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Sustainable Investing Research Initiative

Comments responding to:
The Call for Inputs for an Elements Paper on Financing for Development

Submitted by:
Sustainable Investing Research Initiative (SIRI)
Columbia University

Contact:
Caroline Flammer
A. Barton Hepburn Professor of Economics
Founding Director of SIRI
caroline.flammer@columbia.edu

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GUIDING QUESTION

The guiding question of the Call for Inputs for an Elements Paper on Financing for Development is as follows: "*What are the key financing policy reforms and solutions that the fourth International Conference on Financing for Development should deliver?*"

In the following, we provide a few comments that respond to this question in the hopes that these inputs help inform the Co-Facilitators in their preparation of an elements paper in their preparation for the Conference. These inputs are based on our own research as well as on the insights from roundtable discussions hosted by the Sustainable Investing Research Initiative (SIRI) at Columbia University. These roundtable discussions brought together a carefully curated set of key leaders in the public and private sectors, policymakers, and academia, including ministers of finance, corporate leaders, leading investment managers and asset owners, development finance institutions, multi-lateral development banks, philanthropies, rating agencies, and others.

SUBSTANTIAL COMMENTS

I. A global financing framework

Reforming Macroprudential Policies, Climate and Development Policies, and the World Bank

1) The current global prudential and regulatory framework for the global financial system was established after the 2008 global financial crisis. This includes the Basel Committee, the Financial Stability Board, Basel 3, Solvency 2 and all the financial and providential regulatory framework. Importantly, the global financial regulation was established before the Paris Agreement and has not been revised with the 2015 Paris Agreement. That is, we wrote in the Paris Agreement that we need to align all financial flows with the global climate objectives. Yet, we have not revised the global financial regulations and ensured they were consistent with our new global climate objectives. As a result, a number of requirements that are meant to safeguard financial stability in the short run are now potentially preventing our ability to address climate change, to invest enough, and to invest where we need investments the most (namely, in economically developing and emerging countries where domestic flows are not enough to reach the nationally determined contributions (NDC's) and national targets). For example, regulations in Europe require much higher capital reserves for investments in emerging markets infrastructure compared to investments in European markets. This makes European investors, and developed market investors overall, more interested in investing domestically due to lower capital requirements. In sum, global financial regulations need to be assessed against our climate objectives and potentially be revised in order to align the financial system with the climate goals.

2) While blended finance is considered to be key to rapidly mobilize and scale the necessary volumes of investments, it does not exist in the current financial and prudential framework. Blended finance is not recognized as a distinct category under the Basel 3 and Solvency 2 framework which also means financial institutions using it get unnecessarily panelized when they include this investment on their balance sheet. That is, given the absence of a distinct category, supervisory entities and regulators view blended finance as similar to securitization, which requires high liquidity and considerable capital to protect balance sheets against the potential risks. Since risk-mitigation mechanisms (e.g., guarantees from multilateral development banks and others) used in blended finance are not properly recognized, financial institutions using blended finance are unnecessarily penalized. This makes such investments less attractive for private sector investors.

3) More coordinated action and capital mobilization across the climate and development spheres are needed. So far, international discussions and frameworks around climate and development are mostly separated. To make progress, it is important to integrate and blend discussions of climate and development financing going forward, rather than treating them as distinct silos. Breaking down these barriers between the development and climate agendas could help drive more coordinated action and capital mobilization across the climate and development spheres.

4) Reforms are needed at multilateral development banks (MDBs) such as the World Bank in terms of their guarantee business (including expanded access to guarantees, improved guarantee structure, etc.) to mitigate risk and catalyze private finance.

5) An important potential game-changer for incentivizing low-carbon investments are global carbon pricing mechanisms. Investors show growing interest in low-carbon projects that are commercially viable in markets where a carbon price or similar mechanisms (e.g., ETS markets that incentivize low-carbon investments in Europe) exists. Such a mechanisms allow investors to factor in the cost of carbon into their decisions and provide a powerful incentive to invest in low-carbon options. Establishing a global carbon pricing mechanism would be a major "game changer" in helping address many of the challenges discussed around scaling blended finance. The EU's Carbon Border Adjustment Mechanism (CBAM) could help foster dialogue on carbon pricing in other regions/countries over time.

Risk Perception of Credit Ratings

Blended finance is highly dependent on credit ratings (and hence the credit rating agencies). Yet, credit rating agencies are not used to this form of funding, and it remains a challenge for rating agencies to fully integrate blended finance schemes, protections, and risk mitigation mechanisms into their rating methodologies. Credit rating agencies often do not differentiate project risks from country risks. There is a need to engage with credit rating agencies to update their methodologies in order to better assess risk in blended finance. Their methodologies need to be reviewed and potentially revised to better recognize risk-mitigation mechanisms (e.g., when technical assistance, guarantees, first-loss guarantees, or other insurance-schemes are provided by MIGA and others) in order not to overestimate the risk of these projects. Addressing obstacles preventing credit rating agencies from properly assessing and incorporating risk-mitigation features of blended finance funds merits further exploration.

Below are more details about the key issues faced by investment managers w.r.t. credit ratings in blended finance:

1) When assessed by credit rating agencies, the score is usually either a composite of the underlying assets or based on the sovereign risk rating.

    - Rating agencies usually don't have in-depth knowledge or databases on the specific underlying assets/projects at a micro level, making it difficult to accurately gauge credit risk. Given the lack of access to statistical data to assess the credit risk rating of the portfolio of investments (be it in renewable projects, sustainable agriculture, microfinance, etc., in emerging markets), they tend to conservatively rate the credit risk of such portfolios.

    - They also tend to cap the rating of the underlying investees to the level of the country rating (rather than that of the blended structure protection). Country risk ratings tend to be fairly low for those investing in less developed countries. Having better data on actual default rates of past blended finance projects could help credit rating agencies assess the true risk more accurately. The newly launched GEMs (Global Emerging Markets) Risk Database may help assess project risks: https://www.gemsriskdatabase.org/

2) Credit rating agencies do not take into account the structure of the blended finance vehicle (e.g., junior or mezzanine, first and second loss tranches, etc.), that is, they do not offer a rating of such vehicles. Instead, they rate the full fund, which is not helpful as only the rating of the senior tranche—which is the one dedicated to private investors—is needed. If the rating agencies could rate the assets based on their actual risk, taking into account the cushion provided by the junior and mezzanine tranches, the senior tranches might warrant an investment grade rating.

    - Several participants pointed out that, to their knowledge, there has never been a single instance of a default event on the senior tranche of a blended finance vehicle. But yet, the senior, protected tranches are almost always assigned an equivalent rating as their underlying assets, essentially ignoring the fact that it has a cushion which grows as a percentage over time as the underlying assets amortize.

    - Rating agencies do not integrate adequately and in full the protection offered by blended finance mechanisms:

    - For guarantees, that are usually partial (40/50/60% of guarantee coverage) several rating agencies integrate those guarantees only if the guarantee is at 100%.
    - The mezzanine tranche, particularly if in form of subordinated notes, is often not recognized as a protection to senior investors and only the first lost/catalysts shares will be integrated.

- Rating agencies apply some liquidity notch down as the senior notes/senior equity tranches in blended finance are supposed to be held up to maturity, and while technically they could be considered tradeable securities, there is no organized market on which one could sell them. At the same time, the investors that invest in the senior tranche are usually long-term institutional investors, who are not looking for short-term liquidity, and as such the notch down does not seem to be justified.

According to the participating experts, resolving the above issues would tremendously help in making blended finance funds more attractive for institutional investors and hereby help scale up the global marketplace for blended finance.

In sum, there is a need to actively engage in discussions with credit rating agencies to improve their understanding and methodologies for assessing blended finance. There is also a need to ensure that proposed blended finance schemes are properly evaluated by credit rating agencies, so that private investors have clarity on how such investments would be treated from a risk perspective. This outreach to credit rating agencies could help address the issue of them potentially overestimating blended finance risks.

II. Action Areas

a. Domestic public resources

b. Domestic and international private business and finance

c. International development cooperation

d. International trade as an engine for development

e. Debt and debt sustainability

f. Addressing systemic issues

g. Science, technology, innovation and capacity building

Need for Project Preparation and First-Loss Capital to Mobilize more Private Capital

Blended finance needs to ultimately attract traditional sources of capital, not just relying on upfront public funding. This includes capital from developed markets as well as capital from emerging markets and developing countries. Hence, the aim is to build local capacity, lower risks, and to create investable opportunities that mobilize traditional capital flows into these markets.

1) For blended finance projects to be successful, they need to have a technology that is both technically and commercially viable. Project preparation and the development of pilot projects are crucial as the lack of tangible projects may hinder investment. More dedicated funds are needed for project preparation work and capacity building. Once preparation is complete using public money, projects can progress to financing from MDBs, DFIs, and private investors. By having governments directly pay those costs, this model aims to overcome underfunding of upfront preparation work. It helps get projects investment-ready so that downstream private capital is willing to participate in later investment stages once opportunities are de-risked. To foster smooth and successful project implementation, it is important to build and strengthen project implementation capacity within governments. This involves working directly with governments to strengthen their internal capabilities and resources for successfully carrying out infrastructure and development projects from start to finish. In this regard, the work with local banks is crucial.

2) Blended finance structures can help de-risk investments and mobilize a multifold of the amount of capital invested. Blended finance funds have the highest impact ratios for CO2 emission reductions, biodiversity preservation, etc., compared to other investment strategies. Yet, scaling up has been challenging. It is difficult to find first-loss takers to launch new blended finance funds. The lack of catalytic capital/first loss capital is a major issue that is being discussed and emphasized to governing bodies such as the G7, G20, OECD, and country treasuries/ministries.

3) DFIs (including IFC) tend to invest at the mezzanine or senior levels with less risk (acting similarly to private investors). While DFIs are playing a key role in blended finance, they typically are not willing to serve as first-loss takers. Instead, DFIs often only invest in blended finance funds if someone else (e.g., a foundation) offers a first-loss mechanism. DFIs then invest at the mezzanine or senior levels with less risk. Relatedly, DFIs are quite

involved, but more could be done to communicate whether and to what extent their investments are catalytic, and how they are mobilizing private capital through their investments. In the past they have not communicated much about attracting private capital.

4) At this moment, foundations play an important role in serving as first-loss takers and catalysts through their grant funding, program-related investments (PRIs), and mission-related investments (MRIs). Yet, much more first-loss capital is needed. Such junior-level investing could potentially come from, e.g., DFIs and governments. Also, it is important to note that the foundations' strategic priorities may shift over time (as issues like clean energy rise or fall on their agendas), introducing uncertainty for funds reliant on specific foundation partners. To reduce such uncertainty, it would be helpful if foundations were to pursue longer term strategic priorities, and if funds were able to diversify their pool of first-loss takers.

5) First loss capital programs from governments and foundations need to provide more long-term objectives to allow investors to better anticipate potential fundings when launching a new fund or project as this asset class requires more time to mature from idea generation to investment compared to more traditional asset classes.

Debt, Debt Sustainability, and Addressing Systemic Issues

Several emerging markets and low-income countries are in significant debt burden with some estimates putting them at over 250% of GDP. This requires a rethinking of future financing flows. Even if MDBs/DFIs are able to offer greater financing, this does not mean that this is a solution as it will lead to greater debt burden. While this is primarily a debt issue, one reason it keeps recurring might be because of our lack of looking at “development” and “climate” as a system-wide problem globally (see the related comment above about the need for coordinated action and capital mobilization across the climate and development spheres).

It is also important to note that the climate crisis is deeply intertwined with the biodiversity crisis. Indeed, meeting the Paris Climate Agreement goals depends on the successful conservation, restoration, and management of biodiversity. Moreover, these crises are deeply intertwined with other systemic challenges such as food insecurity, poverty, conflict and forced migration, geopolitical tensions, etc.

Hence, it is important that development finance looks at these issues in a more holistic way. The following might serve as potential solutions that could be tried:

a) Emerging market countries can be offered debt to development swaps: This approach is required to ensure that "development" and the objective of achieving SDGs is not compromised. While climate change remains one of the most significant challenges, it is important that the overall development impact be taken into consideration when structuring debt to development swaps. Additionally, these swaps should be made in a manner that the impact requirements are clearly defined and measured.

b) Blended finance solutions: The debt to development swaps should be clubbed with blended finance solutions that can augment the gap in the development needs left after the swaps are created such that new investments do not create the same issues again. For this it is important that blended finance structures are recognized by both regulators and credit rating agencies, allowing for them to be done at scale. Additionally, one can think of creating "global blended finance solutions" specially for global problems like climate which will allow for larger pools that will also get derisked and allow for pricing to get distributed in these larger pools. Such an approach could also potentially address the issue of pricing as the overall pricing of such pools will be spread beyond the EMs and help everyone afford such financing. This idea could be potentially difficult to execute as it could create concerns about increasing the costs for better rated economies who might push back against such an approach.

c) Local currency financing by MDBs/DFIs and Blended finance solutions: Finally, as a significant part of the increase in current debt has been due to depreciation of EM currencies, MDB shareholders need to mandate MDBs and DFIs to offer their products in local currencies by hedging their portfolios and using grant funding from vehicles such as IDA to pay for the costs of these hedges. Additionally, if the development actually takes place, EM currencies will start to appreciate and the MDBs/DFIs can factor that appreciation to reflect success either in the narrative or in form of returns by sharing part of the gains from currency appreciation. The same approach can be used for pricing both debt to development swaps and blended finance solutions where the grants are used to create local currency financing.

These elements should be supported by a significant component of technical assistance offered by donors and/or MDBs to build pipelines. The main challenge to such an approach is a lack of ODA but the idea might be worth considering as financing from private or public sector cannot be efficiently used if investment pipelines don't exist.

IV. Data, monitoring and follow-up

Data, Impact Measurement, and Communication

Understanding how to measure and communicate impact is critical. Fund managers need to understand how to meaningfully measure their impact as well as how to effectively present themselves and their impact credentials to asset owners who are seeking impact investment opportunities. Asset owners (e.g., young, wealthy individuals and foundations) increasingly demand to see the impact of their investments. In recent years, their focus has shifted more towards climate change and more capital has flowed towards larger planetary-impact investments that can drive systemic changes to decarbonize sectors, compared to people-focused community investments.

1) Measuring impact is a critical issue that requires quality data. Impact measurement should be tied directly to clear environmental/social goals (e.g., forests as a system, income inequality as a system). For investors, this includes two key questions: How can an investor most usefully define a system (e.g., "forests")? How can an investor most usefully set goals for that system? Goals should include both specific targets/metrics as well as broader directionality (e.g., increase carbon sequestration, enhance biodiversity, support Indigenous peoples). Moreover, investors should consider country-specific SDG needs and priorities when setting their goals for blended financing and making their investment decisions.

2) In addition to impact data, investors need to better understand the financial risks and returns of their blended finance investments.

3) Measuring and communicating environmental/social performance data to investors is a key aspect that takes significant capacity building, standardization work, and staff resources to address properly. Smaller asset managers might have research/reporting teams, but reporting remains staff-intensive compared to larger asset managers, driving up their costs. Technical assistance is also often needed through dedicated "facilities teams" to support local partners in emerging markets with reporting, to fulfill various EU and investor requirements such as EU Taxonomy alignment. Meeting all of the assessment, measurement and disclosure needs takes considerable time and human capital that is not always available or affordable for (smaller) fund managers.

4) Data are key. Investors can only be educated and convinced about investing their capital in blended finance if relevant (financial and impact) data are available. Establishing a platform that provides granular data on impact and financial performance would be helpful.

5) Need to enhance impact reporting. This requires capacity building, standardization, and staff resources. A technical assistance facility can help do the reporting according to EU standards as well as various other reporting requirements.

6) Lastly, SIRI identified a need to go beyond existing frameworks and to move towards "Systemic reporting". Various efforts in the public and private capital markets (including by SASB/ISSB, GRI, GIIN, and others) are underway to improve the management, disclosure, and reporting of firms' environmental and social performance. Specifically, these efforts include:

    - mapping and measuring the financial materiality of sustainability to firms and investors;
    - chronicling the negative externalities of impact materiality, or how those same firms and investors affect our global biosphere and civilization;
    - implementing promising new theories and practices of impact investing, which seek joint financial and sustainability gains;
    - working on how to mitigate harm and improve outcomes within major specific domains such as climate change, water use, biodiversity, inequality, and many others.

    At this moment, these efforts are often developed in isolation. To develop global standards and drive forward progress, these various efforts need to be brought together and "converge" through a blend of creation and consensus, innovation and standardization, vision and practicality. Specifically, building on impact investing and systems dynamics, SIRI aims to drive forward "systemic reporting" to inform, support, and strengthen existing efforts by SASB/ISSB, GRI, and others in developing global standards and driving forward progress.