FiCS' contribution for FFD 4

Tentative Report Summary

I. PDBS' INSIGHT ON CURRENT SUSTAINABLE DEVELOPMENT FINANCING CHALLENGES

The imperative to redirect all financial flows towards a Just Transition that leaves no one behind

II. PDBs' CRITICAL CONTRIBUTION TO SUSTAINABLE DEVELOPMENT FINANCING

- *a. Who are PDBs? Key features*
- *b. What are PDBs doing? Key functions*
- *c. Why are PDBs not doing more? Key challenges*
- *d. How to unlock PDBs' potential to finance sustainable development? Key recommendations*

III. A UNIFIED PDBs SYSTEM CATALYZING THE TRANSFORMATION OF THE GLOBAL FINANCIAL SYSTEM

- *a. Leading a more sustainable management of public mandates and concessional finance*
- *b. Driving a systemic financial shift to align all financial flows to sustainable and inclusive development*

Proposed outcome for FfD4

In the conclusions of FfD4 and in order to unlock PDBs' potential to finance sustainable development, Member States should notably consider:

1. Enhancing PDBs' ambition to make them "SDGs enablers"

- *Converge the mandates of all PDBs around the world, around a "dual mandate" model that integrates (1) national priorities— such as poverty reduction, industrialization, job creation, and economic growth—and (2) addressing global challenges, including urgent climate action, biodiversity and inequalities*
- *In order to encourage and monitor the redirection of financial flows, foster the adoption and refining of sustainability mainstreaming among all PDBs, at both entity and operations level*

2. Making PDBs work as one coherent system

- *Place country-led collaboration at the heart of a coherent PDBs system, from MDBs to NDBs, promoting a bottom-up approach, emphasizing country-led development strategies over donor-driven agendas (INFFs, country/regional platforms, etc.).*
- *Extend the reallocation of SDRs through MDBs balance sheets to help refinance smaller PDBs by relying on the credibility and rating of their multilateral regional platform*
- *Foster a better channelling of resources, to ensure they address national needs: set collaboratively agreed targets, bolster origination capacity, extend the reallocation of SDRs through MDBs balance sheets*
- *Work on common procedures, standards and mutual reliance through collaborative global and regional platforms*

3. Improving PDBs' regulatory and risks management

- *Precise regulatory conditions and requirements of PDBs in line with their development mandate, and the distinctive nature of their business models and risk profiles: implement dedicated regulatory frameworks that do not necessarily mirror all norms set for the private sector*
- *Encourage dialogue and coordination among credit rating agencies, financial regulators, private sector and PDBs operating in developing countries on debt management issues, to further refine the methodologies of rating agencies and more realistically capture credit risks in EMDEs*

4. Increasing and boosting PDBs' means to finance sustainable development

- *Proceed to a capital adequacy framework (CAF) review and balance sheet optimization work at the perimeter of FiCS*
- *Create a fast track or "one for all" accreditation process that would simplify access to multilateral funds for PDBs that have undergone substantive efforts of climate and SDG alignment and work towards streamlining the negotiation process after accreditation*

5. Facilitating private finance leveraging to scale up sustainable development finance

- *In order to facilitate all PDBs access to financing markets and scale up private sector mobilization toward sustainable development, launch work with private sector and market regulators to make PDBs a specific asset class defined by a clear and demanding set of criteria*
- *Increase capital for first and second loss, guarantees and long-term exchange rate hedging mechanism, in a proactive approach towards risk-taking and utilizing catalytic structures in development financing. By providing these financial instruments, investors and financiers can mitigate the perceived risks associated with impactful projects, encouraging more investment in them.*

I. PDBS' INSIGHT ON CURRENT SUSTAINABLE DEVELOPMENT FINANCING CHALLENGES

The Imperative to Redirect Financial Flows towards a Just Transition That Leaves No One Behind

- Need for an enlarged and at-scale global financing architecture bridging international and national levels:
  - Fragmented development finance architecture
  - Mistrust in multilateral governance and need for an inclusive, fair and democratic international financial architecture and economic governance
  - Misallocation of global financial resources:
    - Thematically: scale-up of transition finance is needed to go from brown to green investments
    - Geographically: insufficient amounts and accessibility of financial resources to the most vulnerable countries
- Urgency to streamline the multiplicity of frameworks and standards on sustainable development financing that troubles accountability and incentives
  - ODA, TOSSD, climate finance, competing taxonomies, ESG criteria etc.
- Capacity to unlock more ambition to implement the 2030 Agenda and the SDGs, the Paris Agreement on Climate Change, the Sendai Framework for Disaster Risk Reduction and the Kunming-Montreal Biodiversity Framework, with a special focus on scale and leveraging effects required from public and private resources

Objective: redirecting financial flows (public and private) towards sustainable and inclusive development to achieve a just transition that leaves no one behind.

II. PDBs' CRITICAL CONTRIBUTION TO SUSTAINABLE DEVELOPMENT FINANCING

<u>Who are PDBs? Key features</u>

- Public financial institutions established by governments with the explicit mission of fulfilling policy objectives, particularly in promoting sustainable development
  - 5 key features: standalone entity, fund-reflow-seeking instruments, funding beyond government budget allocations, not profit-driven institutions, public control and mandate
  - Current panorama of PDBs: 530+ PDBs in 155 countries in 2023, which represent USD 23Tn in assets, and 12% of investments (both public and private) worldwide. Still 80% of total assets concentrated in G20 countries
  - Global coalition FiCS born in 2020, composed of all PDBs, via the MDBs, the World Federation of Development Financing Institutions (WFDFI gathering AADFI, ADFIAP, ADFIMI, ALIDE and ELTI), IDFC, and with support from all relevant stakeholders, notably UN agencies

- The case of Public Commercial Banks

What are PDBs doing? Key functions

- PDBs' critical role as sustainable development financers:
  - A primary objective to advance public policy goals, rather than maximizing profit
  - Providers of patient and countercyclical capital
  - Providers of specific financial instruments (concessional and non-concessional loans grants, guarantees, equity investments) and drivers of financial innovation
- PDBs' strategic role as sustainable development partners:
  - Deep understanding of local contexts that enhances their role of honest brokers that align financial resources (public and private, international and national) with national priorities
  - Providers of technical expertise to effectively originate, prepare, implement, and monitor development projects
  - Accountability and transparency of PDBs to ensure resources are effectively channeled, and results delivered
  - Sources of technical assistance and capacity building
  - Enablers of dialogues among society, policy makers, academics and the private sector by creating Forums and Platforms to develop and improve public policies
  - Knowledge Banks
- PDBs' influence as market shapers: influencing the direction of economic development by mobilizing and leveraging both public and private capital, and by building market infrastructures.

Why are PDBs not doing more? Key challenges

- Structural weaknesses of the PDBs system:
  - Divergent mandates and lack of clear targets hindering SDGs alignment of funding
  - Uneven financial and technical capacities, with strong geographical inequalities
  - Scarce cooperation leading to inefficiency (scarce co-financing arrangements, competition, overlapping of funds)
- Regulatory constraints:
  - Capital requirements (Basel III) limiting PDBs available capital
  - Credit risk regulations requiring securing loans with collateral and setting aside money for possible loan losses, disincentivizing PDBs financing of risky high-impact projects.
- Risk perception: i) by PDBs that use restrictive risk assessment models, ii) by credit rating agencies that undermine PDBs' borrowing capacities in LDCs. Regulators should put a stronger focus on PDBs specific risks (notably governance and reputation > counterparty risk)
- Financial constraints and limited capacities, leading to financing prioritization and scale up challenges, and hindering frontier/innovative initiatives
  - Insufficient concessional finance
  - Capital shortfalls and difficulty to set "originate and distribute" mechanisms
- Currency risk, directly affecting PDBs' ability to raise funds, manage assets and liabilities, and fund development projects (limited hedging practices).
- Limited scale-up capacities, notably due to overreliance on public finance and de-risking mechanisms alone:

- Systematic and exclusive use of blended finance is impossible (scale) and risky (debt sustainability); it does not allow them to systematically make investments available to the private sector in the riskiest areas (systemic risk transfer).

- Structural Problems in LICs and LMCIs
  - High risk aversion of Credit Agencies due to balance of payments structural deficits, high volatility on exchange rates, interest rates and inflation with associated fiscal fragilities (macroeconomics instability);
  - Lack of confidence in government institutions and high regulatory uncertainties
  - Short concessional loans and grants budgets due to fiscal restrictions

How to unlock PDBs' potential to finance sustainable development? Key recommendations

Building on the "Heads of MDBs' Viewpoint Note: Working as a System for Impact and Scale that outlines 16 key deliverables for joint and coordinated to accelerate progress toward the SDGs and to better support clients in addressing regional and global challenges" and the G20 Roadmap towards better, bigger and more effective MDBs, this paper offers actionable recommendations for all Public Development Banks.

1. Enhancing PDBs' ambition to make them "SDGs enablers"

- *Converge the mandates of all PDBs around the world, around a "dual mandate" model that integrates (1) national priorities— such as poverty reduction, industrialization, job creation, and economic growth—and (2) addressing global challenges, including urgent climate action, biodiversity and inequalities*
- *In order to encourage and monitor the redirection of financial flows, foster the adoption and refining of sustainability mainstreaming among all PDBs, at both entity and operations level. That notably entails:*
  - *Setting clear metrics for climate and SDGs aligned finance projects, particularly in developing countries.*
  - *Encouraging and assisting all PDBs to adopt sustainability impact assessments/filters as an internal steering mechanism for financing decisions, enabling better characterization of alignment or misalignment with sustainability goals, in line with PDBs' sustainable development financing mandate*
  - *Bolstering the adoption on a global level the MDBs-IDFC Common principles for climate and SDGs aligned finance*
- *Explicitly mention the role of PDBs of all sizes in the assessment, the design and the implementation of the national green investment strategy in Nationally Determined Contributions (NDCs), Long-Term Strategies (LTS), National Adaptation Plans (NAPs) and National Biodiversity Strategies and Action Plans (NBSAPs). And include national PDBs, closely articulated with their multilateral and international peers, in the operational design of country platforms.*
- *Leverage PDBs expertise to build capacities and contribute to policy reforms*

2. Making PDBs work as one coherent system

- Consider, in dialogue with all stakeholders and support from the academia, to reframe all PDBs as one PDBs system and extend the current reforms of MDBs to ensure a more efficient "whole-of-PDBs system"

- *Establish a clear division of labour within the Finance in Common system (FiCS), based on comparative advantages and allowing Multilateral, Subregional, and National Development Banks to leverage their respective strengths in complementary ways.*
    - *MDBs could prioritize innovation, collective action through global and regional platforms, and addressing global challenges, while Regional Banks and National Development Banks would handle more of the project origination work and execution at the local level.*
- *Foster a better channelling of resources to ensure they address national needs:*
    - *Encourage MDBs and international PDBs to set collaboratively agreed targets with borrowing countries, ensuring that long-term financing is channeled to NDBs.*
    - *Bolster origination capacity for quality projects, while minimizing risks such as currency mismatch, and ensuring alignment with national development priorities.*
    - *Extend the reallocation of SDRs through MDBs balance sheets to help refinance smaller PDBs by relying on the credibility and rating of their multilateral regional platform.*
- *Work on common procedures, standards and mutual reliance through collaborative global and regional platforms as initiated by the World Bank*
    - *Create a FiCS-wide platform for mutualized issuance for PDBs*

3. <u>Improving PDBs' regulatory and risks management</u>

- *A more structured dialogue should take place between national policy makers, regulators - specifically the Bank of International Settlements (BIS) - and PDBs on how to build a regulatory framework that is more suitable to them and in line with national development priorities.*
- *Precise regulatory conditions and requirements of PDBs in line with their development mandate, and the distinctive nature of their business models and risk profiles:*
    - *Call for governmental decisions to replace conservative parameters on the PDBs under their jurisdiction and implement dedicated regulatory frameworks that do not necessarily mirror norms set for the private sector.*
- *Adapt regulation to ease constraints faced by PDBs and set incentives for the scale-up of blended finance transactions, including via adjusted capital requirements; specific targets for PDBs on the use of catalytic capital; and incentives for philanthropies to increase their share of de-risking investments.*
- *Encourage dialogue and coordination among credit rating agencies, financial regulators, private sector and PDBs operating in developing countries on debt management issues, to further refine the methodologies of rating agencies and more realistically capture credit risks in developing and emerging markets*
- *Risk perception:*
    - *Facilitate the contribution of PDBs and their partners to the Global Emerging Market Risk Database (GEMs) to share data for improving the accuracy of risk assessments by rating agencies and lowering the overall risk perceived by international private investors*
    - *Better take into account the positive impact of climate and sustainable development investments on the Capital Adequacy Ratios and ratings*

4. <u>Increasing and boosting PDBs' means to finance sustainable development</u>

- *In order to measure up to set targets, increase the volume of capital at the disposal of PDBs:*
    - *Strengthen the capacity of MDBs to play their leading role in the new FiCS architecture*[1]

[1] *In line with the G20 Independent Expert Group's "Triple Agenda: A Roadmap for Better, Bolder and Bigger MDBs" and with the Heads of MDBs' Viewpoint Note*

- *Increase the capital of all PDBs and concessional finance flows, building on their respective comparative advantages and to increase the quality of their operations*
- *Proceed to a Capital Adequacy Framework (CAF) review and balance sheet optimization work at the perimeter of FiCS*

- *Create a fast track or "one for all" accreditation process that would simplify access to multilateral funds for PDBs that have undergone substantive efforts of climate and SDG alignment and work towards streamlining the negotiation process after accreditation*
  - *Allow TA and capacity-building programs for capacity-lacking PDBs to gain access to multilateral climate funds which accreditation requires massive efforts*
- *Leverage local currency solutions and risk mitigation instruments to attract domestic private capital : see FiCS and IDFC work with TCX to develop a capacity building program to strengthen currency risk management combined with concessional hedging program*
- *Foster dedicated technical assistance to support the refining of PDBs activities for a systematic integration of environmental and social considerations. This TA should aim at "greening" PDBs and their partner, through a cross-sectors approach (peer-learning between PDBs, aid agencies, philanthropic entities etc.)*
  - *In particular, more grants should be dedicated to technical assistance for project preparations and the setting of widely accessible project preparation funds*
- *Make the most of the PDBs ecosystem's expertise to foster innovative financial instruments at the service of sustainable development (e.g. Climate-resilient-debt clauses, local currency risks management, or Debt-to-nature swaps)*

5. Facilitating private finance leveraging to scale up sustainable development finance:

- *In order to facilitate all PDBs access to financing markets and scale up private sector mobilization toward sustainable development: launch work with private sector and market regulators to make PDBs a specific asset class defined by a specific and demanding set of criteria.*
- *Set incentives for the scale-up of blended finance transactions, including via adjusted capital requirements; specific targets for PDBs on the use of catalytic capital; and incentives for philanthropies to increase their share of de-risking investments.*
- *Develop a globally recognized definition and taxonomy of blended finance transactions*
- *Expand databases on blended finance projects and opportunities.*
- *Increase capital for first and second loss, guarantees and long-term exchange rate hedging mechanism, in a proactive approach towards risk-taking and utilizing catalytic structures in development financing. By providing these financial instruments, investors and financiers can mitigate the perceived risks associated with impactful projects, encouraging more investment in them.*
- *Develop labels that guarantee the sustainability impact and quality of PDBs financing for private investors review.*

III. A UNIFIED PDBs SYSTEM CATALYZING THE TRANSFORMATION OF THE GLOBAL FINANCIAL SYSTEM

A stronger and more coordinated system of all PDBs working in unison to serve public goods would significantly improve financing for development but also trigger a broader systemic shift in the global financial system.

Leading a more sustainable management of public mandates and concessional finance

1. PDBs could channel and optimize more domestic public finance for sustainable development
- With their public mandates, NDBs could manage the budgetary resources of their state – mixing them with their banking resources to optimize public effort, at the national level
- More concessional finance could be channelled from Members States to NDBs/local development banks via MDBs to better direct it without overweighing on national financing capacities
- Most of the financial resources contributing to sustainable development are domestic and imply efficient domestic resources mobilization (DRM) i.e. strong and resilient fiscal systems.
    - PDBs could provide capacity building and TA for enhanced domestic resource mobilization and a better reorientation of savings toward sustainable and long-term investments

2. International public flows for sustainable development financing
- The effective provision of concessional finance by HICs and MICs, to LDCs/LICs/SIDs is vital to live up to the “leave no one behind” principle
- PDBs working as one system could better address longstanding ODA criticisms, including geographic misallocation and resource disparities (11 mega development banks concentrate 70% of all total assets, while Africa concentrates 19% of PDBs but only 0.9% of total assets).
- Standards-wise, PDBs could contribute to reflections on the need for a new common taxonomy of international concessional finance:
    - Much-needed ODA is progressively focusing on solidarity efforts by international donors; new measures and targets should emerge, to track all types of international financial support for SDGs, including public and private funding, with mixed acceptance and debates about its accuracy

Driving a systemic financial shift to align all financial flows to sustainable and inclusive development

1. Transforming national financial systems
- Reinstating financial systems’ effectiveness implies ensuring that financial flows are directly linked to supporting robust, inclusive, resilient and low-carbon economies
- Country ownership is fundamental to achieving just transitions: the reformed PDBs system would facilitate the implementation of national platforms
    - *A coherent PDBs system, from MDBs up to NDBs, would place country-led collaboration at the heart of its organization, promoting a bottom-up approach, emphasizing country-led development strategies over donor-driven agendas (INFFs, country/regional platforms, etc.).*
    - *PDBs would play a dual role in structuring and executing these platforms, ensuring alignment with national strategies, and facilitating project origination and financing.*

2. <u>Contributing to the transformation of the global financial system ; from financing transition to transitioning finance</u>

- Imperative cooperation and dialogue among all financial stakeholders (MoF for Climate Action, NGFS, GISD, GFANSZ, UNEP-FI, ISSB, etc.) to redirect all flows: need for a refined and shared conception of sustainable development financing.
    - A coherent PDBs system would better contribute to the characterization of what constitutes sustainable finance, and work for the reduction, harmonization and/or creation of sustainable financing reporting standards, taxonomies, metrics etc.
- PDBs could play a stronger role in financing the new infrastructures of sustainable finance (deepening existing financial markets, developing carbon and biodiversity markets by providing public support, etc.)
- Comprehensive research and long-term statistical efforts necessary to model and implement a robust alternative framework to the current global financial system.
    - The side effects of necessary reforms to the current financial system should be further analyzed.