestic public, domestic private, international public, and international private. Several different potential financing initiatives can be positioned in each quadrant.

Figure 3: **Key Initiatives to Unlock Additional SDG Finance**

Domestic Public Initiatives to enhance revenue and streamline expenditure	**International Public** Initiatives to attract additional financing from donors, DFIs, ECAs and MDBs.
Domestic Private Initiatives to attract additional financing from local commercial banks, local investors, pensions funds, institutional investors, etc.	**International Private** Initiatives to attract financing from international commercial banks, institutional investors, impact investors, foundations, diaspora, etc.

Source: Adapted from www.inff.org for this Report

[4] UNDP's Development Finance Assessment Guidebook
[5] www.Inff.org
[6] See Nigeria's INFF, unveiled by the President at UNGA, September 2022, https://inff.org/resource/nigeria-integrated-national-financing-framework

Domestic Public Sources

Strategies to increase a country's domestic sources of capital include public sector reforms to expand the financial resources available to fund SDGs, including tax reforms that maximize tax revenue, and more efficient budgeting and spending. They also include addressing "leakages" from national budgets associated with illicit financial flows and weak tax collection capabilities. However, while improvements in public debt management must also be considered, the fact remains that significant national budgetary resources are being consumed by servicing existing and growing debts, often denominated in appreciating foreign currency, rather than going to productive investment. Enhanced revenue (or removal of subsidies) requires government-owned enterprises to be more commercial/profitable. A healthy and well-capitalized National Development Bank (NDB) with a mandate to finance development, and/or a mechanism to capture natural resource wealth for the benefit of the whole country (such as through a Sovereign Wealth Fund) are also key domestic public instruments that can help to finance the SDGs.

Domestic Private Sources

One of the ways to expand SDG financing is to leverage the domestic private sector. Private financial institutions, including banks, pension funds and institutional investors, as well as individual investors play important roles in domestic investment targeting the SDGs, particularly long-term, local currency investments in key sectors such as infrastructure. There are several actions that can be taken to attract the domestic private sector to SDG financing. Some of these include creating a more conducive enabling business environment and incentivizing/encouraging domestic investors to direct their financing towards in-country SDG-aligned investments.

International Public Sources

Donor countries providing Overseas Development Assistance (ODA) and financing organizations, such as Multilateral Development Banks (MDBs), Development Finance Institutions (DFIs), and Export Credit Agencies (ECAs), are already major players in global SDG financing. Developing countries can pursue financing from these institutions where the mandates align with their sustainable development priorities.

International Private Sources

The international private sector provides a wide range of financial resources that could be channeled towards the SDGs. From the capital markets to impact investors, philanthropic foundations, and diaspora remittances, the options are numerous and large-scale. Exploring these fully may require country policy changes and regulatory reforms but the benefits could be significant.

Figure 4: Development Finance Sources

Domestic Public	Domestic Private	International Public	International Private
Tax Authorities, Budget Office, State-Owned Enterprises, National Development Banks, Sovereign Wealth Funds	Commercial Banks, Microfinance institutions, Local Pension Funds, Local Insurance Companies, CSR	National: Aid Agencies, DFIs, ECAs Multilateral: MDBs, UN Agencies	Impact investors, Philanthropy, Remittances, CSR, Commercial Banks, Insurers, Institutional Investors, Others

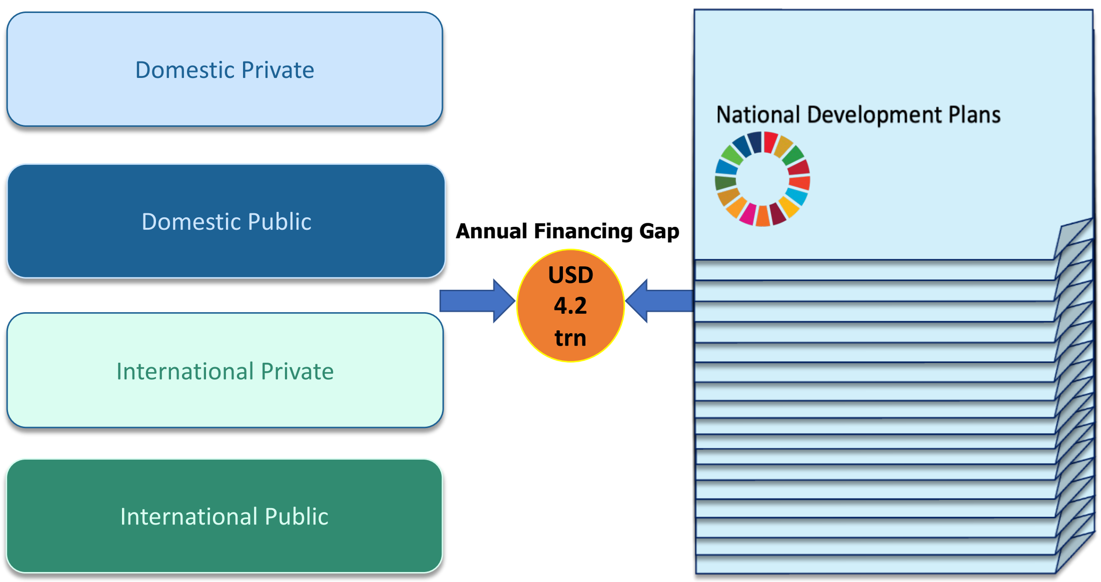
Source: IFCL

5 ***Integrated National Financing Framework***
Designing an INFF that covers these four quadrants of financing sources helps countries frame a strategy to increase investment, manage risks and achieve sustainable development priorities as identified in a country's National Development Plan. The INFF provides a framework for countries to prioritize actions that address SDG financing gaps.

2.4. The Global Balance Sheet

There is a hole in the Global Balance Sheet for development finance. All sources of potential financing must be explored to address this gap.

Figure 5: The Global Balance Sheet



Governments in the developing countries must do their part to improve public financial management, combat illicit financial flows and put in place conducive policies to encourage investment.

International public sources – particularly the donor countries – must play an important strategic and technical role in leveraging balance sheet assets to harness more capital by:
- Focusing efforts on mobilizing international private sector flows;
- Influencing regulatory investment regimes to generate more SDG alignment;
- Partnering for synergy and returns;
- Spearheading use of diversified financial instruments; and
- Taking a "whole-of-government" coordinated approach.

By nudging private capital – via de-risking or incenting through regulation – to invest in SDG-aligned opportunities, the SDG funding gap can be narrowed.

3. DEVELOPMENT FINANCE SOURCES

Given current constraints on fiscal space and in foreign aid, catalyzing much larger volumes of private finance for SDG-related investments is essential to achieving the scale needed in developing countries. This chapter seeks to provide a broader understanding of public and private capital sources, investment frameworks, and opportunities to channel it more efficiently.

As noted in the previous section, there are multiple sources of development finance flows into emerging markets from public and private capital. Each of these has distinct motivations, return expectations, mandates, and operating systems. Figure 3 above shows the sources of development finance and the entities involved in development finance.

3.1. Public Sources

International development finance has traditionally come principally from public sources in the form of ODA grants, debt and equity investments. It can be channeled via a range of institutional structures, with the principal ones discussed below.

International Public Sources of Capital - Overseas Development Assistance
Official Development Assistance (ODA) is defined as official, concessional financing flows to promote the economic development and welfare of low and middle-income countries. The most reliable reported data on total donor country contributions are from the OECD's Development Assistance Committee (DAC), comprised of 31 member countries representing the largest providers of ODA from the Global North. Qualifying funds (including bilateral and multilateral aid) are reported to and tracked by the DAC. Most donor countries deliver up to 70 percent of ODA via bilateral programs. The balance is channelled through multilateral organizations.

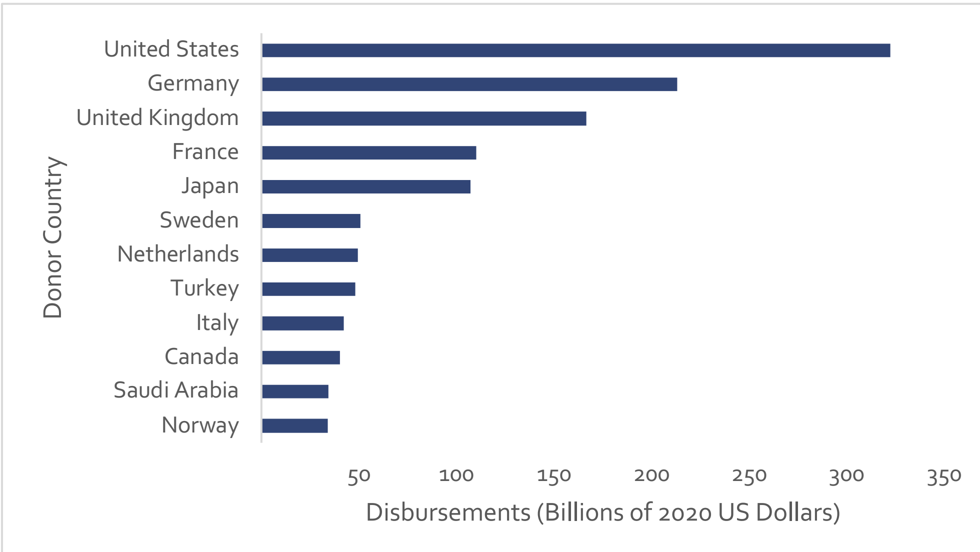
Despite grim prospects for ODA flows in the early stages of the COVID-19 pandemic, they in fact rose in 2020 and again in 2021, largely boosted by donations of vaccines or vaccine funding[7].

Not all donor countries are DAC members and do not report ODA consistent with DAC guidance. China, for example, is considered a significant source of ODA, especially since the 2014 launch of the Belt and Road Initiative, a massive series of sub-commercial loans for infrastructure projects stretching around the world. However, the total volume and the nature of the financial instruments used are unclear. Transfers to developing countries by China are characterized as 'South-South cooperation' and only a fraction of the capital flows are reported. Until the creation of the Chinese International Development Cooperation Agency (CIDCA) in 2018, the Centre for Global Development estimates that over 90 percent of China's bilateral aid funding was managed by the Ministry of Commerce. Even today on-the-ground delivery, payment, and oversight of approved projects in recipient countries, whether financed by a grant, interest-free loan, or concessional loan, is performed by Chinese contractors or enterprises.

[7] Some of these vaccines consisted of excess domestic donor country supply and were valued as ODA at higher prices than actually paid by donor countries. Changing accounting rules can also inflate or, in the case of Sweden, reduce official ODA.

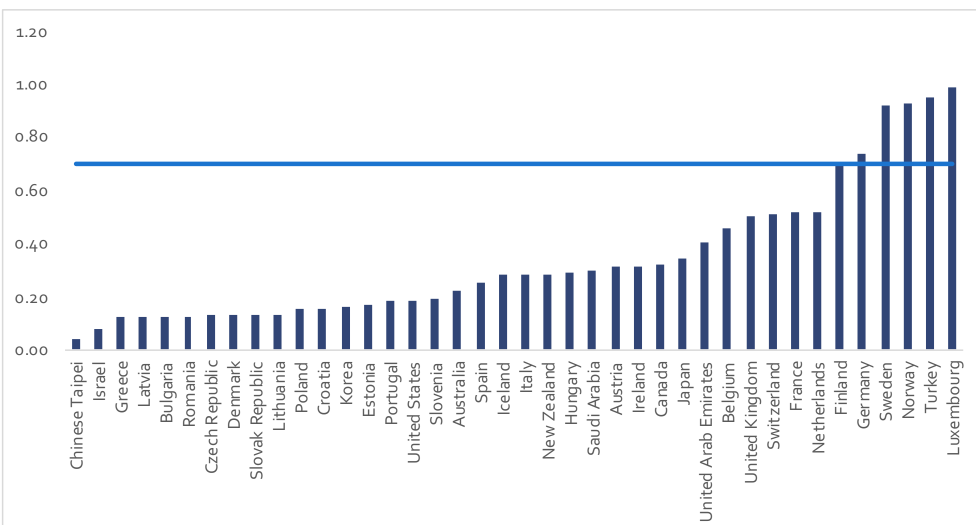
As seen in Figure 5, the USA is the top contributor, in absolute dollar terms, of ODA over the 2013-2021 period with USD 322 bn in disbursements. Turkey and Saudi Arabia have recently emerged as part of the top 12 ODA contributing countries. Neither country is a DAC member although Saudi Arabia is considered a 'participant' DAC country and is expected to join as a member in the future.

Figure 6: Top 12 ODA Contributing Countries (2013-2021)



Source: OECD

Figure 7: Top ODA Donors, as a share of GNI (percent) 2021



Source: OECD

Multilateral ODA

Annual ODA contributions by donor countries through multilateral organizations have ranged between USD 40-46 bn since 2013, with a significant increase in 2020 to USD 67.6 bn. EU institutions, such as European Investment Bank, disbursed the most ODA (36 percent of total multilateral disbursements) followed by the World Bank Group with 23 percent.

Donor countries also channel ODA through UN agencies such as UNICEF, UNFPA, and the UNDP. Donor contributions are made to both 'core funding' of UN agencies' general budget, as well as to specific, or 'earmarked', programs. More recently, the UN has established the Multi-Partner Trust Fund as an arms-length entity that manages segregated fund vehicles that aggregate donor funds for very targeted purposes. There are also a large number of mission-specific multilateral funds such as the Green Climate Fund, the Global Fund and the Gavi Alliance, as well as a wide selection of UN-managed trust funds that aggregate donor funding for targeted issues.

Issues with ODA Reporting

ODA is under threat, not only in terms of the ability of higher income governments to maintain the level of flows in the future due to post-pandemic fiscal pressures but also because the use of ODA is arguably suboptimal. The dynamics of this system influence how grant funding is delivered based on two key considerations – ODA-eligible country selection, and the "accounting" mechanism endorsed by the OECD.

There is an elaborate OECD DAC system to track and report grants from high-income donor countries to lower-income countries. To gain recognition for providing this form of finance, donor countries report their activity to the OECD DAC Secretariat on an annual basis according to an agreed upon formula. Moreover, it is important to note that the DAC's methodology for counting ODA in loans discriminates against donors with high cost of funds.

Apart from grants qualifying as ODA, the definition of ODA includes loans or equity deployed by donor countries through their bilateral DFIs in the form of investments that have expected returns below market or at concessional rates. Globally more than half of ODA disbursements between 2013 and 2020 were recorded as grants to recipient countries. Asian donors (Japan and South Korea) provided the most loans, comprising around 42 percent of that region's ODA between 2013 and 2020. European donors (primarily France and Germany) are the second largest contributors of loans to developing countries, about 11 percent of disbursements.[8]

A DAC agreement that the "grant equivalent" of loans counts towards ODA targets came into effect in 2018. The reforms remain controversial with experts and civil society organisations (CSOs arguing that the calculations significantly overstate the grant equivalent and disincentivize donors from providing grant financing. Critics include Stephen Cutts, former Assistant Secretary-General of the UN.[9]

Public Development Banks

Public Development Banks (PDBs) is the generic term for all types of government-owned financial institutions established with a public policy purpose. PDBs can be multilateral, bilateral, regional, or national. Some grants in the form of technical assistance can be provided, but their mandates are to make

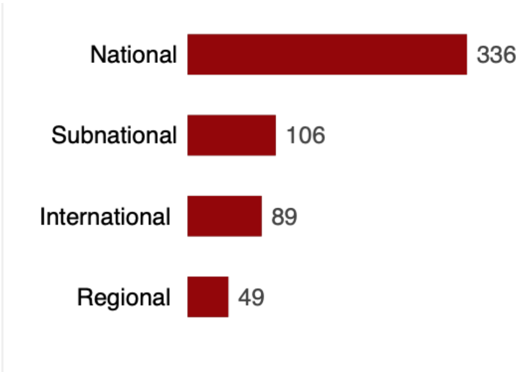
[8] OECD, Query Wizard for International Development Statistics (QWIDS)

[9] https://www.ft.com/stream/f181001c-3dd4-4c2b-9e44-d83354203328

investments using loan or equity products. Some lend only to sovereigns, some work only with the private sector, some are international, and some only work within a designated country or sector. The role of PDBs as financial intermediaries in financing SDGs is central.

There are now more than 500 PDBs according to the Finance in Common Initiative with more than USD 23 trn in assets (the MDBs account for just over USD 2 trn).[10]

Figure 8: Types of PDBs



> **Public Development Banks** signed … [a] joint declaration in 2020….. [to] shift their strategies, investments patterns, and operations modalities, in order to contribute to the achievement of the United Nations Sustainable Development Goals (SDGs) and the Paris Agreement…… PDBs believe that their contribution will help the emergence of a much-needed global framework for SDG-compatible finance.
> *Finance in Common*

National Development Banks (NDBs) operate solely within their domestic economy. Subnational development banks often focus on state-level or municipal level investments. International and regional development banks are cross-border. They can be financed with public funds from domestic or international sources of capital.

There are different types of PDBs, or public financial institutions (PFIs), some focused domestically and others focused internationally. Export Credit Agencies straddle both, by supporting domestic companies to sell products and services into international markets. This is depicted in Figure 8 below.

[10] https://financeincommon.org

Figure 9: Public Financial Institutions that Finance Development

Source: Adapted from the Study on convergence between development finance and export finance, 2019

Development Finance Institutions (DFIs), usually majority owned by national governments, and funded with ODA, occupy an intermediary space between public ODA agencies and private investment. They invest in and provide advisory and asset management services to encourage transformative private sector development in low and middle-income countries. The International Finance Corporation (IFC), a member of the World Bank Group, is the largest DFI and the only multilateral DFI. Instruments deployed by DFIs vary across a range of asset classes and include debt, equity, guarantees, and debt security.

There are 13 European DFIs in addition to those in Canada (FinDev Canada), the US (DFC), Japan (JICA, JBIC) and China (CDB). Australia has been considering establishing a DFI.[11] European DFIs managed total investment portfolios of more than €44bn in 2020. Each DFI has a portfolio of investments worth between USD 1bn-10bn (compared to FinDev Canada with a portfolio of USD 557 mn) and operates under an independent investment strategy. Each utilizes a different mix of financial instruments, which most often include debt, equity, guarantees, and fund investments. In Europe, aggregate portfolios are almost evenly split with 52 percent of funds allocated to loans and 48 percent allocated to equity investments.[12]

DFIs invest in private sector entities, providing growth capital to scale businesses in markets where alternative sources of commercial capital are scarce or expensive. With an expectation that they should mobilize private investment in developing countries, DFIs are at a crossroads. There is an expectation for DFIs to de-risk investments in order to attract other investors, especially into the poorest countries. However, most DFIs are opportunistic and driven by individual deals that conform to profitability objectives. Rather than acting as market-makers, this approach does not lead to transformative investments in the economies of poor countries. For example, only 16 percent of FinDev Canada's 2021 investments were in the least developed countries.[13] The US DFC in contrast, in the two years since its

[11] https://devpolicy.org/australias-development-finance-review-a-dfi-at-last-20220617/
[12] https://www.edfi.eu/members/facts-figures/
[13] https://www.findevcanada.ca/en/what-guides-us/annual-report-2021

relaunch, has allocated 69 percent of all project funding to low-income and lower-middle income countries and fragile states.[14]

Multilateral Development Banks (MDBs) are one of the biggest sources of development finance, offering billions of dollars to developing countries. The largest shareholders are OECD governments which provide a significant proportion of the capital deployed by these organizations to support development in recipient countries. MDBs operate with lower cost-of-capital than commercial banks, by leveraging shareholder capital through market borrowing and then on-lending to public and private clients at favorable rates and longer tenors. There have been recent discussions about how these organizations deploy their capital and the optimal ways of leveraging that capital to achieve enhanced development outcomes.[15]

Financial support from MDBs can provide considerable "halo" effects to projects, allowing third parties to benefit from their preferred creditor status, their extensive due diligence prior to committing funds, and their perceived assurance of governance/management standards for any program supported. Most MDBs can invest capital at scale (> USD 200mn) per transaction as well as providing professional guidance in structuring individual investment programs.

Pressure is building for MDBs to deploy more concessional finance and to boost investing capacity to address both short-term and longer-term investment needs, especially debt restructuring and climate mitigation and adaptation in low-income countries. Earlier in 2022, the G20 released an important independent report on MDB's Capital Adequacy Frameworks – in effect an action plan to ease the constraints on MDBs, which will encourage billions of dollars in new lending.

Beyond financial arrangements, there are also calls for greater transparency from MDBs on risk, including anti-corruption efforts at all stages of the project cycle, and better reporting on SDG impacts. The GEMS database, for example, sets out default rates on sovereign and other borrowers. While GEMS seeks to "[leverage]data from MDBs and DFIs to support investment and development", it does so for the members of the consortium only, whereas this data would be enormously helpful to catalyze other investors and lenders into these markets. As a step towards greater transparency, the consortium of 25 DFIs and MDBs which participate in GEMS have published a report on aggregated default rates of private and non-sovereign borrowers in emerging markets.[16]

MDBs include the World Bank Group (WBG) and regional development banks such as African Development Bank (AfDB), Asian Development Bank (ADB) and its emerging competitor, the Chinese-led Asian Infrastructure Investment Bank (AIIB), Inter-American Development Bank (IDB), the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB).

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[15] https://g20.org/wp-content/uploads/2022/07/CAF-Review-Report.pdf, retrieved on November 15, 2022
[15] https://g20.org/wp-content/uploads/2022/07/CAF-Review-Report.pdf, retrieved on November 15, 2022
[16] https://www.gemsriskdatabase.org/wp-content/uploads/2021/04/gems_default_statistics_private_and_sub_sovereign_lending_2001_2029_en.pdf

With its financial scale and global reach, WBG institutions[17] have long been leaders in funding and supporting major development projects. In 2022 the Group reported disbursements of USD 104 bn.[18] Of this, USD 32.8 bn was committed by the IFC, considered the world's largest DFI. IFC has been a standard-setter for private sector investment since the 1970s and has traditionally made largely commercially sustainable investments in a wide range of developing countries.[19] The Multilateral Investment Guarantee Agency (MIGA) is another arm of the WBG, providing political risk guarantees.

The AIIB, founded by China and now reporting 103 members, supports green infrastructure projects with some transactions above USD50 mn. Key initiatives include the Asia Climate Bond Fund, a fixed-income fund targeting USD 500 mn of investment in green bond issuances to spur more sustainable bond issuances in developing countries of Asia. The European Investment Bank Group, backed by the 27 member states of the EU, is comprised of the European Investment Bank (EIB), the European Investment Fund, (EIF), and the EIB Institute. The EIB, the world's first regional development bank founded in 1958, reported USD 112 bn of financing in 2021 with over USD 100 bn going to EU member states and approximately USD 9 bn invested globally. Approximately 43 percent of total financing was allocated to green projects in 2021.[20]

National Development Bank (NDBs) are PDBs that are government-owned and backed national financing institutions established to support the economic development of the local economy through the provision of financial and advisory services to underserved market segments. NDBs are usually capitalized by their national governments (and sometimes external donors and/or local commercial banks) for the purpose of investing in economic development projects domestically. NDBs can be focused on particular sectors (agriculture, infrastructure, SMEs, etc.) or multisector, filling market gaps and financing innovation.

NDBs play a critical role within a country's economic and financial ecosystem. Many developing countries have an NDB with a mandate to address a particular public policy dimension. They sit at the nexus of the main economic actors – acting as a hub between government ministries, international agencies, private capital markets, commercial banks, local businesses, and project sponsors.

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[17] The World Bank Group's five institutions are: the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC), the International Development Association (IDA), the Multilateral Investment Guarantee Agency (MIGA) and the International Centre for Settlement of Investment Disputes (ICSD)
[18] World Bank Annual Report 2022
[19] https://www.worldbank.org/en/about/annual-report/leadership-perspectives
[20] https://www.eib.org/en/about/key-figures/index.htm

Key functions include:

- Filling market gaps in underserved market segments
- Mobilizing capital from MDBs and bilateral DFIs
- Catalyzing private finance
- Providing counter-cyclical finance
- Encouraging innovation and economic diversification
- Enhancing financial inclusion
- Promoting environmental sustainability

The Role of NDBs in National Development Plans

Uganda's National Development Plan (NDP) for 2020-2024, known as "National Development Plan III" (NDPIII), identifies priority sectors and key public and private implementation partners that should drive the achievement of the country's strategic goal of attaining middle-income status by 2040. **Uganda Development Bank is recognized in the NDPIII** as one of the key entities and implementation partners in supporting the interventions outlined, particularly those that relate to the provision of affordable finance to facilitate and catalyze private sector investments. In response, UDB has fully aligned its strategy with the NDPIII and continues to accelerate socio-economic development through sustainable financial interventions in priority sectors in line with the Plan.

These institutions vary in effectiveness and capacity, but each have the potential to play a central role in their country's development. A number of countries' National Development Plans (NDP) note the role their NDBs will play in financing the implementation of these plans and NDBs whose vision and operating mandate are directly linked to these NDPs are considerably more effective.

Export Credit Agencies (ECAs) have a primary mandate to promote national exports, trade and investment. They facilitate capital flows into developing markets through loans, insurance or guarantees. These financing flows can also bring significant development benefits to the importing country by enabling the purchase of critical inputs to grow the economy. Whether or not it is an ECA's main objective, or whether they measure development impact, they are able to harness financial resources that benefit SDG-aligned development projects critical to economic growth.[21]

ECAs exist to address market gaps which prevent private sector participation in financing exports and cross-border transaction, principally associated with risk assessments. They encourage private sector participation in the financing of exports and large-scale infrastructure projects (particularly in emerging markets) and facilitate the rollout of new and disruptive technologies which are needed to support the energy transition and achieve the SDGs.

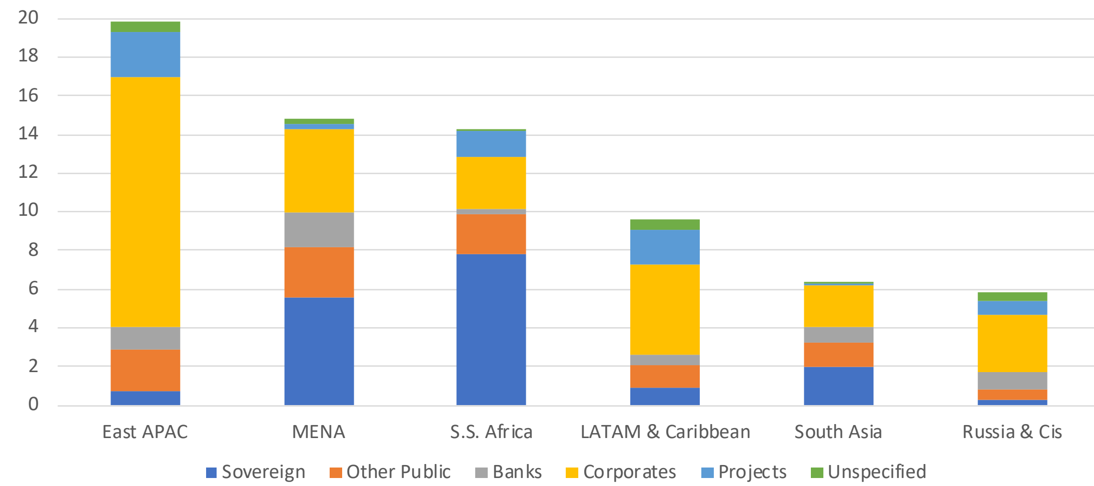
Sustainability in Export Finance: Leveraging export finance to support the delivery of the SDGs

Of the more than 115 countries that have established ECAs, over 25 support medium and long-term (MLT) transactions with financing tenors of up to 20 years backing infrastructure and large capital goods exports. Long-term capital is the hardest for developing countries to access due to a lack of market appetite for long-term credit, FX and other risks. Infrastructure and other projects backed by MLT support are often those that can have positive social and macroeconomic impacts in developing countries. These include geothermal electric power plants and modern rail transport networks. Between 2017-2021, ECAs'

[21] Sustainability in Export Finance: Leveraging export finance to support the delivery of the SDGs

annual new MLT business volumes ranged from USD 205 bn to USD 143 bn.[22]

Figure 10: New MLT Commitments by Region & Types of Obligors (2021 USD bn)



Source: Berne Union State of the Industry, 2021

While ECAs are typically national agencies, there are also multilateral agencies, such as the Multilateral Investment Guarantee Agency (MIGA of the World Bank Group), Africa Trade Insurance Agency (ATI), Inter-Arab Investment Guarantee Corporation and Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), all of which are multilateral specialized insurers.

Sovereign Wealth Funds (SWF), also known as sovereign investment funds or social wealth funds, are state-owned and capitalized from surplus state revenues, and invested in assets domestically and globally. Depending on the assets and objectives, SWFs' risk management can range from very conservative to a high-risk tolerance.

The amount of money in SWFs is substantial. The largest is the Norway Government Pension Fund Global with assets of USD 1.2 trn. The Norway fund, colloquially known as the Oil Fund, invests in equities, fixed income and is reputed to hold 1.4% of all the world's listed assets. China Investment Corporation also boasts assets of USD 1.2 trn. The fund issues special bonds and is used for managing a portion of the country's foreign currency reserves.

The **Nigeria Sovereign Investment Authority** (NSIA) was an anchor investor in the Development Bank of Nigeria, whose mandate is financing MSMEs. It also has invested in the Infrastructure Credit Guarantee Company Limited (InfraCredit), Nigeria Mortgage Refinance Company, Family Homes Funds Ltd (FHFL), and the Infrastructure Corporation of Nigeria Limited (InfraCorp).

As with any investment fund, SWFs have their own objectives, terms, risk tolerances, liability and liquidity concerns. They all seek to preserve and grow their core capital. Global market investment returns are re-

[22] Berne Union, State of the Industry, 2021

invested in the development of their home country. Given their size, they have become large, influential international investors as their fund managers deploy capital in the global capital markets at scale.

SWFs invest principally in major capital markets of the world. They have, however, allocated capital for investment in emerging markets. Examples of such investment include Temasek Holdings investment in India's ICICI Bank and Tata Sky, the Kuwait Investment Authority's investment in China's ICBC, and the Abu Dhabi Investment Authority's investment in EFG Hermes and Malaysian land projects.

It is estimated that funds from the Gulf hold an estimated 22 percent of their assets in Asia, North Africa, and the Middle East. Therefore, while not classified as development finance providers per se, SWFs are potentially significant investors in developing countries on a commercial basis given their size and professed ESG/climate finance ambitions.

Summary of Public Financial Institutions

There are massive financial resources available from the array of public financing institutions listed above that could be better coordinated and channeled to achieve the SDGs.

Three observations can be made in relation to public financial institutions delivering financial support:

1. Historical efforts to untie **ODA**[23] have resulted in better procurement and competitive bidding processes. However, in some donor countries, this has resulted in uncoordinated policy between ODA and export policy priorities (discussed in Section 5). Where development and export objectives are coordinated, especially where they have significant overlap as in renewable energy projects, enhanced outcomes can be achieved. The case for more coordination in donor countries of an agenda across government-controlled investment vehicles is compelling. For example, ECAs and bilateral DFIs are often both supporting similar projects in recipient countries, albeit with differing success metrics and lack of dialogue.
2. **Multilateral Development Banks** are a mainstay for channeling development resources and are being further charged with financing climate finance targets. Many see emerging competition between the traditional Western MDBs and new entities such as the AIIB and the BRICS New Development Bank (BRICS-NDB) as a possible shift away from western-dominated institutions.
3. **National Development Banks** in developing countries are well-positioned within their country's financial ecosystem and able to participate in funding national development plans. Many are underfunded, lack appropriate governance arrangements, and do not have the technical capacities to design, measure, and report on their development impact. Some NDBs are highly commercial, deposit-taking financial institutions while others have a track record of poor financial performance and political intervention. Strengthening these institutions could help them fill gaps in national governments' execution of their INFFs and to better serve as effective partner institutions to channel international development finance.

[23] ODA that is tied to donor country companies is often not matched to recipient country national development plans

3.2. Private Sources

The estimate of a more than USD4 trn annual financing gap to achieve the 2030 SDG goals put a spotlight on private investors and financial institutions as the largest source of potential contributors to development finance. Modern mobilization and blended finance agendas emerged from the 2015 conference on Financing for Development. The outcome document, the Addis Ababa Action Agenda, set as its ambition a framework for aligning all financing flows and policies with economic, social, and environmental priorities.

Since 2015 however private finance mobilization has not increased significantly. The Global Investors for Sustainable Development (GISD) Alliance estimates that most capital targets middle-income countries where investable assets are easier to identify and risk levels are lower.

Private sources of capital are increasingly adopting innovative investment strategies. Impact investors seek to optimize the climate and social impacts of their investments through compliance with globally recognized reporting and disclosure standards. In its 2022 Report, the Global Impact Investor Network (the GIIN) estimates the current impact investing market size to be USD 1.164 trn in assets under management (AUM). The GIIN report also highlights the rise of green bonds and corporate impact investing.

Fund managers, considered financial intermediaries, represented 61 percent of impact AUMs in the GIIN report while DFIs accounted for 27 percent. Other impact investors deploying private capital include foundations, diversified financial institutions, and family offices.

Growing expectations from stakeholders and investors for environmental and social results alongside financial returns are putting pressure on companies, asset managers and institutional investors to demonstrate value beyond financial returns. This has resulted in the introduction of a whole new asset class, broadly termed sustainability-linked financial instruments. Within this asset class, green bonds, for example, are familiar capital market instruments with novel covenants that allow issuers and investors to finance environmental projects and infrastructure that meet the demand for greater environmental accountability. The market for these bonds is growing rapidly at an estimated annual rate of 43 percent. The popularity of green bonds has led to the development of other sustainable fixed-income instruments, such as blue (ocean-related) bonds. Sustainability bonds amounted to over USD 1 trn in 2021[24]. This is an excellent example of sophisticated financial structuring being applied to social finance and appetite for such structures signals an as-yet unexplored interest by private investors in development finance.

Crowdfunding is another innovation in raising capital through donations, debt and equity investments, and even rewards funders that vary according to the size of the donation. Crowdfunding is a way for individuals, NGOs, and organizations to raise money by collecting and aggregating small, individual contributions through online platforms such as GoFundMe. Crowdfunding for development is a sub-set of all the types of crowdfunding, which is projected to experience 20 percent growth, hitting USD 250 mn by 2024.[25] For development, the World Bank has been advocating the expansion of the range of platforms

[24] https://www.brookings.edu/wp-content/uploads/2020/09/Impact_Bonds-Brief_1-FINAL.pdf
[25] https://www.globalfields.co.uk/insights/crowdfunding-for-development-and-climate-finance

and methods of outreach.[26] Microfinance institutions such as Kiva and Tridos Bank, are examples of the long-term successful use of crowdfunding for development.

Philanthropic Organizations and Family Offices

Philanthropic foundations and family offices are historically significant donors to sustainable development in LMICs through grant-making. More recently, influential foundations such as Gates, Rockefeller, Open Society, the Mastercard Foundation, Syngenta, and others, are actively influencing the design of, and capital flows to, SDG financing. Rockefeller, for example, incubated what has become the global network for impact investing, the GIIN, and has committed up to 20 percent of its endowment to impact investments. Many are also partnering with DFIs and MDBs with concessional finance including refundable grants to anchor high-risk deals in low-income countries.

Family offices invest family-owned assets and capital. Many have been at the forefront of sustainable investing, boldly innovating and testing new financial instruments for development such as direct cash transfers to beneficiaries and support for crowdfunding. The Omidyar Network, Pierre Omidyar's family office, considers itself a 'philanthropic investment firm' hosting both a foundation and an impact investment firm.

Impact Investing

The growth of assets under management (AUM), both public and private sources, has been rapid, particularly in response to challenges being addressed during the pandemic. According to the IFC, total global AUM is USD 2.3 trn, representing 2 percent of all investment AUM globally.[27]

Impact investment is the umbrella term for private funds making investments rather than providing grants, to achieve ESG impact objectives. It has evolved from frontier to mainstream as investors validated making market-rate returns alongside social or environmental impacts. Impact investors come in all shapes and sizes, particularly in the US where many impact funds include DFIs alongside private capital. Most impact investor funds are less than USD100mn in AUM. While not significant, these impact funds are able to make investments that generally smaller than MDBs or DFIs. Nonetheless, some impact investment firms have topped the USD 1 bn AUM threshold.

Increasingly, impact investors are attracted to the same kind of deals as the DFIs and can be active competitors for investment opportunities. Alternatively, they can join DFI-led consortia which serve to "crowd in" their form of private capital to DFI-led deals. Impact investment managers and funds are experiencing increased popularity with institutional asset managers to satisfy client demand for "ethical investment," although this relationship is at an early stage of development. This can be seen in the acquisition of significant stakes in impact investors by commercial asset managers.

Impact investors are increasingly seeking to unify around analytic and reporting standards overseen by one or more major organizations with broad acceptance. The SDGs, and their associated Indicators, are the single most widely accepted expression of impact objectives around the globe. Being able to articulate

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[26]https://documents1.worldbank.org/curated/en/409841468327411701/pdf/840000WP0Box380crowdfundingostudy00.pdf

[27]https://www.ifc.org/wps/wcm/connect/publications_ext_content/ifc_external_publication_site/publications_listing_page/impact-investing-market-2020.

a Theory of Change (or "impact story") consistent with these standards is critical to assessing impact, but how the impact is defined and measured remains a field with multiple competing standards.

Launched in 2019 by the IFC, the Operating Principles for Impact Management ("the Impact Principles") are the impact investing industry's leading investor framework for the design and implementation of impact management systems, with impact considerations integrated throughout the full lifecycle of an investment. The IFC recently announced plans to transfer hosting of the Secretariat for the Impact Principles to The Global Impact Investing Network (GIIN). The hand-over is to be completed by the end of 2022.

In addition to a strong impact story, impact investors look for investee companies or projects that can effectively monitor and report on progress to meet Monitoring, Evaluation, and Learning (MEL) requirements. The IFC defines impact investing as differentiating between funds that can actually "measure" impact and those that only "intend" to measure impact. During the negotiations for funding, a business is expected to commit to reporting practices and performance metrics which demonstrate impact, alongside financial returns, including an evaluation methodology that often requires third-party validation. Impact investors are looking for the same "double bottom line" returns as DFIs, while using private capital for their initiatives.

Corporations

Corporate participation in development finance includes both impact and SDG investing and grants aligned with perceived corporate social responsibility (CSR) objectives in low and middle-income countries. CSR activities are strategic to the business and are primarily off-balance-sheet grants to promote positive social and/or environmental outcomes, most often in markets or sectors where the company is active. In some jurisdictions (India), profitable companies are legally required to invest in CSR initiatives.[28]

Further, shareholder pressure to invest cash reserves productively, coupled with stakeholder demands for corporations to address broader issues including climate change, race, gender or social inequality, have led to a rise in companies using cash reserves and off-balance sheet options such as CSR. In 2020 in the US alone cash reserves held by non-financial companies rose to USD 2.15 trillion, up 32 percent from the prior year. The scale of cash held by companies, along with pressure to demonstrate ESG impact alongside financial returns is a promising opportunity for development finance, even recognizing that most will be invested domestically rather than globally. Microsoft, Netflix, Starbucks and other companies are investors in US-based Calvert Impact Capital, regularly purchasing bonds in the USD 10-20+ mn range. Calvert Impact's book is 50 percent domestic and 50 percent in low and lower-middle income countries.

Asset Owners and Asset Managers

Asset owners are pension funds, insurance companies, endowments (universities, churches, etc.), foundations, and high-net-worth and retail investors. They own the underlying assets but entrust the management of those assets to an asset manager. *Asset managers*, sometimes called portfolio managers or financial advisors, may work independently, for an investment bank, fund, or other financial institutions. Investment *brokers* act as intermediaries buying stocks and securities.

[28] https://cleartax.in/s/corporate-social-responsibility

The commercial investment universe is many times larger than all sources of development capital from ODA/DFI/impact funds. The public capital markets in 2022 are estimated to top USD 100 trn and set to rise to nearly USD 150 trn by 2025. Private capital markets add another USD 9.8 trn to the total of available global investable capital.[29] A significant sub-category of commercial asset management is "alternative assets," which references non-marketable securities and assets such as real estate, hedge funds, natural resources, and private equity. Data provider Prequin estimates USD 14.7 trn is currently allocated to alternatives and may rise to USD 20 trn by 2026.[30]

Driven by the sustainable investing global market trend, a substantial share of this vast market liquidity may be attracted to opportunities in developing countries. As with impact investing, an increased appetite from clients to see their investments generate social as well as financial returns has resulted in the burgeoning investment product category of environment, social and governance, or ESG investing. According to the consultancy Deloitte, ESG-mandated investment products are on track to account for half of all professionally managed assets by 2024.[31]

As an evolving area of investment activity, asset managers face some confusion about ESG mandates due to the lack of market coherence and consistency in standards, not to mention regulatory guidelines. Nonetheless, the pressure is on commercial investors to adopt proactive investment strategies that address ESG considerations. Moreover, as ESG is being harnessed to climate change considerations, asset owners and managers are under pressure to align action on the climate emergency to the broader ESG agenda.[32]

> Amid public sector initiatives to reach the objectives of the Paris Agreement and the Sustainable Development Goals (SDGs), there has been a sharp growth in investors' use of ESG approaches, including the incorporation of climate transition factors into investment decisions. In turn, ESG investing has become a leading form of sustainable finance for long-term value and alignment with societal values and has evolved from its early stages of development to mainstream investing in a number of OECD jurisdictions.
> *ESG and the Climate Transition, OECD 2021*

In light of this trend, asset managers and their regulators have been working towards creating a level regulatory playing field for investors in this space. An early leader was the Financial Standards Board, sponsoring complex exercises such as the Taskforce on Climate-related Financial Disclosure (TCFD) and subsequently the Taskforce on Nature-related Financial Disclosure (TNFD), both aiming to create market standards to govern definitions and reporting obligations for the financial sector with respect to the implications of the climate and the environment for their investment activity. Several major market regulators, such as the ESMA, SEC and newly created ISSB are sponsoring active consultations within the finance industry on how to embed TCFD/TNFD obligations and ESG ratings into required financial reporting standards.

[29] https://www.wealthbriefing.com/html/article.php?id=195322#.YzZ7WS8w3aY
[30] https://www.forbes.com/uk/advisor/investing/what-you-need-to-know-about-alternative-investments/
https://www.forbes.com/uk/advisor/investing/what-you-need-to-know-about-alternative-investments/
ility.html
[32] https://www.oecd.org/finance/ESG-investing-and-climate-transition-market-practices-issues-and-policy-considerations.pdf

"…. Shifting 1.1 percent of the total financial assets held by banks, institutional investors or asset managers (USD 4.2 trillion) would be enough to fill the growing financing for sustainable development gap. These new actors hold financial assets valued at more than USD 378.9 trillion that have grown at 5.9 percent year on year since 2012, due to increased financial intermediation."
Global Outlook on Financing for Sustainable Development 2021

In its annual outlook for sustainable finance, the OECD presented estimates of how much private capital is circulating globally and how diverting even a small amount of this capital could meet the SDG financing gap.

The potential for commercial investors that manage trillions of investor dollars to combine with experienced impact investors, whether public or private funded, is already stimulating new developments in the finance sector, such as the GFANZ[33] initiative.

Nonetheless, limitations on the potential for these players must be recognized. Many have suffered losses in the past and are conscious of the risk of investing in developing countries (credit risk, FX risk, political risk). There are also new, intriguing influences on these investment decisions as the ESG investing agenda is swept up in the culture wars, leading to accusations and backlash regarding investment objectives and fiduciary responsibilities.

Commercial banks

Commercial banks in developing countries include multinational banks and national and cooperative banks such as Fidelity Bank in Nigeria and Axis Bank in India. These banks generate revenue by lending to micro, small and medium-sized enterprises (MSMEs) and project finance but tend to prefer lending to the national government to finance fiscal deficits.[34] These banks generally charge high interest rates ranging from 6 percent to 48 percent to non-state borrowers.[35]

These high interest rates reflect the premium applied against the risk of investing in developed economies. However, commercial banks are often willing to partner with DFIs or ECAs to create lending facilities that are backstopped or underwritten by the ECA/DFI, that result in a lower overall rate of borrowing.

Additionally, major global banks with wealth management divisions, such as J.P. Morgan[36], have been pursuing impact investment strategies in response to demand for

…..The deepest segment of most capital markets in Africa is the market for government securities (mostly short-term): the volume of outstanding government bonds represents, on average, some 20 percent of GDP across the continent. By contrast, most African countries do not have a market for corporate bonds… represent less than 5 percent of GDP in most cases…. Government securities are attractive to banks as they represent 'risk-free' assets and do not encumber banks in terms of capital adequacy…..

FSDA, January 2022

[33] https://www.gfanzero.com
[34] https://www.fsdafrica.org/news/long-term-debt-financing-in-africa-is-a-problem-and-an-opportunity/
[35] https://www.theglobaleconomy.com/rankings/lending_interest_rate/Africa/

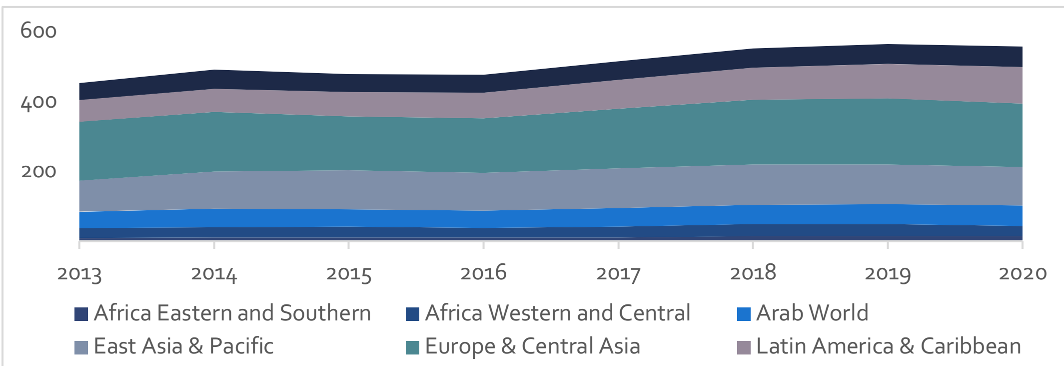
[36] J.P. Morgan has recently also established its own internal Development Finance Institution, it is the first commercial bank in the world to have done so. [Development Finance Institution | J.P. Morgan (jpmorgan.com)](https://www.jpmorgan.com)

customized strategies from wealthy clients. Their work in ESG investing and structuring investment vehicles has brought increased, non-traditional commercial bank activity into developing countries.

Remittances

Remittances refer to the money sent home by immigrants and migrant workers to more than 800 million family members in developing countries (excluding China). Comparable in scale to foreign direct investment flows, remittances exceed ODA flows by nearly three times according to the World Bank. Principally directed for personal/family needs and small business support, they lift families out of poverty, put food on the table, pay for education, cover health expenses, allow housing investments, and many other family goals according to Gerald Houngbo, former President of the International Fund for Agricultural Development (IFAD). The International Organization for Migration (IOM) assessed the magnitude of these flows at just over USD 605 bn in 2021 according to the *MobileRemit Africa*. Mobile and digital channels have accelerated and simplified remittance flows and are seen by IFAD as opportunities to boost rural development as over half of these funds go to rural areas.

Figure 11: Remittances by region in billions of US Dollars



Source: World Development Indicators

Private Credit and Political Risk Insurance

The private sector provision of specialized insurance called Credit and Political Risk Insurance (CPRI) provides significant risk capacity to commercial banks, lenders and investors for their developing country business activities. Similar to coverage from ECAs and other specialized development insurers such as MIGA and Africa Trade Insurance Agency (ATI), their policies protect against a range of commercial and political risks that can arise in cross-border transactions and therefore can be tapped in support of development finance transactions.

There is deep capacity in the private insurance market which consists of a variety of Lloyd's syndicates, and insurance companies. As an example, The Hartford, a leading CPRI provider, indicates that there is risk appetite by private insurers for sovereign payment risk in (certain) developing countries for loans on tenors for up to 15 years, and for political risk (war and insurrection, inconvertibility and expropriation) on investments up to 15 years with transaction limits of up to USD 100 mn[37].

According to the BPL, a leading specialist broker in credit and political risk insurance (CPRI), there remains significant capacity (of up to USD 3 bn) for new long-term business (of up to 20-year tenors) in developing markets[38].

There is a long history of cooperation between ECAs and the private market and only more recently with MDBs (with bilateral DFIs cooperating less often). IFC's Managed Co-Lending Portfolio Program (MCPP) leverages IFC's origination capacity and deep market knowledge to source investment opportunities for third-party investors to co-lend alongside IFC on commercial terms, using a variety of offered structures that adjust to the investors' needs. From the private insurers' vantage point, MDBs as policyholders represent an attractive client because of the "halo" effect.

Example of Collaboration between Private Insurers and an MDB

"The Asian Development Bank (ADB) has signed an agreement with five leading global insurers which will mobilize up to USD 1 billion of co-financing capacity to support lending to financial institutions in Asia and the Pacific.

The Master Framework Program for Financial Institutions will allow ADB to increase its lending to both commercial banks and non-bank financial institutions in the region through the use of credit insurance.

ADB has signed an initial 3-year partnership with Tokio Marine Group (Tokio Marine & Nichido Fire Insurance Co. Ltd, and Tokio Marine HCC), AXA XL, Chubb, Liberty Specialty Markets, and Allianz Trade.

The highly rated insurers participating in the program will cover the risk of nonpayment on a portion of ADB's loans to financial institutions. This will allow ADB to transfer credit risk from its portfolio to insurers' balance sheets, freeing up ADB's capital, managing its exposures, and increasing its lending capacity."

https://www.adb.org/news/adb-partners-global-insurers-mobilize-1-billion-lending-capacity-financial-institutions

Summary of Private Sources

There are significant pools of private capital that, with the right deal structures, can be (and need to be) tapped to a far greater extent in support of development finance. Figure 11 below illustrates the relative scale of capital available from public and private sources. These sources – each with their own strategic interests and abilities – have the potential to be mobilized to augment or even surpass public financial resources.

Understanding the business model and mechanisms that enable the giants of wealth management, private equity, and institutional investment to participate in emerging markets and poor countries is essential and must be prioritized. These include changes to regulatory schemes that limit risk, prevent individuals from participating as investors, and so forth. Fostering partnerships and collaborations across players with different expertise and identifying public financial instruments that are attractive to private capital are all priorities for leveraging increased capital into developing countries.

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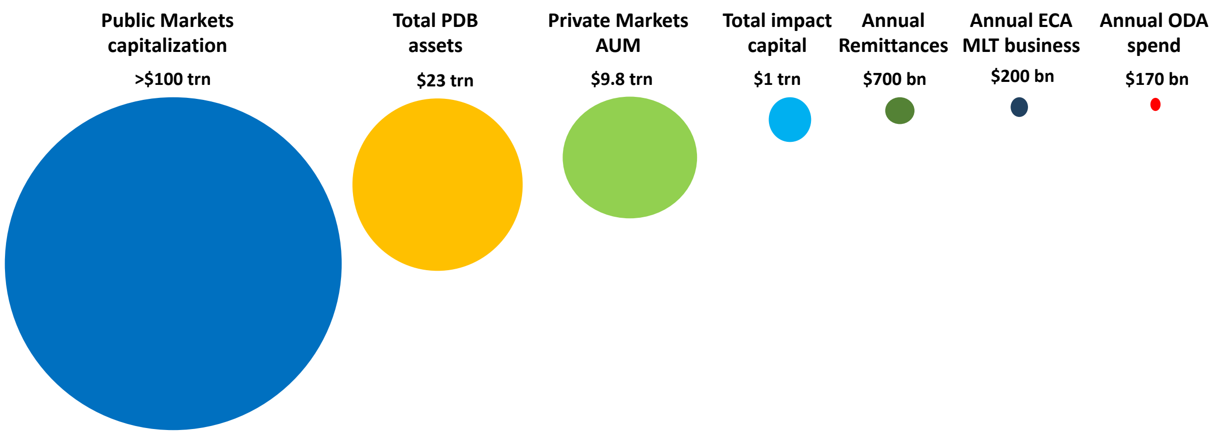
[37] https://so.hfdstatic.com/sites/the_hartford/files/credit-political-risk-overview.pdf
[38] Global Market Capital Survey 2021 https://bpl-global.com/wp-content/uploads/2021/02/BPL-Global-Market-Insight-2021.pdf

Figure 12: Comparative Size of Private Capital Potential



Source: Adapted from How Public Markets Can Unlock Emerging and Front Market Opportunities (https://mobilistglobal.com)

4. DEVELOPMENT FINANCE INSTRUMENTS

Important to the global balance sheet is the type of financial instruments that can be deployed to attract and efficiently allocate capital towards the SDGs. Beyond grants and ODA, more complex methods of financing can be structured to leverage increased capital flows into developing countries.

4.1. Debt

Debt, in its simplest form can be a loan or a bond. The size of the global bond market was USD 128.3 trn in 2020, of which African bonds comprised USD 802 billion. Bond markets were split between sovereign (government) issuances (68 percent) and corporate issuances (32 percent.)[39]

China is one of the largest government creditors to Africa with more than USD 150 bn committed to African public sector borrowers between 2000 and 2019[40], including zero-interest loans, concessional loans and commercial loans. In August 2022, it forgave 23 interest-free loans to 17 African countries[41] and the annual new loan commitments from China have been dropping since their peak in 2018.

In the corporate debt market, loans and debt-like instruments are widely used to facilitate business growth. Traditionally viewed as a simpler product, debt investment is usually easier for companies to negotiate and manage than equity. It also requires fewer ownership or management concessions and can be booked as a simple liability in accounting terms.

[39] https://www.icmagroup.org/market-practice-and-regulatory-policy/secondary-markets/bond-market-size/
[40] SAIS-CARI http://www.sais-cari.org/publications-briefing-papers-bulletins
[41] https://www.bloomberg.com/news/articles/2022-08-23/china-to-waive-some-africa-loans-offer-10-billion-in-imf-funds

Commercial debt products can be expensive in developing countries due to premiums associated with credit, political, and/or foreign exchange risk. Therefore, only relatively mature enterprises are able to access sufficient working capital at a manageable cost, especially those generating foreign currency earnings.

The provision of debt products by some DFIs fills a gap in the market where they are able to take higher risks and provide credit on more concessional terms. DFIs are also able to access capital at a lower cost than most commercial players, given their government backing and higher credit ratings. Lending with a 25 percent or greater "grant equivalent" can be reported as ODA, making lending an attractive means of supporting economic growth in developing countries. Recycling capital rather than giving it away in the form of grants is increasingly preferred.

Debt has other characteristics beyond the interest rate. The length of the life of the debt instrument, or tenor, as well as the grace period (time before making first principal payment) are also linked to perceived risk factors and borrowers from developing countries often receive shorter tenors from commercial lenders than borrowers from developed countries. The term "patient capital" has come to characterize the longer-dated investment products offered more readily by DFIs than by commercial debt providers. On the other side of the tenor spectrum, short-term working capital in the form of trade finance and supply chain financing has been in limited supply from the commercial sector at an affordable rate. DFIs have attempted to improve this by arranging guarantees and revolving credit facilities in tandem with banks, bringing down costs and expanding credit supply.

When setting financial return objectives, DFIs may be willing to take lower-than-market financial returns in exchange for ESG impacts. In addition to lower returns, development finance transactions often feature other characteristics that distinguish it from commercial capital. These features may include greater risk appetite, offering a longer tenor than the typical market investor would be able to tolerate, or other performance criteria that maybe waived or eased.

More recently, the utilization of complex, structured debt products within development finance has been growing. For example, there is considerable appetite for sustainable bonds, of which green or social bonds are a subset, that are structured with covenants that require the borrower to deliver desired development outcomes in exchange for lower coupons (the cost of the debt). Issuance in 2021 was a spectacular 69 percent increase over 2020, surpassing USD 1 trillion for the first time.[42] Even the corporates in developing countries can access capital with a reduced cost by making environmental and/or social commitments alongside their debt issuances.

> The first corporate green bond was issued in Kenya in 2019, a USD40m issuance from Acorn, committing the company to develop a stock of green housing for university students. Meanwhile, a combination of DFIs and government entities – the Nairobi Stock Exchange, Kenyan Bankers Association, FMO and FSDA – are collaborating to build a thriving domestic green bond market. Leading corporates are learning how to structure these instruments and gain regulatory approval for their issuance.

[42] https://www.environmental-finance.com/content/the-green-bond-hub/sustainable-bonds-insights-2022-introduction.html

As investors become increasingly interested in financing the SDGs, there may be increased capacity among developing countries to monetize future cash flows generated by projects with positive SDG impacts in areas such as renewable energy, mobile money, and infrastructure revenues. These cash flows can be converted into debt instruments, to increase available funding for growth in the present term. DFIs or other sub-commercial investors, can play a role by supporting subordinated, or less senior tranches, in credit structures, or by providing other credit enhancement to mitigate risk. This is how distinct investor types can combine to produce “blended” financial instruments, meeting multiple return expectations. As debt structures become increasingly sophisticated, transforming the risk levels of the issuances into credit ratings that are acceptable to institutional investors, there is the potential to expand the flow of commercial private capital into developing countries and the SDGs.

4.2. Equity

Global equity market capitalization stood at USD 124.4 trillion in 2021.[43] In terms of scale, equity investment is comparable to debt markets. Much of the global equity market is publicly traded on stock exchanges. There is also a sizable private equity market, where shares do not have to be listed, to be purchased. Much of the equity investment in developing countries is private equity, due to the lack of publicly listed companies. To meet the large SDG financing gap, whether on public or private markets, equity can provide a powerful boost to businesses in developing countries and must be tapped.

The scale of equity investment (in which the providers of development capital take an ownership stake in businesses) has rapidly increased since the late 1990s in the development finance world. As this occurred, it was accompanied by an expansion of the impact and ESG fund management industry and their assets under management (AUM), as well as growth in the size of the equity portfolios managed by DFIs. The estimated size of the impact investing market alone recently topped USD 1 trillion, as reported by the GIIN at their 2022 Amsterdam conference.[44]

Equity investments can be made directly or via a fund investment. DFIs are active equity investors in developing countries using both channels. By doing so, they hope to have a “demonstration” effect to the broader commercial financial sector, showing that it is possible to successfully make and exit equity investments in developing countries. Direct investment demonstrates that growing companies in developing countries are ready to responsibly absorb and effectively utilize investor capital, and that these investments can be successfully exited with reasonable returns on capital. Fund investments help to professionalize and grow the overall investment sector, increasing assets under management (AUM), scaling funds to make them more economically productive.

Private equity has played an outsized role in boosting entrepreneurship in the developing world. In turn, commercial equity investors are experiencing greater pressure from their client base to address ESG impacts and play a role in the achievement of the SDGs. This confluence of boosting entrepreneurial businesses with investor demand for ESG-friendly investment choices has promising potential to attract a larger proportion of PE capital into developing markets. Evidence of this is emerging through the new investment products being offered in developed country capital markets and through the business

[43] https://www.sifma.org/resources/research/fact-book/
[44] https://thegiin.org/research/publication/impact-investing-market-size-2022/

collaborations that have emerged between commercial investors/asset managers and experienced developing country investors.

Investment returns to private equity in developing countries are often, although not necessarily, lower as the investments have a higher risk profile and aim to achieve other "returns" in addition to, or instead of, financial returns. This is particularly the case for DFIs and impact investment managers, who are prohibited by their policies from adopting some of the more aggressive financial practices that PE firms been known to practice (i.e. loading balance sheets of acquired companies with debt, extracting excessive dividends) to maximize returns. Offsetting this, however, is the fact that investible companies in developing countries generally have very high growth rates, leading to rapid capital appreciation and robust returns.

Private equity can be provided along a range of timelines, from early stage/seed capital to growth capital for firms with a proven track record and multiple years of growing revenues and profits. Equity investment remains committed to the company or project for potentially long periods of time (traditional PE is 5-7 years of being invested, whereas equity investment for development purposes tends to be held longer, anywhere from 7-15 years).

There are several types of equity investment used in developing countries; convertible instruments, such as mezzanine debt, are very popular, where an investment is initially structured as a debt product, but with the option to convert the instrument into an equity investment in the event certain conditions are met.

Development finance investors providing equity to companies often require the company to meet additional obligations alongside expected financial returns. These obligations are usually linked to the ESG standards encouraged or even required by investors. This makes development finance providers experts in the field of applying ESG standards to investment and as the demand for ESG reporting grows internationally, it is now being adopted in a limited but growing way by commercial investors to their investments in companies around the world, not just in developing countries.

4.3. De-Risking

De-risking is a form of transaction enabler to alleviate barriers to closing financing transactions. De-risking instruments are those financial tools that entice private capital to invest by improving their prospects for and attractiveness of financial returns.

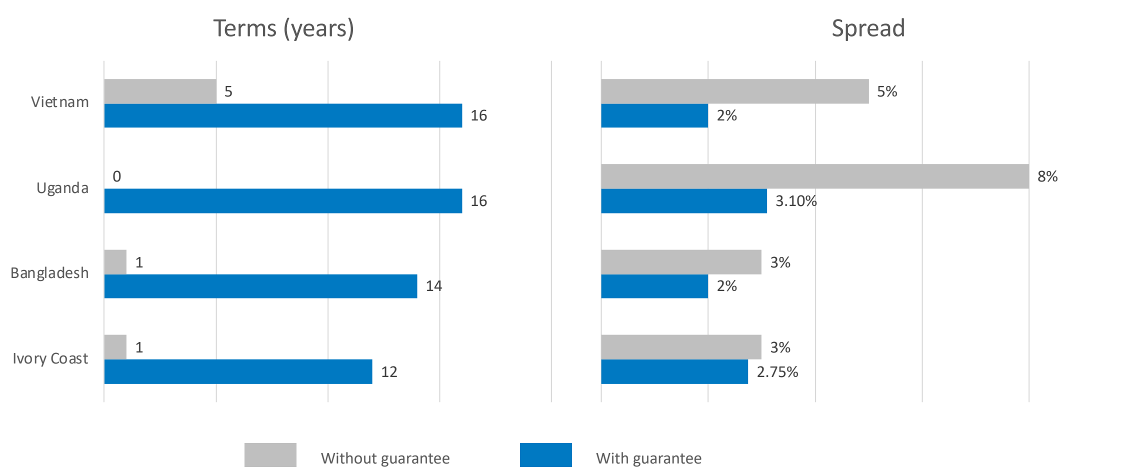
> Blended finance is a new tool to crowd in private sector financing that would otherwise not be available to projects with high development impact. One such approach is to blend concessional funds – typically from development partners – alongside commercial funding. https://www.gafspfund.org/private-sector-financing

Blended finance is a form of de-risking, using concessional or grant financing to help create a stronger financial return for the commercial player(s). By taking "first loss" positions, providers of risk capital agree to absorb early potential losses in an investment proposition, protecting the more conservative investors higher up in the capital structure. As each investor agrees to take risks and returns appropriate to its investment mandate, these blended structures enable the completion of transactions that were otherwise too one dimensional and could not find sufficient commitments to reach close.

There are a number of financial instruments and structures involved in de-risking.[45] These have the effect of transferring the risk to another party, enhancing, or mitigating the risk still held and/or improving the financial return/cost of capital.[46]

1. **Guarantees** transfer risk in whole or in part to a third party. They can address a range of risks including credit, political and (exceptionally) technology risks, making it more attractive to investors. The most common guarantee product offered by MDBs and DFIs is the partial credit guarantee, a credit enhancement mechanism for debt instruments (bonds and loans). It is an irrevocable promise by the MDB/DFI to cover principal and/or interest. Using their superior credit ratings, MDBs/DFIs seek to facilitate a successful transaction and support borrowers in obtaining financing at lower prices and extending maturities. As illustrated in Figure 12, the provision of guarantee-enabled transactions to complete and increase their tenor and reduce their cost.

Figure 13: Financial Impact of Guarantees Provided by the World Bank



Source: World Bank[47]

Some MDBs/DFIs also offer partial risk guarantees, in which a financial guarantee is extended to commercial lenders to cover payment defaults that result from the non-performance of a government or government-owned entity on its obligations with respect to the specific project.

2. **Credit insurance** mitigates against non-payment or default by borrowers and is offered by ECAs and private insurers. **Political Risk Insurance** insures against Breach of Contract, Transfer Restrictions/Currency Inconvertibility, Expropriation along with the risk of War & Civil Disturbance. Several development institutions (such as MIGA, the African Trade Insurance Agency

[45] https://www.oecd-ilibrary.org/docserver/357c027e-en.pdf?expires=1661130435&id=id&accname=guest&checksum=1711CE603C678846596AE4B2C7AA1F85

[46] https://www.chathamhouse.org/2021/07/financing-inclusive-circular-economy/03-de-risking-financing-circular-economy-0

[47] https://publications.iadb.org/en/multilateral-development-banks-risk-mitigation-instruments-infrastructure-investment

(ATI), the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC)), ECAs and private insurers are able to provide such policies with varying eligibility criteria. The value of the insurance policy to a bank can be impacted by the credit quality of insurer in terms of whether it can be a full risk transfer instrument or a risk mitigation tool.

3. **Stand-By facilities** inject liquidity in the case of a cash shortfall in the project. In these cases, liquidity risks are covered when a project faces a crunch due to currency risks or offtake risks. OPIC (the former US DFC) for example established an Exchange Rate Liquidity Facility for a Brazilian transaction to mitigate devaluation risk.[48] KfW/ATI's Regional Liquidity Support facility (RLSF) which covers up to six months of the Independent Power Producer's revenue via a Stand-By Letter of Credit. KfW and ATI provide the collateral for the Letters of Credit, lessening the burden on power utilities and enabling more projects to reach financial close.[49]

4. **Co-financing and co-investment** with a MDB or DFI can make a transaction more attractive to the private sector. A "halo" is conferred by a DFI on co-financiers who benefit from the value of their preferred credit status.

5. **Foreign exchange (FX)** hedging addresses a key risk where borrowers need to use local currency revenue to repay debt denominated in a foreign currency. Loans are made in what is often a strong international currency, while revenue generation of the project is largely in highly fluctuating domestic currencies. Protection from FX risk can be purchased but is costly. MDBs or DFIs can mitigate FX risk by investing capital in vehicles that provide local currency lending, such as ALCB who have in turn protected themselves through portfolio diversification. Other solutions, such as the TCX sell local currency hedging products in developing countries, as well as GuarantCo, which provides flexible guarantees against local currency loans, and are market leaders in this space.

Risk mitigation products are often but not always a sub-set of the debt market designed to offset some of the risks that contribute to high levels of risk premium and therefore the high cost of debt in developing countries. When combined with debt structures, especially in large-scale infrastructure project finance, the availability of such risk mitigation products can make all the difference to the feasibility of an investment arrangement.

4.4. Return Expectations

Within the array of financial instruments being utilized in development finance, apart from grants, investors expect a financial return on their capital, whether the instrument is a fixed income product or an equity stake.

[48] https://www.piie.com/publications/chapters_preview/351/3iie342x.pdf

[49] https://www.esi-africa.com/renewable-energy/three-de-risking-tools-to-attract-private-investors/

29 The rapid rise of ESG investing, as investors demand more products that reflect their values, has prompted commercial asset managers to design credible investment vehicles requiring the assessment and validation of non-financial return metrics. In parallel, regulators have had to act quickly, to create the standards and rules that govern investment reporting, bringing discipline to the sector and maintaining an even playing field for the industry and consumers. An example of this regulatory response is the creation of the new International Sustainable Standard Board (ISSB), overseen by the global authority IFRS, an accounting standards and practices board that is setting the global framework for measuring, validating and reporting on sustainability-linked metrics.

> "The intention is for the ISSB to deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions."
> https://www.ifrs.org/groups/international-sustainability-standards-board/

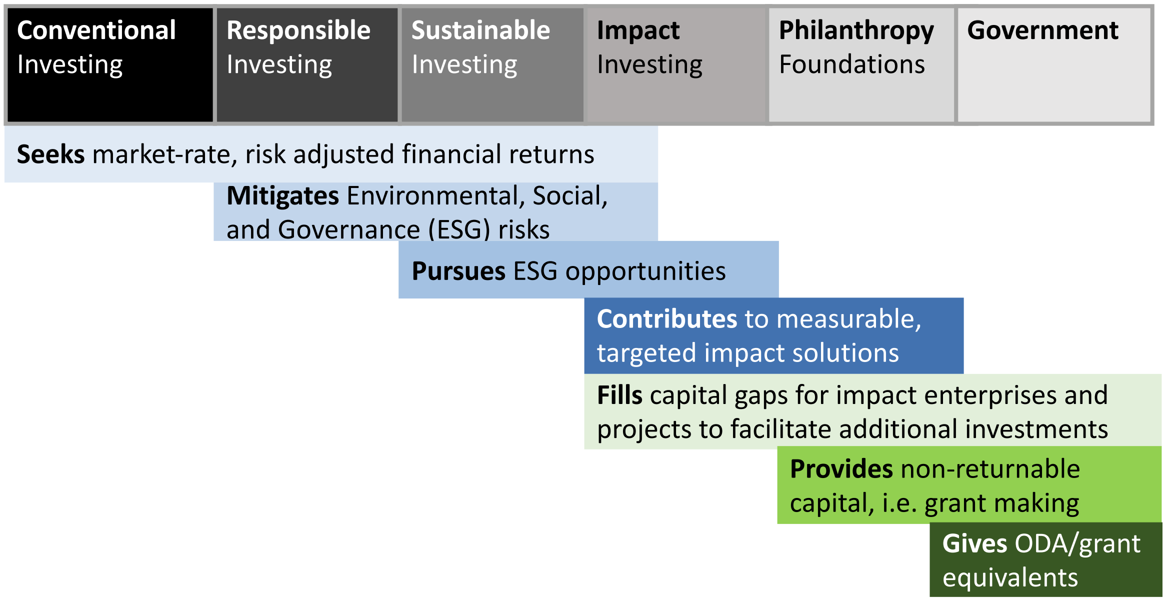
Nonetheless, there are limits on the extent to which commercial asset managers can move into development finance. Regulators of investment products continue to impose fiduciary obligations on asset managers to achieve the best possible *financial* return for clients and there are investment quality restrictions as to what investments can qualify for certain investment vehicles.

As investors from developed countries seek new investment products that address their financial and social concerns, commercial asset managers have sought ways to access investment opportunities that are consistent with these new expectations. While the entire +USD 100 trn investment market cannot shift towards wholesale ESG investing approaches in developing countries, the industry sees sufficient strength in the trend to not only develop new products but to make some corporate strategy changes, including (a) the acquisition of subsidiaries with this kind of investing experience and (b) incurring operational costs to develop their ESG capabilities.

> "Three-quarters of the ODA-eligible countries…. are rated as "speculative" (i.e., B+ or lower), and thus outside of the mandates of most commercial debt and equity investors. Commercial capital (even capital tracking 'purpose' investment themes like sustainable finance or ESG investment) will therefore not flow to "speculative" markets at scale without some form of risk mitigation."
> https://www.ifrs.org/groups/international-sustainability-standards-board/

What is important about these trends in the huge commercial financial markets is that the development finance sector has long coped with the challenge of (a) weighing the risks of investing in developing countries, (b) assessing the relationship between financial and non-financial returns, and (c) reporting to their investors on the impact of their investments. Moreover, they have extensive experience finding and managing successful investments in those spaces. Therefore, DFIs have a unique set of capabilities that are increasingly of interest to commercial market players looking to satisfy their client demand and their own corporate ESG commitments. This is leading to an unprecedented shift from siloed investor types across the spectrum of investment activity, towards greater collaboration and joint investment activity. This is demonstrated in Figure 13, where the overlap between investor types, based on their return expectations, is graphically represented.

Figure 14: Classification of Return Expectations



Source: Adapted from Tideline's Catalytic Capital: Unlocking More Investment and Impact (2019)

In this representation of the investment returns spectrum, there is an overlap between the conventional, commercial investment sector and the sectors that value non-financial considerations, all the way through to the impact investment sector (which includes DFIs). There is, interestingly, much more activity/overlap between impact investors and the philanthropic sector as well.

Having turned to non-traditional markets looking for non-traditional investment opportunities, investor expectations for their capital are evolving. First, they are discovering that financial returns are not always vastly different. For example, fund returns are lower across Africa, but due to macroeconomic issues such as demographics, entrepreneurship, and deregulation, the financial return gap is narrowing.

The trend in the lowering of financial return expectations on the left of the spectrum is mirrored on the right side of the spectrum where there has been a shift amongst philanthropic organizations, including NGOs, towards generating returns or at least getting their money back (returnable capital or repayable grants). Private philanthropy for development finance was assessed by the OECD as averaging USD10.6 bn annually between 2016-2019, approximately equal to 7 percent of all ODA made available during those years.[50] While the OECD captured the activity of over 200 foundations it is not likely to be a comprehensive survey as such organizations are not obliged or incentivized to report their financial activities as ODA.

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[50] https://www.oecd-ilibrary.org/sites/cdf37f1e-en/index.html?itemId=/content/publication/cdf37f1e-en

Recycling capital rather than providing grants can magnify development finance efforts. By investing returnable capital (where some or all of the principal investment is returned) and having the potential of earning even a modest financial return on their capital, more can be done with the same envelope of funds. As a result, return expectations have risen, so that some philanthropic capital now overlaps and has expectations consistent with some impact investors. This has led to productive collaborations between what used to be considered the charitable "silo" of grant-making and the investment "silo" of the finance sector.

> "Median gross of fee returns from African PE investment are comparable to those from developed markets, but for private equity funds, African median net IRRs are closer to 5 percent, compared to 14 percent for developed market PE funds net IRRs over the last 10 years (although future expectations are nearer 8 percent)..... [Going forward, this] could result in a more than 4 percent improvement in net returns, putting median African private equity performance ahead of expected global private equity median returns...."
>
> *https://caia.org/blog/2021/11/23/african-private-equity-returns-risk-and-potential-global-context-part-i*

> "People working at NGOs possess valuable social and environmental expertise but rarely have backgrounds in banking and finance. Financial terms such as "concessional equity" and "internal rate of return" can therefore be daunting to professionals at NGOs. But both sides have much to gain from working together. Blended finance is one way for NGOs to engage with the private sector and bring in additional sources of capital – whether for their own operations or for the people and companies on the receiving end of the transaction. Blended finance is a structuring approach that uses catalytic capital from public or philanthropic sources to increase private sector investment in sustainable development." https://www.convergence.finance/news-and-events/news/5gG6kXkd4XUTUlTFuO2zcD/view

4.5. Summary

As the sustainable finance/SDG agenda increasingly resonates with investors and donors, there is a greater convergence between investor types than was the case in the past, opening the door to (a) more capital flowing towards impactful investment in developing countries, and (b) more investors with common objectives for ESG outcomes generated by their investments. These sources of capital are better able to leverage more complex financial instruments than they have in the past due to a "cross-fertilization" of expertise and market experience. The capital required to achieve the SDG objectives may now come from the conventional commercial side of the return spectrum and/or the formerly grant-only (charitable) side of the return spectrum. The fusion of these capital sources is the great hope for filling the SDG financing gap in years to come.

5. FIVE KEY PRINCIPLES OF SUCCESSFUL DEVELOPMENT FINANCE SYSTEMS

5.1. Introduction

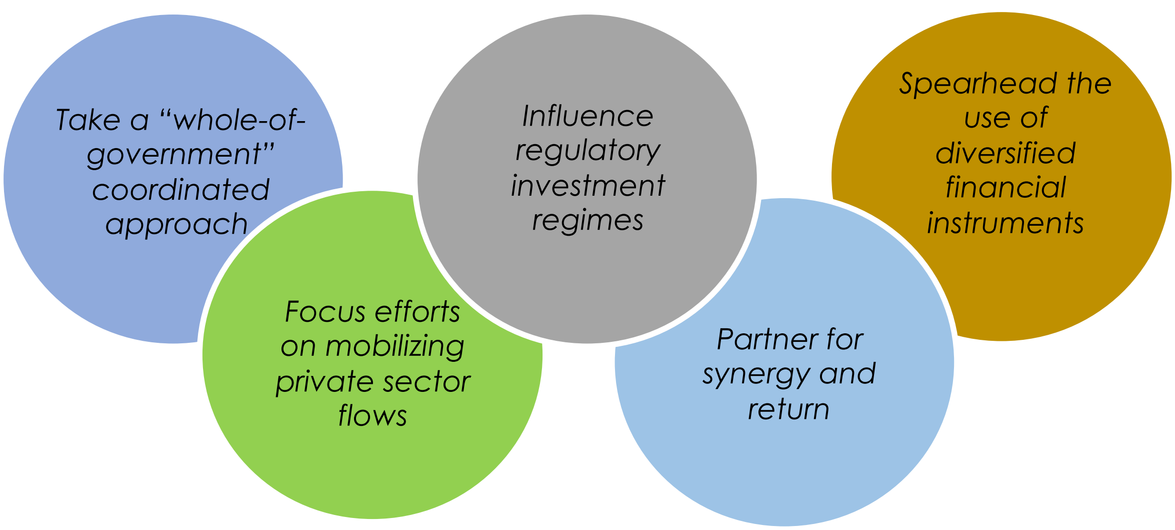
Donor country development finance contributions take many shapes and sizes. Each system reflects national interests, including strategic foreign policy interests, and historic ties.

Building the appropriate products and services to attract private capital at scale requires a deep understanding of both the investors' needs and the markets, along with the operational expertise to connect the two. This is especially true in low-income countries where deals are seldom standardized as in developed countries. DFIs, more than government agencies, are well-positioned to bridge the gap between private sector sources of capital and public institutions.

Matching policy objectives with talent matters. With the scale of capital needed to achieve the SDGs outstripping ODA, donor countries are challenged to bring the expertise across finance and development agencies and their professionals. As noted in the previous chapter, collaboration and coordination is essential for governments to lead in successfully mobilizing new capital.

While no two donor country systems and contexts are alike, there are a number of ways that successful donor countries are adopting progressive approaches to achieving the 2030 SDG Agenda. Below, five key features are identified and explained, with a view to seeing these features increasingly dispersed across the development finance landscape.

Figure 15: Five Key Principles of Successful Development Finance Systems



Source: IFCL

5.2. Donor Countries that take a "whole-of-government" coordinated approach

Governments that treat the use of ODA and development finance as part of a larger international agenda are more strategic and effective in targeting their financial contributions. Global agendas that cover international development, export promotion and foreign relations as part of the same strategy can be more effective, but implementation of the strategy and coordination of the instruments is a critical feature.

Coordination between the export and development agencies of donor countries has been more challenging. Since the 1990s, the concept of "tied aid" kept trade interests and development interests separate. OECD governments could not be seen to be tilting the competitive playing field in their favor using aid money to help recipient countries purchase donor country exports. Procurement decisions taken by a developing country buyer were to be based on the quality and price of the export and not on the financing provided.

> Coordination …. is multifaceted, occurring at many levels (e.g., country, regional, thematic) and for different purposes (e.g., knowledge sharing, policy development, market shaping, transaction support). Some collaboration is more formal and structured, with BII staff providing regular technical input into ongoing FCDO programs.
> https://ettg.eu/wp-content/uploads/2022/10/Donors-implementing-agencies-and-DFIPDB-cooperation-The-case-of-the-UK-BII-and-FCDO.pdf

However, as noted in the Study on Convergence of Development Finance and Export Finance (2019)[51] there has been a confluence of the activities of donor countries' DFIs and ECAs. Partnerships between these donor institutions to meet the needs of developing countries, whether funding flows through a DFI, an ECA or another national channel, must be prioritized. Those countries that proactively link the business of their DFIs and ECAs to achieve national objectives, in which these institutions play systematic and complementary roles, strengthen the overall offering.

More joint products are being created between ECAs and DFIs and other ODA-funding organizations. This is especially the case where ECAs have strategic commitments to support the energy transition and are using their ECAs to back green investment. There are also new initiatives such as Acre Impact that are stepping in to fill the gap between export credit instruments and bank financing, which are a common challenge in developing countries. An example of ECAs supporting development is the DGGF – the Dutch Good Growth Fund – which is managed by the ECA of the Netherlands and designs non-traditional export finance products to support trade and MSMEs.

Another way in which the provision of aid has come to be linked to broader political agendas, especially that of Europe, is the link between ODA and climate finance. Official policy commitments to discontinue the use of coal-fired power plants was an early red line for donors and this trend towards using aid money to advance the energy transition is growing. While developing its latest "taxonomy", the European Commission has faced criticism for not excluding natural gas from its delineation of acceptable transition

[51] https://www.ekf.dk/media/5gdbojbq/final-report_convergence-of-development-and-export-finance.pdf

fuels. Given the response, future European ODA-funded projects will lean heavily towards renewable power projects and other environmentally helpful support.

In the UK, where the independent DFID was absorbed into the newly created FCDO, the inclusion of its ECA, UKEF, in the International Development Strategy signifies a whole-of-government approach has been adopted, recognizing that delivery of UK aid can be carefully targeted alongside the delivery of UK expertise, business and technology expertise.[52] While not reverting to "the bad old days" of tied aid, the UK recognizes that it has both economic and political tools to bring to its development partnerships.

Japan is another example of how this balance is achieved. Japan takes a top-down and centralized approach to international development finance programs ensuring that they are aligned to Japan's industrialization and export promotion strategy. The national industrial policy focuses on developing technologies in which it has the potential to be internationally competitive. Japan seeks to ensure all the players work together on a cooperative, coordinated basis with the primary objective of maximizing Japanese exports and commercial influence. JICA closely coordinates its activities with those of the commercial sector, often coming in alongside private capital to support development projects. The use of experts via JICA's technical assistance is often in fields related to the promotion of Japanese technical expertise. Japan seeks to ensure seamless technical and financial support by agencies for the adaptation and export of these technologies, which when linked with technical cooperation funds, helps embed Japanese technology abroad and seeks to make it a technology of choice.

5.3. Donor Countries that focus efforts on mobilizing private sector flows

The predominant trend in development finance is "mobilization" of the private sector. All donor countries are pushing on this agenda, with varying degrees of success. While this concept has been around for many years, the extent of the current pressure to increase involvement of the private sector in solving issues associated with sustainable development has grown enormously. Where public funding is being deployed, there should always be strategies to ensure that the use of these funds lead to concomitant capital flows being drawn in from the private sector. This can be done through joint investment vehicles (as with the Netherlands' FMO) or via relationships and direct outreach.

Efforts to mobilize private sector finance can be at the transaction level, portfolio level and more strategic fund management level. Donors with the ability to catalyze additional private capital towards development objectives are in the forefront of growing the capital pool to achieve the SDGs. Donor countries, such as the Netherlands, applying a variety of financial solutions that channel private financial resources are using their powers efficiently and effectively to meet the SDG agenda.

DFIs and ECAs have a long history of backing transactions that have facilitated the participation of private capital. The levers to attract private capital are discussed in Section 4.3 and include blended finance and risk mitigation products. More recently, sophisticated financial structuring of transactions designed to comply with the market requirements of institutional investors and private commercial capital has brought together commercial investors and development finance organizations at the transaction level. This is particularly noticeable in the sustainable (and green) bond markets where debt covenants

[52] https://www.gov.uk/government/publications/uk-governments-strategy-for-international-development/the-uk-governments-strategy-for-international-development

associated with ESG outcomes have been attached to issuances that are highly rated and compliant with institutional investment mandates.

At the portfolio level, there are myriad ways to mobilize additional private sector capital. A novel approach has been taken by FMO, the Dutch DFI. FMO, with close to 50 percent of its shares held by the private sector, has been managing private money for some years now, accepting private investment mandates with customized investment strategies. In 2012 FMO established a private asset management company (FMO Investment Management – FMOIM) which co-invests on behalf of private institutional investors in transactions sourced and managed by FMO. It holds approximately USD700mn assets under management.[53] In product terms, portfolio-level securitization of assets or cash flows is another innovative approach to making developing country financial assets investible by global institutional fund managers.

At the strategic level, some donor governments looking to mobilize private sector sources of capital are harnessing the power of the capital markets to improve the quality and cost efficiency of providing development finance. For example, the UK government is trying to change pension investment rules to enable green infrastructure investment in both domestic and international markets. Where this kind of private capital finances renewable energy in developing countries, for example, it serves multiple objectives – aiding the energy transition, meeting NDC commitments and leveraging patient capital into projects that advance the SDGs.

5.4. Donor Countries that influence regulatory investment frameworks

Within the private sector, there are forces pushing commercial asset managers and owners towards the traditional development finance space. The climate change-related net zero commitments made by many firms in support of global carbon emission reductions, have resulted in private companies acting to reduce or offset their own emissions and to report publicly on these efforts. In turn, investment managers are adjusting their portfolios to reflect these efforts, resulting in higher market values for those firms that offer a compelling ESG/climate plan. Either to satisfy their own investment strategies or because they are being pushed by clients through divestment campaigns or new product demands, investors are rewarding companies with credible strategies.

These forces have expanded to be about more than just carbon emissions, with investors and other stakeholders seeking investment products that embed more rounded considerations of issues such as the energy transition, increasing biodiversity, and other ESG considerations. Investments that improve societal outcomes have become a major commercial opportunity and even an institutional reputation risk mitigant. ESG-linked investment strategies are growing and seeking assets that generate these non-financial positive social outcomes. As DFIs have long emphasized ESG considerations in their investment activity in developing countries, commercial investors are more willing to consider investing alongside them. In this way, the new emphasis on ESG considerations is attracting commercial capital to firms and sectors that they previously overlooked or excluded for risk-adjusted financial return-related factors.

If financial instruments are designed with impact performance obligations, then mechanisms for defining and calculating those obligations become essential. Several regional and global initiatives are working to

[53] https://www.impactinvest.org.uk/wp-content/uploads/2021/06/Emerging-Markets-Loans-Fund.pdf

gain international consensus on definitions and calculations that embed impact into financial reporting and disclosure standards.

In 2020, the European Commission introduced a taxonomy for sustainable activities, a classification system for determining whether an economic activity is environmentally sustainable. However, it is a challenge for EU institutions to embed the use of the taxonomy. For example, until there is more clarity on its application outside the EU, FMO in the Netherlands will continue to classify assets, steer, and report based on its in-house “Green label” system. At the same time, FMO will review developments in the taxonomy to determine what can be aligned at each stage and fill data gaps where required. FMO sees a risk that it could become harder to invest in developing countries if institutions are not given the flexibility and time to align with the taxonomy. EU sustainable investment disclosures via the SFDR regime are further driving commercial firms to adopt consistent ESG disclosure practices that make the sector more investable.

Other reporting issues that affect capital allocation include potential new regulatory reporting changes as championed by the Taskforce on Climate-related Financial Disclosure that will influence how investment capital is allocated due to disclosure of business risks associated with climate change. The evolution of the work has led to the establishment of a new body, the ISSB, which is charged with establishing an acceptable global accounting framework that is able to capture climate related impacts on firms and investment and which may be broadened with the addition of nature-related disclosure standards associated with biodiversity and wildlife preservation. The US SEC has undertaken a consultation on climate-related disclosures with findings recently published.[54] The work done by the EU, the SEC and ISSB on this subject demonstrate that changes need to be made to financial reporting to reflect increasing awareness of and concerns for the social impacts of climate change.

Institutional buy-in is gradually being achieved and the trend remains in favor of institutional investors being required to assess financial and non-financial return issues, pushing them firmly towards greater convergence and partnership with the development finance world, especially the DFIs. Donor governments who are active in harnessing all sources of finance, both public and private, and are engaged with the regulatory bodies to encourage and incentivize private investments, are able to achieve national objectives for development goals.

For governments to encourage the crossover of the private capital sector into SDG financing, an examination and modification of the global investment regulatory regime is required. By modifying fiduciary obligations that singularly demand profit maximization with a more nuanced, whole-picture view of return, private sector investment management firms (asset managers/owners, pension funds) would be freed to make more socially responsible investments, where financial returns and social returns are more optimally balanced for the long term.

5.5. Donor Countries that partner for synergy and return

There are many ways to partner among entities that share objectives. In the ODA universe of the top 10 international ODA providers, it is common for “Western” donors to collaborate on transactions, especially large infrastructure investment programs, with a view to making risky financial investments “bankable”.

[54] https://www.sec.gov/news/press-release/2022-46

This ability to collaborate on "club deals" comes from a common set of SDG goals and the standardization of financial practices. In contrast, Turkey and Saudi Arabia, as the 9th and 12th donors of ODA respectively, tend not to collaborate to the same extent and will structure financial transactions (often applying Shariah financial instruments) in distinct ways from other donor countries, limiting opportunities for partnering with Western DFIs. Increasing the cross-over between international regions and international financial products would increase the overall leveraging of global capital for development purposes.

Proactive partnering and facilitation of partnerships among disparate groups, including commercial capital, should be prioritized. This goes, for example, for domestic industry players active in sectors that can drive achievement of the SDGs – water treatment facilities, renewable energy, healthcare systems strengthening – and demonstrates how they can build their businesses and do good in developing countries by bringing much-needed capital, technology and skills development. Intermediaries can play the role of catalytic investors, bridging any financing gaps with the instruments at their fingertips, or as convening powers, paying to bring interests together and identifying/removing barriers to progress.

It is the gains to be derived from these strategies, proactively developed and promoted, that is often underappreciated by non-financial actors. For example, government funding is often channeled via "calls for proposal" of one kind or another. The passive nature of these initiatives, where issuers are "takers" of whichever applicants respond, can result in sub-optimal outcomes. While they have their place, they are no substitute for active outreach and proactive engagement to form strategic partnerships with key market players. Governments can use their influence to encourage specific private sector players to participate and contribute to achieving the SDGs in a pragmatic, coordinated way.

Despite the best of intentions, collaboration can result in the overlap, and excess claims for meeting SDG objectives. This is particularly true of climate investment and gender lens investing. The desire to meet multiple objectives can result in the prioritization of transactions that meet several objectives at once – improving gender equity, addressing the challenges of environmental change and leveraging private capital – in a way that can lead to "badging" a single investment in multiple buckets for reporting purposes. Moreover, multiple entities can claim these benefits for a single transaction, albeit they (should) only claim for the capital "attributable" to their portion of the transaction. Therefore, while partnerships among likeminded organizations are certainly productive, there is a danger that outcomes appear magnified relative to actual dollar amounts deployed.

5.6. Donor Countries that spearhead the use of diversified financial instruments to achieve catalytic impacts

There are many interesting transactions being done by development finance organizations, and the market is increasingly seeking to participate in these transactions to meet their own ESG commitments. KfW is a leader in this sector, harnessing as it does multiple government entities to provide a diverse set of products with a range of return profiles. They are also considered a professional and experienced capital market player, making them desirable co-investors. The combination of their government backing with a related high credit rating and their market reputation means that commercial investors can look to them to structure attractive deals.

An example is the program Insuresilience, managed by the German government but backed by the G20, to explore methods of driving adoption of insurance solutions to achieve climate resilience and adaptation in developing countries. This multidimensional program is active in both grant and investment activities, driving change at the policy level as well as industry level. Still young, having been formed in 2017, Insuresilience and KfW have already made a greenfield equity investment to support the provision of index-linked natural disaster insurance products which prompted a major insurance sector firm to provide additional risk capital that backs developing country insurance products.

There are trends in how instruments are being designed, taking lessons from the capital markets, which have attracted new investor types or increased investor demand. Fixed income issuances designed with a link between the cost of the debt and covenants associated with impact performance, have increased tremendously in the last couple of years. These have multiple labels, depending on the impact being achieved – sustainable bonds, social bonds, green bonds, etc. They are increasing in popularity and in 2021 over USD 1 trn worth of such sustainability-linked products were issued. According to Linklaters, over USD 442 bn was raised during the first half of 2022.[55]

Innovative financial structures contribute to channeling money within the international capital markets to achieve SDG objectives in developing countries. These initiatives are truly "catalytic" in the sense that they use ODA or sub-commercial capital to leverage multiples of private capital into these countries in ever greater magnitudes.

Summary

Donors that use their influence and instruments to involve different investor types to solve contemporary and technical problems are the most successful. Optimizing use of donors' available levers to catalyze additional sources of development finance towards meeting the SDGs must be prioritized. An untapped lever is to encourage greater access to the GEMS database to bring private sector risk perceptions to better align with risk realities.

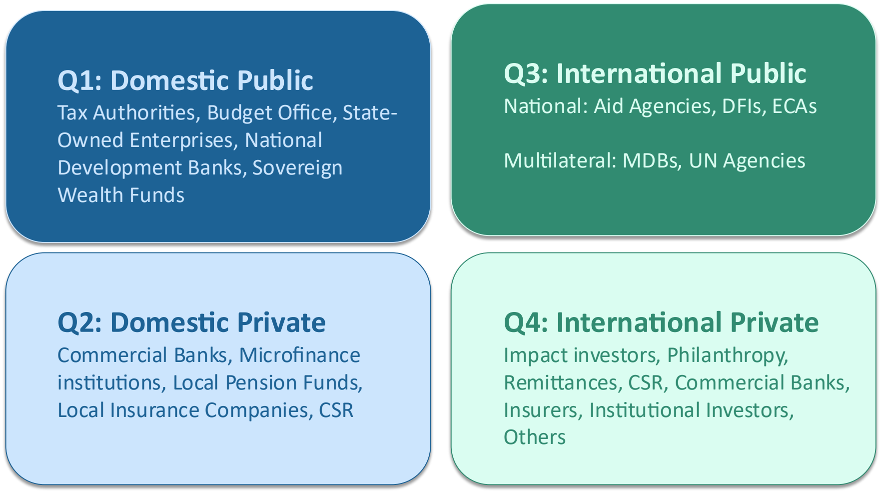
6. SUMMARY AND CONCLUSIONS

By presenting the global landscape for development finance as a "balance sheet" this paper aims to illuminate the levers at work in the financial system. By discussing the "liability" side of the equation, in which the needs of developing countries are defined through the framework of the INFFs, it is possible to better understand how to shift the many "assets" of the financial systems towards accomplishing the SDG agenda. There are several interlinked aspects of the development finance landscape - where are the financial gaps associated with the SDGs, how can these gaps be addressed by the financial markets, which financial products can be used most effectively, and who will create and distribute these products – all of these questions are tackled in this report in a descriptive and comprehensive way.

Within the INFF, there are four quadrants from which incremental development resources could be harnessed to meet the SDG financing requirements.

[55] https://www.linklaters.com/en/about-us/news-and-deals/news/2022/july/global-sustainable-bond-market-raises-442-billion

Figure 16: INFF Four Quadrants of Sources of Development Finance



Source: Adapted from www.inff.org for this Report

How these four quadrants interact is critical to understand. International private capital is attracted by an enabling business environment that the government in a developing country must seek to actively create through better, more favorable and more reliable policy frameworks with fewer bureaucratic processes. Better public sector financial management and identifiable success at combatting illicit financing flows gives international public sources more confidence in providing additional concessional resources. Domestic private capital, such as from local financial institutions, can be more engaged with additional capital from international sources, as well as incentives to shift focus from buying government paper to finance the fiscal deficit to lending to the real economy.

With this overview of the landscape, several observations of the development finance ecosystem emerge:

- Investor interest in this type of investing is opening the door to greater participation from private sources of capital, particularly commercial capital. Philanthropic capital is also more open to creative investment structures to fund their activities.

- Commercial private capital sources are able to bring to bear greater expertise with complex financial instruments and provide access to institutional investors.

- Therefore, it may now be possible to supplement the capital traditionally dedicated to achieving the SDG objectives (national and international public sources) with conventional commercial capital.

- Private sources of philanthropic capital may be able to work with non-traditional partners such as commercial investors, to design innovative SDG-related financial solutions for developing countries.

This report concludes with five key features of successful development finance systems, which are approaches and organizational strategies that can optimize the use of existing financial envelopes and potentially grow those envelopes by moving the levers in the control of donor countries.

The levers in the hands of donor countries within the International Public quadrant include financial instruments (grants, loans, equity and de-risking), all of which can be brought to bear in optimizing the development finance flows that can be channeled towards meeting the SDGs. However, other levers within donor countries' control, such as influence, awareness and the powers to collaborate with other partners are also crucial to unlocking private sector flows.

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