Increasing private finance mobilization:

Recommendations for development banks and the global development community

GISD Global Investors for Sustainable Development Alliance

Increasing private finance mobilization: Recommendations for development banks and the global development community

The GISD Alliance would like to thank Convergence Blended Finance for the support in developing this paper.

Cover photo: Los Muertos Crew on Pexels

October 2021

Introduction

The global development community – comprising the United Nations, G7, G20, OECD countries, ODA donors, International Financial Institutions[1], Multilateral Development Banks[2] and Development Finance Institutions[3] – estimate the investment needs in developing countries to achieve the SDGs and climate objectives to be around $4 trillion per annum. But with aggregate GDP of these 145 developing counties (ex-China) at $18 trillion and domestic financial assets around $16 trillion, there is insufficient domestic financial resources within the developing countries to self-finance the SDGs. The UN estimates actual investment levels around $1.4 trillion leaving a $2.5 trillion SDG investment gap annually[4]. These investments will need to be aligned with the Addis Ababa Action Agenda and the SDGs.

The identification of this SDG investment gap led the global development community to acknowledge the urgent need to mobilize a higher portion of the $379 trillion of global financial assets,[5] held mostly by private sector financial institutions and investors, to developing countries. The modern mobilization and blended finance agendas were born in 2015: a view that IFIs, MDBs, DFIs and OECD DAC members should play a larger role to mobilize private finance to developing countries. The Addis Agenda notes the role that blended finance can play in mobilizing the private sector, while also recognizing that it may not be suitable for all SDG investments. It also defined a set of principles for blended finance.

Six years later, private finance mobilization has not increased tangibly beyond 2015 levels and continues to face multiple challenges. Best available estimates are that official development finance mobilizes around $30 billion of private finance annually, with most of the resources (more than 70% between 2012 and 2018) going to middle income countries where projects are easier to realize. In contrast, Least Developed Countries have only participated in a small share of blended finance transactions (around 6% between 2012 and 2018). There is a still a discussion in which sectors and contexts blended finance can be used appropriately to ensure financial and developmental additionality. As laid out in the Addis Agenda, it is important that blended finance transactions are transparent, share risks and rewards fairly and include clear accountability mechanisms.

The 30 members of the GISD Alliance have engaged with the global development community since October 2019 to identify ways in which the Alliance members increase the private finance flows towards achieving the SGDs, including considering ways in which blended finance solutions can mobilize higher levels of private finance to all developing countries. These should be seen as part of a range of collaborative investment strategies and approaches between the public and private sectors that will be needed to comprehensively address the SDG financing needs.

Recommendations to Increase Private Finance to $100+ billion by 2025 and $1 trillion by 2030

The GISD Alliance makes 8 priority recommendations to the global development community to increase private finance mobilization[6] summarized in Table 1. Noting different priorities and business needs among development actors, the GISD Alliance is convinced that the realization of the

[1] Such as The World Bank Group
[2] Such as AsDB, AfDB, IADB and EBRD.
[3] Such as UK CDC, US FDC, Canada FinDev, Netherlands FMO, France Proparco and German DEG.
[4] The OECD estimates the SDG Investment Gap likely has increased to $3.2 trillion during the 2020-21 Covid pandemic.
[5] Only 4% of global financial assets are invested in developing countries (excluding China).
[6] Box 1 in Annex 1 provides technical information, including description and context for private finance mobilization.

recommendations would lead to higher levels of cross-border private finance to all developing countries. This will support the implementation of an increasing number of projects with high SDG and climate impact that have a sound business rationale but are currently not attracting private investors. Taking a broader perspective, there is also a need to review regulatory frameworks that may restrict investors from investing in certain markets.

Table 1: 8 Recommendations to increase private finance mobilization

#	Description
1	**Development Community (e.g., OECD DAC members) strategy** to increase SDG investment in all developing countries by prioritizing and budgeting development finance that mobilizes private finance in appropriate areas
2	**MDBs and DFIs: Amend governance and business model** to increase private finance mobilization and financial additionality
3	**Support mobilization and blended finance activities** that will mobilize private finance at scale
4	**Collaborate to allocate limited catalytic and/or concessional funds** to most effective mobilization proposals
5	**Standardize blended finance structures and investment assets** produced by mobilization and blended finance activities
6	**Align investment assets to investment mandates of high interest to private investors**
7	**Increase investor access to investment assets derived by blended finance and development finance**
8	Aggregate and fund **best data/information** to support cross-border investment to countries and asset classes unfamiliar with investors (e.g., GEMS database)

Recommendation 1: **The global development community should design and communicate a strategy that prioritizes and allocates budgets for private finance mobilization towards the SDGs in appropriate areas in all developing countries**

The 2030 agenda calls for an increase in private investment that is aligned to sustainable development. But private investment levels in developing countries, and global development community mobilization efforts remain low – comparable to prior to the 2015 adoption of the SDGs. A review of annual OECD DAC member reports and the reports listed in Annex 2 indicates OECD DAC members allocate around \$3 - 4 billion per annum of the \$150 billion of ODA and ODA-like resources with the intent of mobilizing MDBs, DFIs and/or private finance: (1) around 45% allocated to/through MDBs and DFIs to blend with their own capital to finance transactions and (2) around 55% allocated to blended finance transactions with the private sector directly. This is equal to around 2% of the annual ODA and ODA-like resources OECD DAC members commit annually.

It is recommended the global development community collaborates to scale private finance mobilization that could include the following steps, taking into account perspectives of all stakeholders:

- Design and implement a Strategy where a known amount of development funds can efficiently be allocated on an annual basis to best-practice[7] blended finance transactions (e.g., 7% of ODA, or $12 billion), in conjunction with an increase of total ODA. The objective should be to increase the quantity and quality of SDG and climate projects implemented in all developing countries through targeted private finance mobilization. Any re-allocation should be additional and not at the cost of other critical uses of ODA. Non-concessional resources (such as from development banks) should be used when possible to avoid diverting ODA from sectors that may be less suitable for blended finance. The Strategy should also cover a wider range of instruments that have the potential to mobilize private investment, such as guarantees, risk insurance, first loss participation, and SDG bonds.
- Strategy should be fully aligned to the SDGs and 2030 agenda.
- The Strategy should clearly communicate how "private finance mobilization" fits alongside and in addition to donors' traditional ODA activities. For example, how (i) $138 billion of ODA plus $12 billion of ODA that mobilizes $80 billion of private investment finance to SDG projects in developing countries leads to a larger number of SDG projects implemented in developing countries compared to $150 billion of traditional ODA alone, including through , (ii) mobilization activities have high sustainable development impact and increased SDG investment as their dual core objectives and (iii) mobilization activities should be focused on scale activities to tangibly narrow the SGD Investment Gap. Efforts to scale up activities should be accompanied by measures to strengthen transparency and reporting, as well as information sharing on new vehicles and programmes.
- The Strategy should focus on mobilizing private investment to SDGs, sectors, and projects where blended finance has a comparative advantage and private investment is more willing to invest (e.g., infrastructure, climate and SMEs). The Strategy should clearly map market needs and the products needed in each market segment.
- The Strategy should articulate how donors will collaborate and coordinate towards mobilizing private finance at scale and ensure sustainable development impact, as opposed to the current fragmented, uncoordinated mobilization blended finance activities;
- The Strategy should identify how the global development community will focus on mobilizing investments from institutional investors, significantly scaling from the current very low investment levels;
- Ensure private finance mobilization through various instruments is one of the core performance indicators for OECD DAC members, their development agencies and MDBs & DFIs;
- Transparently communicate availability of catalytic and/or concessional funds, including to private sector asset managers and asset owners.
- MDBs and DFIs should develop onboarding programs for financial institutions to enable a better understanding of risk and mitigation instruments and how blended finance solutions can shift risks towards investment grade.

[7] A body of best practice blended finance has been established over 15 years and 600+ transactions, and includes strong financial additionality, development additionality, minimum concessionality, private investment mobilization at scale, and ideally a transitory period to sustainable private finance without the need of donor support.

Recommendation 2: Shareholders should modernize the governance and business model of MBDs and DFIs to ensure private finance mobilization and financial additionality are top transparent performance indicators

MDBs and DFIs have a key transformational role to play for the implementation of the SDGs and the Paris Agreement, particularly in the poorest countries. It is therefore important that they are fully aligned with sustainable development and climate objectives. Shareholders should recapitalize MDBs where necessary to ensure that they can fulfill their mandates.

To increase private finance mobilization, it is recommended shareholders govern their MDBs and DFIs towards increasing the quantity and quality of aggregate SDG finance to increase the likelihood of achieving the SDGs:

A. **Govern towards aggregate SDG investment**
B. **Share transactions with private investors instead of focusing on deploying own funds**
C. **Maximize financial additionality by focusing on asset types systematically under-supplied in developing countries and less suitable for private investors**
D. **Maximize capital utilization**

A. Govern MDBs and DFIs towards increasing the quantity and quality of aggregate SDG finance

The MDBs and DFIs should be governed towards playing a more important role to meet the annual SDG investment needs, including the discontinuation of support to projects that are not aligned with the SDGs. As part of the Strategy above, the MDBs and DFIs should be governed towards playing a more tangible, important role than achieving aggregate finance of only around 4% of SDG investment needs annually. A short-term objective of 10% towards a long-term objective of 25% could be SMART[8] objectives.

B. Share transactions with private investors instead of focusing on deploying own funds

Table A in Annex 1 provides an executive summary of MDBs and DFIs main development finance assets on their balance sheets.[9] The MDBs and DFIs strongest comparative advantage is arranging and managing senior loans. The benefit of the existing MDB and DFI business model is that their primary private sector finance asset is hard currency loans – around 75% of aggregate private sector assets. These assets are the ones which private sector financial institutions and investors provide and understand the most and have the largest amount of investment capital available.

Two core amendments to the MDB/DFI business model would have significant impact on mobilizing significantly higher amounts of private finance to developing countries: (1) transferring arranged hard currency senior loan exposure to private investors (e.g., A-B loan structures) and (2) subscribing second tier capital in blended finance structures. Through these amendments, MDBs and DFIs should be governed as mobilizers of private finance - originate and arrange senior loans and then transfer exposure to private investors. This practice will free up MDB and DFI financial and human resources to

[8] SMART is an acronym for Specific, Measurable, Achievable, Relevant and Time-bound.
[9] The MDB and DFI financing and mobilization amounts presented in this paper are best estimates using MDB and DFI reported information.

take on the financial assets that present higher levels of financial additionality in developing counties (see below).

The most effective blended finance structures that mobilize private finance at scale include MDBs and DFIs (i) originating and arranging these hard currency loans, then (ii) distributing risk into blended finance vehicles. Best practice examples for such blended finance vehicles are AfDB – European Commission Room2Run and IFC-Sida MCPP Infra. Other solutions that have offered interesting results are the Credit Guarantee & Investment Facility offered by ADB, InfraCredit and the recent GuarantCo offering of full financial guarantees for project bonds in Kenya. Efforts should also be taken to allow for a greater degree of flexibility through the creation of frameworks and vehicles that fund a general purpose instead of individual projects.

Table B in Annex 1 summarizes the four most important organization types for successful blended finance solutions at scale and lists their main comparative advantage in blended finance structures.

The most optimal blended finance structures leverage the main comparative advantage of the four main participants identified in Table B with the minimum use of concessional finance while maximizing sustainable development impact. The biggest supply of debt capital from private debt investors is available for debt investments rated (actual or implied) Investment Grade (e.g., BBB- or better). At the same time, MDBs and DFIs have an appetite for, and a large amount of capital for, speculative grade debt investments (e.g., BB and B).

Given these comparative advantages, requirements and constraints, likely the most effective blended finance structures would deploy a three-tier blended finance capital structure:

- Tier 1: Commercial investors targeting Investment Grade (e.g., BBB- or better)
- Tier 2: MDB and DFIs who are authorized to and encouraged by their shareholders to hold higher-risk, speculative grade BB. B and CCC risk
- Tier 3: Donor funds in most junior position to create Investment Grade investments for commercial investors and BB and B investment profiles for MDBs and DFIs

Subject to project and country context, it is recommended MDB and DFI shareholders target a significantly higher mobilization ratio for their hard currency senior loan exposure through their private sector window. For example, the MDBs and DFIs currently provide around $30 billion of senior loans to private sector borrowers in developing countries annually. Maintaining those same net positions retained by MDBs/DFIs, while achieving a three-times leverage ratio, would produce around $120 billion of hard currency senior loans – an extra $90 billion of financing for SDG projects.

C. **Maximize financial additionality by focusing on asset types systematically under-supplied in developing countries and less suitable for private investors**

Financial additionality should be a core metric of MDB and DFI performance in addition to sustainable development impact. As of today, the MDBs and DFIs systemically, relatively, over-supply hard currency senior loans and under-supply other assets of higher financial additionality (that are systemically under-supplied by the private sector): e.g., local currency loans, equity and mezzanine capital. Also, domestic private financiers can play an important complementary role to international financiers. Partnerships between domestic and international financiers, for example through co-investment platforms, have the potential to reduce foreign exchange as well as political risks while transferring valuable know how to domestic investors.

The five financial assets listed in Table C in Annex 1, in principle, provide higher financial additionality for the SDGs in developing countries.

In summary, it is recommended MDB and DFI businesses models be amended in the short-term along the following lines:

- MDBs and DFIs should be primarily mobilizers of private finance for the assets they originate and arrange - senior loans are most attractive to private investors, but other financial assets could be attractive (e.g., direct equity);
- MDBs and DFIs should maximize their financial additionality by providing more financing to systemically under-financed assets;
- MDBs and DFIs should commit more funding to second tier capital (mezzanine capital) in blended finance transactions;
- MDBs and private investors should work together to develop financing solutions (e.g., local currency facilities) and hedging instruments to reduce the currency mismatch for project sponsors and investors.

D. **Maximize capital utilization**.

The 2020 ODI Report suggests MDBs only utilize around 45% of their capital. It is recommended the shareholders require MDBs and DFIs to fully deploy their capital through changes to existing mandates and rules. For example, a key KPI for MDBs and DFI could be 90% capital utilization. All other things being equal, this would lead to a 100% increase in MDB and DFI balance sheets and annual development finance volumes. That is, at least an extra $45 billion of MDB and DFI private sector finance annually. In addition, MDBs and DFIs should ensure greater flexibility in terms of process to reduce transaction cost when deploying private investment.

Recommendation 3: The global development community should support blended finance vehicles that will mobilize private finance at scale (and in alignment with the SDGs)

Convergence's State of Blended Finance 2021 Report findings reveal the median size of blended finance vehicles has been $55 million between 2018 and 2020. At the same time, institutional investors have advised that if they are requested to invest in a non-standard investment asset, they will need to allocate more due diligence and analysis resources - they state they would each seek to invest $100+ million in an investment in developing counties derived from blended finance and would prefer to hold maximum 20% of the financial exposure. Therefore, it is not possible/practical for institutional investors to invest in most blended finance transactions as practiced today - they are too small. Based on feedback from investors, the global development community should be supporting the development of scalable blended finance vehicles that have a clear development impact in alignment with the SDGs.

In general, there are two ways to achieve blended finance vehicles at scale:

1. Support individual blended finance transactions where the aggregate deal size is at least $250 million, and preferably $500+ million[10].

[10] $500 million is derived by two requests from institutional investors: (i) $100 million minimum investment size and (ii) maximum 20% of exposure.

2. Support innovative "aggregation" structures. This "aggregation" approach can produce results of benefit for all parties:
    a. The donor allocates its development funds to a small vehicle that pursues specific development impact results
    b. The institutional investors are able to invest large amounts to meet their minimum investment criteria
    c. The fund manager of the micro fund would usually be an "impact" fund manager with experience in impact investing
    d. The fund manager of the macro aggregation fund could be a traditional, mainstream fund manager that will attract institutional investors

Recommendation 4: The global development community should allocate scarce catalytic and/or concessional funding to mobilization / blended finance proposals with the highest sustainable development impact

Ideally, blended finance solutions can support incremental risk capacity and funding into this whole spectrum of financing activity. Good, blended finance proposals to accelerate the SDGs by financing more projects are available, but they lack the funding and risk capacity. In 2021, there appears to be three main channels to allocate catalytic (concessional):

- Multilateral organizations, like the European Commission, Global Environment Facility, Green Climate Fund and IDA Private Sector Window, allocate catalytic capital to proposals submitted by a limited number of entities. Usually, these entities are MDBs and DFIs.
- Bilateral organizations (e.g., UK FCDO) allocate funds to unsolicited proposals or for specific requests for proposals.
- Donors create "challenge funds" open to many organizations to submit proposals, and the proposals with the highest sustainable development impact are identified and funded[11].

The third type is the least funded. It is recommended donors should collaborate to fund the proposals with the highest sustainable development impact, with a transparent process implemented to encourage proposals and better understanding of decision-making.

Recommendation 5: The global development community should promote harmonization of mobilization and blended finance structures while ensuring flexibility to adapt to different contexts

Most blended finance transactions have been bespoke / tailor-made. To encourage scale, donors should ensure funds are allocated to blended finance transactions that pursue harmonized solutions that have potential to mobilize investors at scale, while ensuring sufficient flexibility that allows for the use of blended finance in different countries and sectors. Innovative programmatic approaches that encourage standardization and replicability should be identified and scaled up. This will have many positive impacts, a larger primary market and, over time, a secondary market that can provide liquidity. For example, Annex 3 summarizes four blended finance structure that donors and institutional investors agree hold a lot of promise to mobilize at scale through standardization of structure.

[11] Donors evaluate blended finance transactions across many criteria, with development as the main criteria, for example (i) the five OECD Blended Finance Principles, (ii) sustainable development and (iii) sustainable finance.

It is recommended for the global development community to:

- Support harmonization of mobilization and blended finance solutions that mobilize private finance at the project level (e.g., a $300 million infrastructure project in a developing country)
- Support harmonized mobilization and blended finance solutions that mobilize private finance at the portfolio level (e.g., a $1 billion fund that will invest in ten infrastructure projects in multiple developing countries)

Recommendation 6: The global development community should align investment assets derived from mobilization and blended finance to sustainability - related products that are of interest to private investors

Private investor interest and demand for investment assets aligned to "purpose" investments, such as *Responsible Investment, ESG Investment, Climate Finance, Green Finance, Sustainable Finance and Impact investing* is growing substantially. Investors continue to have low interest/appetite for investment labelled *developing countries* and *frontier markets*. Therefore, mobilization and blended finance activities should produce investment assets aligned to one of more of these investment themes in demand by investors – to attract investors and scale up investment in developing countries and frontier markets. At the same time, this should not result in the exclusion of certain country groups and sectors due to labelling.

Recommendation 7: The global development community should increase investor access to investment assets derived by blended finance and development finance

GISD Alliance members have good access to (i) public markets investment opportunities globally and (ii) private market investment opportunities in developed counties.

Most investment opportunities derived from blended finance in developing countries are available in private markets. But access to these investment opportunities is poor.

The GISD Alliance recommends that the global development community creates a single marketplace that houses investment opportunities derived by blended finance and development finance. A practical solution could be (i) ensuring all blended finance / development finance investment opportunities are located on that platform and (ii) access is free/universal to accredited investors. GISD Alliance members stand ready to engage in further discussions with MDBs and DFIs on the way forward. The GISD Alliance has launched the SDG Investor Platform to provide private sector investors with access to country level market intelligence, including on-the-ground insights on the local investment landscape, investment opportunities and investor connections.

For platforms to be effective, it is also important to support more proactively the development of an investible pipeline of SDG related assets. It is suggested to:

a. Step up ongoing efforts to strengthen the real sector (e.g. transport, energy, water) and financial sector ecosystem so EMDEs increase their institutional capacity to generate investible projects;
b. Expand, improve or replicate, as appropriate, experiences DFIs existing initiatives to support specific project structuring such as the Global Infrastructure Facility (GIF) sponsored by the

World Bank, InfraVentures sponsored by IFC, or EBRD's Sustainable Infrastructure Policy and Project Preparation (SI3P).

Recommendation 8: The global development community should make their track record data available to enable informed private finance investment decisions

Investors have limited access to data of investment performance – both debt and equity – in developing countries. Most credit rating agency reports aggregate debt investment in developed countries with debt investment in developing countries – not very helpful when assessing developing countries only.

The GISD Alliance recommends that the global development community consolidates key data/knowledge of investing in developing counties and make this data/information available to investors universally. A non-exhaustive list includes:

- The Global Emerging Markets (GEMS) database for MDB and DFI senior loan track record (i.e., default rate, recovery rate) to private sector borrowers in developing countries – good data for risk, defaults and losses
- Similar information for direct equity and portfolio/fund equity investments
- Expand reporting on impact and transparency and ensure that blended finance facilities strengthen the quality of monitoring, evaluation and, ultimately, sustainable development impact.

Further work on standards and measurement tool can be supported by joint initiatives between MDBs, DFIs and the private sector.

Annex 1

Technical information

Box 1: Private finance mobilization

The breadth of *private finance* in this note comprises all financial assets such as debt, equity and guarantees. Private finance is provided by private sector financial institutions and investors, including banks, pension companies, private equity, etc. Private finance providers are located in developing countries and developed countries. The focus of the GISD is to increase private finance to SDG projects in developed and developing countries.

Private finance mobilization comprises activities by development-focused organizations, such as the global development community, to increase the provisions of private finance to developing countries. A typical example is when an MDB provides a loan to an SDG project/company in a developing country, and that loan is syndicated with commercial banks participating in the syndicated loan (e.g., in MDB parlance an A-B loan structure. Another example is when an OECD DAC member subscribes junior, subordinated capital to a private equity fund that allows the fund to attract private equity investors into senior capital, with the fund's capital deployed in developing countries (e.g., blended finance vehicle).

All GISD Alliance members (and private sector investors) have a fiduciary mandate to invest capital at market-terms. Most debt assets under management of GISD Alliance members are under an Investment Grade mandate (e.g., must be invested at "BBB" or better). The four main challenges GISD Alliance members and private investors seek in mobilization and blended finance activities are:

1. Acceptable risk in line with fiduciary mandate: The median sovereign risk rating of the 145 developing counties is S&P-equivalent "B". Most private sector borrowers in developing countries will have implied risk ratings of B and CCC. These rating are far too weak for almost all private debt investors. GISD Alliance members and private debt investors seek implied ratings of primarily Investment Grade (e.g., BBB or better) or secondarily strong Speculative Grade (BB).
2. Market-equivalent risk-return: GISD Alliance members and private investors require market-equivalent returns, with most market benchmarks determined in developed countries. In general, investment in developing counties requires a premium to developed markets.
3. Scale: GISD Alliance members and private investors seek to make individual investments usually of $100+ million. With individual SDG investment needs in developing counties well below $100 million, matching up investment supply and SDG project investment demand generally means aggregation of many SDG projects in portfolios.
4. Bankability: Investors indicate they are prepared to invest in bankable and near-bankable projects (e.g., requiring a small amount of credit enhancement) that happen to be in high-risk countries, but not unbankable projects.

Table A: MBD and DFI development finance assets: Ability to Mobilize Private Finance

Asset	Ability to Mobilize Private Capital	Estimated percent of MDB and DFI balance sheet (Private sector finance operations only)	Comment
Public sector - (sovereign) Loans	Low		Interest rate on loans is large discount to market rates and loan tenor is very long. NPV of loans is low relative to FMV.
Private sector - Hard currency loans	High	80%	MDBs and DFIs report high net interest margins, reasonable default rates and low losses.
Private sector - Local Currency Loans	Medium	7%	Few investors are interested to take open currency risk. MDB/DFI origination is low.
Private Sector - Direct Equity Investments	Low	6%	In general, internal rates of return below investor expectations and requirements. Some (e.g., IFC and CDC) could mobilize.
Private Sector - Portfolio (fund) Equity Investments)	Medium - High	6%	MDBs and DFIs participate on same terms and other market investors (e.g., limited partners). In principle, could attract private finance – but no/limited precedent.

Table B: Four main organization-types for successful blended finance structures at scale

Organization Type	Main comparative advantage
Arrangers of financial assets in this case, MDBs and DFIs	Strong ability to originate, arrange and manage good quality assets with good development impact. Ability to hold speculative credit risk (e.g., B and CCC) for the medium term.
Private investors, for scale, institutional investors like pension companies and insurance companies (e.g., asset owners)	Provide scale investment, e.g., investment of $100+ million. Ability to allocate lots of funds at reasonable interest rates, if underlying risk is Investment Grade.
Donors – who can allocate development capital at below-market terms to create market-equivalent investment assets for private investors – concurrently creating development impact and mobilizing investors	Ability to allocate a small portion of their ODA budgets at below-market, catalytic terms to achieve impact and mobilize investors.
Asset managers / funds manages – who can create and manage blended finance structures and mobilize private investors	Ability to create and manage blended finance structures. Ability to mobilize institutional investors.

Table C: Financial Instruments systemically under-supplied in developing countries: Financial additionality of MDB and DFI financial assets

Financial instruments	Description
Common equity	In general, the most under-supplied form of financing in developing countries is equity. Equity represents likely less than 12% of MDB and DFI aggregate exposure. MDBs and DFIs could significantly increase their equity finance. Not only would this boost the most under-supplied form of finance in developing countries, but it would increase the creditworthiness of hundreds of recipient financial institutions and real-economy companies. This in turn will increase the ability those entities to raise debt and equity from private investors (and MDBs and DFIs). As the creditworthiness of these entities increases though higher equity capitalization, it will likely lead to deeper capital markets in developing countries: (i) these entities will be more creditworthy to issue bonds and (ii) these entities will take on governance models (though MDB and DFI part-ownership) that can put them on a path to raise equity in capital markets.
Local currency loans	MDBs and DFIs do not take open currency risk for their loan portfolio. That is, they will only issue local currency loans when they can fund themselves or hedge the currency risk. But (likely) less than 10% of MDBs and DFI loans to the private sector are denominated in local currency. This hard currency lending leads to huge FX risk for borrowers - most acute for infrastructure projects and SMEs, who earn their revenues in local currency. MDBs and DFIs could increase their local currency loans for infrastructure and SME projects – including taking a limited amount of open currency risk.
Mezzanine capital	For many reasons, a large number of companies in developing countries cannot be financed by conventional common equity (e.g., very high levels of informality). For many companies, mezzanine capital is a more effective form of financing (e.g., loans with equity-like features). The financial additionality of mezzanine capital, like common equity, is generally much greater than the current stock of hard currency senior loans.
Tier 2 capital for banks and microfinance institutions	The banking and microfinance sectors are systemically under-capitalized. This translates into a significant under-financing of the real economy, especially SMEs. Increasing tier 2 capital to banks and MFIs would produce good quality assets for MDBs and DFIs, bolster capitalization and increase risk capacity for loans to SMEs and mid-caps.
Subordinated funding in blended finance structures	See Mobilization above.

Annex 2

Third party reports to support observations and recommendations

#	Report and Link	Authors and Date	Synopsis	Key Stats
1	Global Outlook on Financing for Sustainable Development 2021	OECD, November 2020	Bi-annual report on funding the SDGs in developing countries.	Financing the SDGs in developing counties is well off track. Annual SDG Investment Gap may have increased from $2.5 trillion to $3.2 trillion.
2	Mobilization of Private Finance by MDBs and DFIs	MDBs and DFIs, January 2021	Annual Report compiled and published jointly by MDBs and DFIs summarising their private investment mobilization activities and statistics	Table A.4 on Page 42 summarises aggregate Private Direct Mobilization at $20.6 billion for 2019: $18.7 billion for MICs and $1.9 for LICs
3	DFI Working Group on Blended Concessional Finance for Private Sector Projects: Joint Report	DFI Working Group, January 2021	Annual Report compiled and published jointly by MDBs and DFIs summarising their private investment mobilization activities and statistics when using concessional funds (provided by donors)	In 2019, DFIs financed total project volume of $10.4 billion for private sector operations when using various blended concessional finance. The projects were financed with (a) $5.1 billion of DFI own-resources, (b) $1.4 billion of concessional funds and (c) $3.1 billion of Private Direct Mobilization and Private Indirect Mobilization. Although no breakdown of mobilized amounts is provided, using the ratio in report above, implies $2.1 billion was Indirect (e.g., co-funding) and $1.0 billion was Direct. That is, MDBs and DFIs deployed $1.4 billion of donor concessional funds to mobilize $1.0 billion of Private Direct Investment.
4	From Billions to Trillions: Transforming Development Finance	MDBs, April 2015	A one-off report from MDBs committing to transforming their business models towards delivering the USD trillions required to achieve the Sustainable Development Goals.	In paragraph 70, the MDBs commit to five actions to boost their ability to finance and mobilize more private investment to fund the SDGs in developing countries including (i) increasing available financial resources and (iii) promote and catalyze private investment.

5	All hands on deck; how to scale up multilateral financing to face the Covid-19 crisis	Overseas Development Institute, April 2020	A one-off report evaluating the capacity to provide more SDG financing.	The MDBs can expand lending by at least $750 billion (160% above current levels) while maintaining a AAA rating, or as much as $1.3 trillion (nearly triple current levels) if they are willing to risk a downgrade to AA+. MDBs actually deploy only around 40% of the capital they require to maintain AAA ratings.
6	Blended Finance Funds and Facilities Report: 2018 Survey	OECD, January 2020	Bi-annual OECD survey on blended finance funds and facilities gathers information on the latest trends in the blended finance market. The survey helps to define the size and shape of the blended finance market and to improve its visibility to policy makers and private sector actors.	$60.2 billion of funds and facilities in place to fund the SDGs: (i) $41.5 billion in facilities and $18.7 billion in funds. MDS manage $22.2 billion of facilities and $2.6 billion of funds. Commercial asset managers manage $13.7 billion of funds.
7	State of Blended Finance Report, 2021	Convergence Blended Finance, October 2021	Annual Report on a sub-set of OECD's broader definition of blended finance. Report focuses on the use of concessional development funds to mobilize private investment.	Annual Aggregate blended finance flows around $9 billion in around 55 transactions. Estimate that aggregate concessional funds in blended finance are around $2-4 billion (e.g., 2% of ODA).
8	Blended Finance in the Least Developed Countries 2020	UNCDF, OECD, December 2020	The report provides an update on the deployment of blended finance in LDCs.	Between 2012 and 2018, approximately USD 13.4 billion was mobilised ind LDCs - about 6% of the total.

Annex 3

Most effective blended finance structures

Based on analysis of (i) private investor preferences and (ii) what has worked well for donors to date, the annex identifies four blended finance structures that have the greatest potential to mobilize private investment at scale. They are also relatively easy to implement and standardize.

Blended Finance Structure 1 blends debt investment from private investors and development funds from development agencies into a portfolio structure (e.g., a fund), and the fund in turn provides debt to bankable projects located in (high risk) developing countries.

Blended Finance Structure 2 blends equity investment from private investors and development funds from development agencies into a portfolio structure (e.g., a fund), and the fund in turn provides equity to bankable projects located in (high risk) developing countries.

Since Structures 1 and 2 usually result in small and medium-sized funds (typically less than $200 million), they generally do not mobilize institutional investors which seek vehicles of $500+ million. Less than 3% of blended finance vehicles have been in excess of $500 million. To mobilize institutional investors requires **Blended Finance Structure 3** – an aggregation vehicle akin to a “fund of funds” where private and development funds are co-invested and a fund manager allocates investment to multiple Structure 1 or Structure 2 blended finance vehicles.

These three structures require good, experienced fund managers to allocate the fund’s capital to SDG projects.

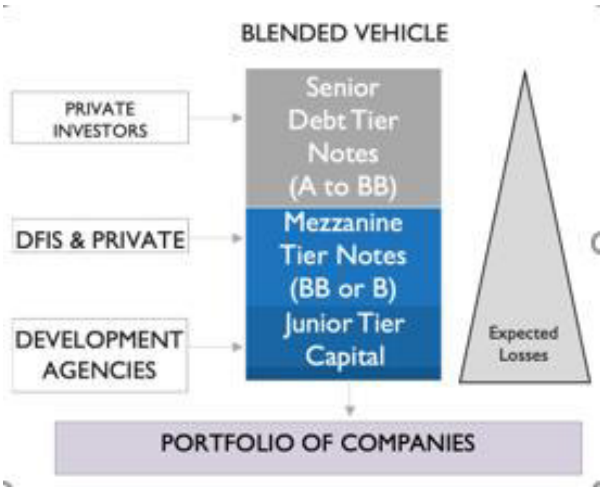
Blended Finance Structure 4 combines development funds from development agencies, and sometimes private investment capital, into a company/entity, and that company/entity extends guarantees to support:

- Bankable projects in (high risk) developing countries (e.g., AGF and GuarantCo) and/or
- Near-bankable projects by providing credit enhancement for all or some risks, and all or portion of debt obligation (e.g., GuarantCo and MIGA)
- Private investment is mobilized primarily at the project level – either domestic capital or cross-border capital.
- This structure requires good quality, experienced management team to underwrite guarantees that achieve superior development impact and sufficient financial results consistent with funders’ governance.

Structure 1: Blended Finance Vehicle to mobilize cross-border debt investment at scale (Portfolio)

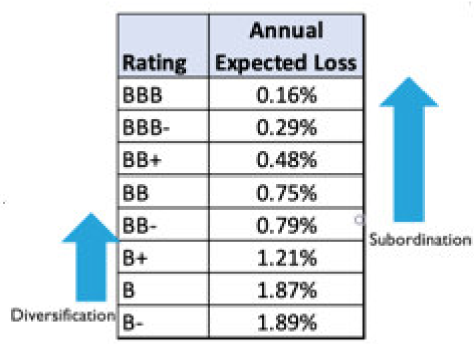
Figure 1: Illustration of Blended Finance Structure 1

1. Establish blended finance vehicle with 2-3 capital tiers
2. Vehicle typically a fund with experienced fund manager
3. Vehicle interest in portfolio of debt investments (loans) rated BB- to B-.
4. Diversification (1-2 notch uplift) and subordination (1-6 notch uplift) reduces probability of default and expected losses for senior tier investors.
5. Senior tier notes can achieve investment grade rating (e.g., A or BBB) and mezzanine notes good-quality non-investment grade rating (e.g., BB).



6. Investment grade rating allows a large universe of investors restricted by investment grade mandate.

- Assume portfolio of 100 loans to borrowers with B risk rating
- Portfolio diversification can enhance risk rating to BB-.
- Assume portfolio funded by three tiers of capital: (i) Senior notes for [75]%, (ii) Mezzanine notes for [15]% and Junior for 10%.
- Can credit enhance Senior Notes to equivalent of investment grade, BBB subject to enough Mezzanine and Junior

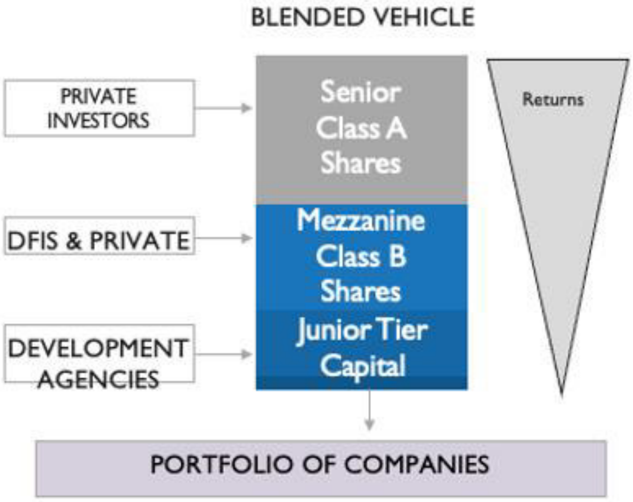


Rating	Annual Expected Loss
BBB	0.16%
BBB-	0.29%
BB+	0.48%
BB	0.75%
BB-	0.79%
B+	1.21%
B	1.87%
B-	1.89%

- Junior and Mezzanine must be sufficient to absorb at least (i) the expected losses in this case between BB- and BBB or 0.63% per year (i.e., 0.79% less 0.16%) plus (ii) some unexpected loss
- Possible to achieve investment grade BBB for Senior notes with a minimum of 15% of subordinate capital (for a 10 year tenor)

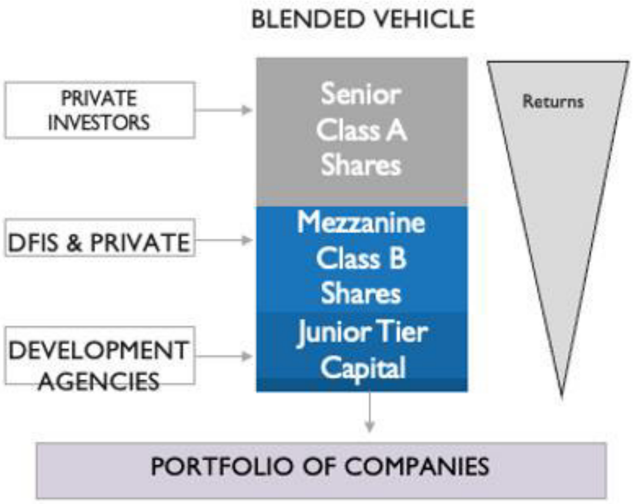
Structure 2: Blended Finance Vehicle to mobilize cross-border equity investment at scale (Portfolio)

Figure 2A: Illustration of Blended Finance Structure 2 (Junior capital funded as grant)



1. Establish blended finance vehicle with 2-3 capital tiers
2. Vehicle typically a fund with experienced fund manager
3. Vehicle invests in portfolio of equity investments in investee companies.
4. Prioritization of waterfall of distributions:
    a. First distribution to Class A until IRR of 0-5%
    b. Second distribution to Class B until IRR of 0%
    c. Third distribution of up to grant amount from donor(s) – donor instructs at outset where grant monies should follow if fund is successful – typically a classic ODA purpose
    d. Fourth distribution to capital providers by negotiation
5. Waterfall prioritization for Senior Class A shares: (i) reduces likelihood of losses, (ii) increases likelihood of achieving market benchmark and (iii) increases likelihood of high IRRs

Figure 2B: Illustration of Blended Finance Structure 2 (Junior capital funded as equity)



1. Establish blended finance vehicle with 2-3 capital tiers
2. Vehicle typically a fund with experienced fund manager
3. Vehicle invests in portfolio of equity investments in investee companies.
4. Prioritization of waterfall of distributions:
    a. First distribution to Class A until IRR of 0-5%
    b. Second distribution to Class B until IRR of 0%
    c. Third distribution to Junior Capital under IRR of 0%
    d. Fourth distribution to capital providers by negotiation
5. Waterfall prioritization for Senior Class A Shares: (i) reduces likelihood of losses, (ii) increases likelihood of achieving market benchmark and (iii) increases likelihood of high IRRs

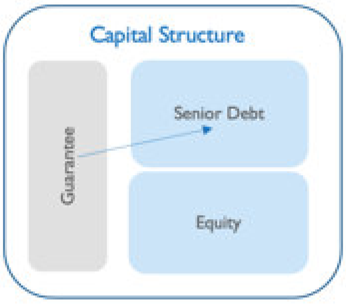
Structure 3: Aggregation Vehicles for scale mobilization – either debt or equity (Portfolio)

This structure is simply an aggregation of Structure 1 or Structure 2 approaches to create the scale required to mobilize institutional investors. For example, Structure 1 and Structure 2 blended finance vehicles have usually been for around $200 million. But institutional investors seek investment vehicles of $500+ million. An aggregation vehicle, such as a "fund of funds" can create the critical mass that attracts institutional investors.

Structure 4: Blended Finance Vehicle to mobilize debt investment (Project)

Figure 4: Illustration of Blended Finance Structure 4

- Guarantee best deployed at project level to convert a "near-bankable" project to bankable
- Guarantor must be rated (investment grade, e.g., A)
- Guarantee can be for 100% of debt obligations or less
- Guarantee can be for all risks, or sub-set of risks (e.g., political risks)
- Big 3 Rating Agencies cap credit enhancement uplift for partial guarantees to 2 notches (e.g., B risk can become BB-)



- Proposition: Investors and project would benefit more from a 100% guarantee from an A listed entity (e.g. GuarantCo) than from a AAA entity (e.g. development agency)

Table 1 identifies indicative terms of Blended Finance Structures 1 and 2 that meet the requirements of institutional investors and development agencies.

Table 1: Indicative Structures for Blended Finance Vehicle

Topic	Debt Blended Finance Vehicle	Equity Blended Finance Vehicle
Blended Finance Vehicle Description	• A fund with three tiers of capital • Diversification of assets credit enhances risk by one or two notches from weighted average risk rating of underlying assets • Subordination of junior capital tiers enhances senior tier to Investment Grade or strong Non-Investment Grade (e.g., BB+)	• A fund with three tiers of capital • Diversification of equity investment reduces variability in return • Subordination of junior tiers and preferred returns for senior tier (i) reduces distribution to returns expected to be negative and (ii) increases expected IRR to premium to market-equivalent
Assets of Blended Finance Vehicle	• Senior debt: Bonds, loans and loan risk participations • Diversified across 50+ senior debt instruments in 25+ countries • Largest exposure no more than [3]% of portfolio	• Common equity: Shares in investees • Diversified across 10+ equity investments • Largest exposure no more than [12]% of portfolio
Fund Life	• 12-year life	• 12-year life, comprising 5-year investment period and 7-year divestment period

Entities financed in developing countries	• Banks, microfinance institutions, Infrastructure projects, PPPs, telecommunications companies, FDI, mid-caps, SMEs, food processors, agribusinesses	• Banks, microfinance institutions, Infrastructure projects, PPPs, telecommunications companies, FDI, mid-caps, food processors, agribusinesses
Fund manager/asset manager	• Organizations of sufficient size, experience in managing debt funds and knowledge of developing countries seen as bona fide manager by investors	• Organizations of sufficient size, experience in managing equity funds and knowledge of developing countries to be seen as bona fide manager by investors
Originators, Arrangers and Managers of underlying assets	• Fund manager / asset manager described above • International commercial banks • Local banks in developing countries • Private credit originators	• Fund manager / asset manager described above • Bonafide fund managers operating in developing countries
Senior Tier of Capital Structure Investors	• [65-85]% of capital structure, subscribed as notes • Preferred Investors are Institutional Investors (not MDBs and DFIs) • Target institutional debt investors (e.g., pension companies and insurance companies) • Likely risk profile: Investment grade (A and BBB) and BB+	• [50-75]% of capital structure, subscribed as Class A Shares • Preferred Investors are typical LP investors (not MDBs and DFIs) • Target pension companies and Limited Partners in PE funds
Second Tier of Capital Structure Investors	• [10-25]% of capital structure, subscribed as notes/loans • Target institutional investors with “high yield” mandate, MDBs and DFIs • Likely risk profile: Non-Investment Grade: BB to B-	• [10-25]% of capital structure, subscribed as Class B Shares • Target institutional investors with “high risk” mandate: Hedge funds, MDBs, DFIs, High Net Worth, Foundations
Third Tier of Capital Structure Investors	• [5-15]% of capital structure, subscribed as instrument(s) that work for ODA donors - notes, equity, grants and/or guarantees • Target private investors with “high yield” mandate, ODA donors, foundations, developing country governments and multidoor funds (e.g., Green Climate Fund) • Likely risk profile: Speculative Grade at B- or lower	• [5-15]% of capital structure, subscribes as instrument(s) that work for ODA donors - equity, grants and/or guarantees • Target private investors with “high risk” mandate, ODA donors, foundations, developing country governments and multi-donor funds (e.g., Green Climate Fund)

Typical Terms of Senior Tier Credit Enhancement via Junior Tier subordination	• Sufficient size and terms to credit enhance senior tier to target: A, BBB or BB+ • Second Tier and Third Tier capital are subordinate to Senior Tier in cashflows and security • Diversification across at least [35] debt assets in at least 10 countries • Weighted Average Risk Rating of Fund Loan Portfolio "B" or higher • Collateral: Ratio of Performing Loans to Senior Tier around [1.33] • Debt Service Coverage Ratio of [1.33] • Remuneration of Senior Tier [75] bp premium to comparable bond portfolio.	• Sufficient size and terms to improve risk-return for Senior Tier • Second Tier and Third Tier capital are subordinate to Senior Tier in cashflows and security • Diversification across at least [15] equity investments in at least 5 countries • Collateral: Ratio of Fund Portfolio Investments to Senior Tier around [1.33] • Distribution Waterfall of Cashflows to Investors: 1. All Returns to Senior Tier until Internal Rate of Return of Zero 2. Next Returns to Second Tier until IRR of Zero 3. Next Returns to Senior Tier until IRR of 8% 4. Next Returns to Third Tier until IRR of Zero 5. Next Returns to Second Tier until IRR of 8% 6. All remaining Returns distributed proportionately to all three tiers • Expected Remuneration of Senior Tier [200] bp premium to expected returns in developed countries.
Implied Returns for Senior Tier	• Assume fund management fees are 1% per annum • Assume the required interest rate to remunerate the Senior Tier would be the market equivalent of BBB plus 100 bp. • In downside scenario, the Senior Tier would realize a loss of capital and/or returns in the event around 25% of loans went into default with 100% write off • In all other scenarios, the Senior Tier would recover 100% of tis principial and 3.5% interest rate • For comparison purposes, since inception in 2007, the leading emerging bond market benchmark (the JP Morgan Emerging Markets Bond ETF) has generated an average annual return of 6.15% since inception.	• Assume fund management fees are 2% per annum • Assume the required Expected Rate of Return to mobilize private investors into Senior Tier would be 15% • In downside scenario, the Senior Tier would realize a loss of capital if 100% of Fund resources were deployed and the fund only realized around 85-90% of returned proceeds • To generate the 8% IRR described above, Fund returned procced would need to be around 180% of Fund size. • For comparison purposes, since inception in 2000, the leading emerging market equity benchmark (the MSCI Emerging markets Index) has generated an average annual return of 9.7% relative to 6.0% for its MSCI world benchmark.
Implied Returns for Third Tier	• The Third Tier funders would incur a loss if around 10% of the loans went into default with 100% write-off	• The Third Tier funders would incur a loss if returned net proceeds were less than around 180% of Fund Size. That is, the Fund gross return would need to be 6% or higher for Third Tier to break even
Public or Private Markets	• For large vehicles, endeavour to create notes that can be public listed	• Possibility to list in public markets?

The Global Investors for Sustainable Development (GISD) is an Alliance of 30 business leaders convened by the United Nations Secretary-General to provide decisive leadership in mobilizing resources for sustainable development.

GISD Global Investors for Sustainable Development Alliance