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DEVELOPMENT & CLIMATE FINANCE: IS JUST LOOKING AT THE QUANTUM OF FINANCE SUFFICIENT?

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VIEWPOINT

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INTRODUCTION

Cop 28 saw the pledging of increased capital flows to emerging markets and developing economies ("EMDEs") to finance development and climate investments. Some of this was the result of various discussions in different fora as to how to the innovative ways in which this might be achieved.

But these increased international official flows are just part of what needs to be done. Capital from the private sector is also required – domestic as well as international. And at the same time, we need to stop building up an ever-increasing debt overhang in a context where concessional funds are tiny compared to the financing challenge. So, what are the priorities for action? Even with an increased quantum of resource, is business as usual, in terms of the existing approaches and operations of the key development partners optimal, or is there a case for more radical change?

This Viewpoint Note reports on innovative methods to scale up the financing capacity of the multilateral development banks (MDBs), and explores some of the new proposals, emanating from the Global South. Whilst supportive of some of the innovative proposals to increase resources, it is cognisant of the limited availability of concessional finance especially and the consequent need for these limited resources to be used alongside other non-concessional funds to enable the mobilisation of both international institutional capital and domestic savings. A key, but often over-looked corollary to this is the need to move away from dollar or other FX-based pricing, to pricing in local currency (LCY). This note draws from a broader based review of development and climate finance which can be found here.

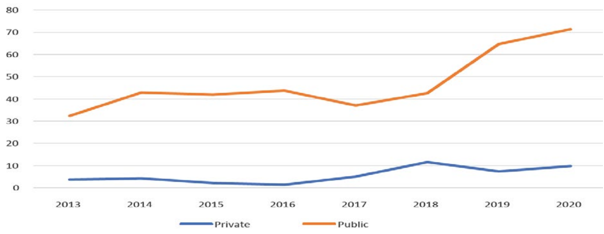
Context

In recent years, the world has become increasingly afflicted by a series of crises, including climate change, pandemics, and geopolitical polarisation that cause inflationary pressures as well as energy, food and water shortages. The mounting debt difficulties in the developing world are once again constraining credit, particularly to low-income countries, at a time when investments for job creation and improved climate resilience are more needed than ever. On the other hand, institutional investors in the private sector, such as insurance companies and pension funds, administer a large share of the world's recurrent savings surplus, amounting to trillions of dollars. It is essential for achieving the UN 2030 Agenda and the Paris Climate Agreements to engage a substantial part of this vast pool of private institutional capital for funding of SDG- and climate related investment projects and actions. But it will be difficult for EMDEs to tap into international capital without addressing the currency risk that is currently crystallising in many such countries.

Insufficient flows of finance: a snapshot

Total financial flows from private sources (debt and equity) to low- and middle-income countries exceed those from the public sector (debt and grants). However, private flows are declining, and as far as climate finance is concerned, public sources far exceed private ones. As shown in Figure 1, while public flows of climate finance from advanced economies to EMDEs grew to reach US$71 bn in 2020, private flows at US$10bn fell well short of that volume.[1]

Figure 1: Climate Finance Flows, OECD to non-OECD (US$ billions)



Adapted from G20 Task Force-Lankes-Robins (2023): *Private capital for climate action*, page 5 (indicating Climate Policy Initiative as original source)

These numbers pale in comparison to the immense needs: an authoritative estimate indicates a need of additional spending in EMDEs (excl. China) rising to US$3tn per year over the 2019 - 2030 period (an increase from US$2.4tn to US$5.4tn) of which US$1.8tn represents additional investments in climate action, mainly in sustainable infrastructure, and US$1.2tn in additional spending to attain other SDGs[2]. A major share of the additional financing would need to come from private sources. The question then arises as to what role the international development finance community can play in making that happen, particularly in how exchange rate risks can be addressed.

However, the several high-profile proposals for dealing with challenges that have lately been introduced in international fora and in reports by international expert groups and think-tanks have largely been focused on increasing the overall quantum of public resource, and finding ways for multi- and bilateral institutions to mobilise private finance. Notable actors are the Group of 20, the Independent High-Level Expert Group on Climate Finance, the Bridgetown Initiative and internal working groups of the international finance institutions. The main common theme in the discourse is that the world needs to reform its development and climate finance order, as it is realised that finance must dramatically be scaled up over the next few years. This applies across the board, including finance provided through the MDBs, other development finance institutions ("DFIs") as well as official and private sources. While the MDBs are called on to multiply their flows of finance by a factor of three in the next five years[3], particularly climate-related finance from private sources will have to increase many times over from current levels[4].

Indispensable role of the MDBs

As for mobilisation of private finance, the main challenge identified is how to deal with the risks – actual and perceived – that are specific to EMDEs, in view of the risk-adjusted return that investors require, so that private capital can flow to underserved countries and projects. A recent report opined that it is not the lack of finance *per se* that is the main problem, but rather the scarcity of the right combination of finance, incentives, investable propositions and an appropriate institutional framework[5].

MDBs, DFIs and national development banks are key actors in this context, both as financiers in their own right, whether in the form of sovereign lending or provision of risk capital for the private sector, and as catalysts for third-party co-financing. Different risk-sharing methods can be used by these institutions in their efforts to mobilise private capital, which is further described in this Note. MDBs in particular – with their unique strengths as regards shareholding, capital base, preferred creditor status, and ability to originate, arrange, and package investable transactions across sectors and across diversified EMDEs[6] and absorb long-term risks – are indispensable to support this process.

FUTURE DEVELOPMENTS, OPTIONS AND ISSUES

Looking ahead, some trends can be observed that are supported by the development finance community:

Continued MDB reform process

The push for reform of the MDBs and an accelerated use of different risk-sharing methods is gaining momentum, driven by the G20 and the COP process, and is likely to boost MDB investment capacities and mobilisation of private finance.

It was recently reported in media[7] that the World Bank, as a response to the calls for reform, is working with shareholders and rating agencies to make it feasible to expand WB's lending by a significant amount without affecting its AAA status. This would be possible thanks to callable capital that would be specifically pledged by a group of "willing shareholders" to repay sovereign loans for countries in default.

Greater risk transfers to support the presence of commercial banks in EMDEs

Risk transfers via securitisation or guarantees can be used more frequently by MDBs as a tool to alleviate capital reserving constraints of commercial banks. MDBs can offer capital relief for Basel III-constrained banks that are securitising some of their loan books. By supporting or investing in the securitised portfolios, MDBs would be in a position to induce the banks to finance SDG-aligned investments in EMDEs, including infrastructure and climate-related projects.

Opportunities for institutional investors would be created in the process, via de-risking (on near commercial terms) of securitised tranches so that they match investors' risk/return requirements. As an alternative or complement to investing, MDBs and development partners can offer credit guarantees on specific risk layers (or specific tranches of issued securities in the case of true sale securitisations), ideally complemented with technical assistance to issuers.

An increased role for official guarantors

Bilateral institutions and blended finance initiatives can add significant value in supporting the catalysing efforts of MDBs. From a developmental perspective it is essential to enhance the reach of sustainable investments that are made possible by the freed-up capital. As the positive experience with official development guarantees shows, this would be a suitable area for bilateral donors to engage in.

Building on precedents, bilateral donors and official guarantors could step up their cooperation with MDBs to create substantial headroom for new investments in challenging environments by off-taking risk on sub-portfolios of loans that meet pre-agreed developmental criteria.

Against the backdrop of increasing budgetary constraints, donors are likely to progressively favour unfunded guarantee-based approaches, not only for the benefit of MDBs and DFIs, but also directly targeting private capital (e.g. in layered fund structures). Such progression would be greatly helped by a modification of the ODA reporting procedures within the OECD/DAC, as current metrics do not allow direct ODA assessment of guarantees and risk capacity contributions.

Proliferation of de-risked public-private funds

De-risked investment funds are becoming more frequent, particularly in the public-private sector, where DFIs/MDBs take first loss layers positions to cover part of the risks that investors are not willing or able to take[8].

In the public sector, the International Finance Facility for Education (IFFEd) and the Innovative Finance Facility for Climate in Asia and the Pacific (IF-CAP) exemplify novel forms of risk transfer, where donors can contribute to either a grant or guarantee window to support sovereign lending to respectively the education sector and climate investments.[9]

Both facilities work through MDBs as implementing partners. Repayment guarantees by respectively IFFEd and IF-CAP will free up MDB capital currently set aside as risk buffers for exposures to sovereign member states.[10]

Other facilities to engage private capital based on similar financing partnerships, making use of de-risking instruments such as grants and guarantees, are on the drawing board.

The growing demand–supply gap for concessional finance

The proposals presented under the Bridgetown Initiative presuppose a significant increase of concessional finance for development and climate action. The MDB reform process is expected to release already existing capital resources and shareholders' back-up commitments, making better use of callable capital, and engage increasing volumes of private institutional capital, but is also likely to require additional concessional finance in significant amounts for de-risking purposes.

There is an impending squeeze in multilateral and concessional finance to meet dramatically increasing demand. As such, there are concerns about sufficient levels of concessional resources available, in view of the plethora of competing demands for concessional and ODA resources to deal with the global challenges.

Notable factors that contribute to the growing demand–supply mismatch are (among others):

- Calls for increased concessional finance for the broader range of WB operational countries – not just IDA countries[11].
- Concessional finance being raised in significant amounts for the IDA Crisis Facility, expansion of the IDA Private Sector Window, and replenishment of IDA (IDA 21).
- New climate finance initiatives, and facilities such as IFFEd and IF-CAP will consume aid funds.
- Decision at COP-27 to set up a Loss and Damage Fund to compensate particularly vulnerable nations that are suffering from climate change, and, more recently, decision at COP-28 to operationalise the Fund.
- Call by IMF on countries in strong positions to replenish subsidy resources in the Poverty Reduction and Growth Trust (PRGT)[12].
- Official donors and guarantors are increasingly expected to fund loss-absorbing tranches, subsidise guarantee fees or buy down hedging costs.

While a boost in rechannelling of SDRs is likely to happen (e.g. the hybrid capital structure, pioneered by the AfDB, where MDBs would use SDRs borrowed from countries with excess reserves to back up bond issues for additional funding), there are other initiatives that are currently being prepared for further discussion, such as the proposal for a general capital increase of MDBs (those that have binding headroom constraints), relaxing of statutory limits on lending by MDBs, and the plan to set up a platform to facilitate for investors to contribute funds that can be leveraged by MDBs , to crowd in "coalitions-of-the-willing among donors and non-sovereign investors, as proposed by the Triple Agenda report. [13]

Among the other proposals at the idea stage are a new Green Development Bank; SDR-denominated bonds to be issued by the World Bank[14]; a fresh issue of SDRs to help seed a Climate Mitigation Trust; and a new multilateral entity to be set up to pool currency risks and offer foreign exchange guarantees.

In view of the current, overlapping, global crises and rapidly rising demand for concessional finance, there are voices that clamour for global taxes and levies to be introduced, such as carbon border tax; tax on financial transactions; shipping levies[15], and biodiversity credits. The proceeds would be used to help countries deal with climate change, and can counteract the growing gap in the financing of loss and damage from natural disasters.

The need for MDBs and DFIs to stem the off-loading of currency risk

The constantly increasing hard currency debt burden and the risk this causes to low-and-middle income countries is beginning to be increasingly recognised, although this is yet to translate into meaningful concrete actions at scale, not least because it is one of the most challenging issues in development finance. For instance, a significant expansion of institutions with a development mandate that offer currency hedging products is strongly recommended by different expert technical groups.

Whilst it is possible to provide credit guarantees to LCY financing in EMDEs, the MDBs and DFIs are facing increased pressure from the global development finance community to change their lending practices radically and make a concerted effort to stem the build-up of huge FX debt overhang afflicting LIC/LMICs. A possible solution could be to drastically increase the offer of FX loans indexed to local currency, especially as long-term finance, coupled with currency risk off-loading via hedge providers such as TCX.

TCX has embarked on an ambitious expansion path and is likely to be able to support a significantly expanded portfolio of swap transactions, going forward, which would open up the possibility of offering sizeable EMDE currency risk bundles to institutional investors. Nevertheless, in view of the huge FX debt overhang accumulated over the years, there is a pressing need for the MDBs and DFIs to step in alongside TCX to stem further off-loading of exchange rate risk onto lower income countries (and in particular, their governments, where financing is on a sovereign basis).

As outlined in the previous CEPA Viewpoint[ii], another area where MDBs and DFIs can have great impact is to provide finance for development and construction of greenfield projects in the infrastructure, energy, and industrial sectors. This is where there are acute financing gaps, while there is little shortage of finance for operational projects. Once projects are operational, development finance should exit, permitting institutional and commercial capital to take over, and thus allowing for a faster recycling of capital. The participation of local institutions such as national development or infrastructure banks[16], would be facilitated if there were a sufficiently large portion of LCY in the refinancing.

VIEWPOINT

In terms of our own Viewpoint on the above, we agree with the general sentiment, as expressed in recent publications, that a watershed has been reached in the development finance arena, where business-as-usual is not a workable option any longer. More radical measures need to be taken by key actors and institutions to meet the formidable challenges ahead. In particular, we see the often, innovative ways of raising more public finance – as set out above – as being a necessary, but not sufficient condition in increasing *sustainable* financial flows to development and climate assets.

In other words, it can be seen that there are ways in which the quantum of development and climate finance is being increased. The question is then about *how* these still relatively scarce resources should be deployed. In themselves they cannot meet the scale of the development and climate finance challenge; they also need to help mobilise and directly leverage private resources, both **international** and **domestic**.

A critical point is that we need to find ways of moving away from the pricing of finance in FX terms and seek to employ *pricing* in the local / domestic currency of host countries (note that this is a separate point from the currency in which revenues are transferred).

In terms of domestic resource mobilisation, this is less of an issue. The challenge here is about how to intermediate domestic savings into the financing of development and climate projects (as well as growing the overall volume of domestic savings).

[ii] How the typical DFI business model should be revised to better promote the engagement of institutional capital in the financing of operational projects is the subject of a previous CEPA Viewpoint: *The New Build Back Better (B3w) Initiative* (2021), at https://www.cepa.co.uk/news-insights/view/the-new-build-back-better-b3w-initiative.

In many poorer countries, in particular, there continues to be a reliance on cross border finance, from both public and private sources. If this continues to be largely priced in FX, debt overhangs will continue to grow. Whilst private capital providers will understandably wish to mitigate FX risks, there are questions as to how, in mobilising private cross border capital flow, public institutions can take on more risk in support of this.

The use of scarce subsidies needs to be considered in the context of this domestic pricing objective. There is a growing demand–supply gap for concessional finance and realism is called for, as we are moving quickly towards a critical ODA squeeze – with 'Who should pay for all this?' being the elephant-in-the-room.

Whilst not necessarily wishing to provide a full agenda of priorities, we would highlight the following as being more than worthy of consideration:

Mobilising cross border private sector flows

- Scaling up of international private capital flows to EMDEs is indispensable, a major part of which (i.e. to middle-income countries) would be non-concessional. That being said, to use public aid funds to lower the bar for private sector engagement in more challenging environments is also necessary but requires advocacy with the general public and CSOs to build acceptance.
- Among the most interesting initiatives on the table are the prospective rechannelling of SDRs via the MDBs (that could leverage private funds for both private and public sector investments), and a significant scale-up of currency risk protection via boosted institutions such as TCX and MIGA.
- Bilateral donors are increasingly favouring unfunded guarantees, considering the resource efficiency (i.e. leverage of scarce aid funds) of these instruments, and their capacity to leverage cross-border as well as domestic finance. The movement in this direction could be boosted through modified ODA reporting procedures within the OECD/DAC, as current metrics do not allow direct ODA assessment of guarantees and risk capacity contributions.

Mobilising domestic local currency finance

- The role of guarantees should be vastly enhanced, particularly in the context of local currency solutions, but requires tweaking of the business models of MDBs and DFIs, as well as on-boarding of staff and changing incentive structures at these institutions.
- The role of national development and infrastructure banks is vital but relatively neglected, in the context of domestic resource mobilisation and local currency solutions. Such institutions are not dependent on short term deposits which create asset-liability mismatches. Growth in levels of contracted savings such as pensions are a vital local currency denominated resource which can be intermediated by these national banks to climate and other investments.

Pricing of MDB / DFI finance

- The MDBs and DFIs should revise their lending practices and make a concerted effort to stem the build-up of huge FX debt overhangs afflicting LIC/LMICs. This could be done by a measured increase in direct currency exposure via LCY-denominated or, more significantly, by a drastic increase in the offer of hard currency loans indexed to local currency, working with EMDE currency risk hedge providers such as TCX (notwithstanding high nominal interest rates and hedging costs for indexed LCY debt). A more challenging issue is the extent to which such institutions may be able to explicitly absorb a degree of currency risk (for example, *real* exchange rate depreciation in the case of the most poor and / or heavily indebted countries).

- In the longer-term, there is merit in the idea of lifting the FX hedging function to a multilateral level, at least for cross-border transactions in the public sector, to benefit from economies of scale and multilateral status so that the cost of currency hedging can be lowered.

Do readers agree? If so, how should some of these ideas be taken forward? If not, what should be the priorities?

END NOTES

[1] G20 Task Force-Lankes-Robins (2023): *Private capital for climate action.*

[2] *The Triple Agenda - Strengthening Multilateral Development Banks*, Report of the independent experts group, vol. 1 (2023), p.13.

[3] Songwe V, Stern N, Bhattacharya A: (2022), *Finance for climate action: Scaling-up investment for climate and development* p. 10.

[4] Bhattacharya A, Dooley M, Kharas H, Taylor C (2022): *Financing a big investment push in emerging markets and developing economies for sustainable, resilient and inclusive recovery and growth*, p.54.

[5] Le Houérou, Philippe & Lankes, Hans Peter (2023), pp. 5, 11.

[6] Convergence (2022): *The action plan for climate & SDG investment mobilization for emerging markets & developing economies*, p. 35.

[7] Financial Times, 2023-07-18: *World Bank to stretch every dollar with new lending measures*. The article mentions the target of expanding WB lending of up to $30bn over 10 years, backed by $5bn callable capital as guarantee.

[8] *High-level expert group on scaling up sustainable finance in low- and middle-income countries - mandated by the European Commission* (2023), p. 7.

[9] IFFEd contributors would only pay in 15% of their guarantee commitment to capitalize the facility, with a contingent commitment covering the remaining 85%. This allows for increased leverage on paid-in capital. If the paid-in capital falls below the 15% threshold because of arrears, IFFEd calls for the contingent capital to restore the required floor within a specified timeframe. IFFEd has received a preliminary AAA rating due to the high ratings of its target contributors. [Source: *Boosting MDBs' investing capacity: An independent review of multilateral development banks' capital adequacy frameworks* (2022), p. 37].

Sida announced in December 2022 that it would provide a loan portfolio guarantee of SEK 2.8 bn (US$200 million) to IFFEd for the purpose of unlocking affordable finance for LMICs to support education of the world's most vulnerable children. The UK foreign secretary announced at the 28th General Assembly of the UN that UK will contribute up to £180 million of support to IFFEd, incl. £95 million in grants and paid-in capital, and a contingent guarantee of up to £85 million.

[10] IFFEd's innovative combined guarantee and grant mechanism served as a model for ADB's design of IF-CAP. [Source: Asian Development Bank (2023): *Establishment of the Innovative Finance Facility for Climate in Asia and the Pacific Financing Partnership Facility*, footnote 24].

[11] Following the meeting between US President Biden and Indian Prime Minister Modi on 2023-06-22, their joint statement highlighted mobilization of concessional financing at the World Bank to support all developing countries as a key objective in the evolution roadmap. [Source: Matiasen, Karen, CDG Blog (2023-06-28): Key Takeaways from the Paris Declaration on MDBs.

[12] Statement by IMF's Managing Director at the third meeting of the G20 Finance Ministers and Central Bank Governors in Gandhinagar, India (2023-07-18).

[13] The Triple Agenda, report of the IEG, vol. 1 (2023), p.16. The report's proposal, which is directed at G20 members, is that a Global Challenge Funding Mechanism be initially hosted by the WB under separate governance arrangements.

[14] Central banks could buy an SDR-denominated bond, earn interest on it, and trade it between each other and the 15 other 'prescribed holders' (as defined by the IMF) — thus ensuring its liquidity. Furthermore, the bond could be SDR-denominated but cash-settled (with dollars or euros), which would simplify and streamline its use as a reserve asset. [Proposal presented in an article published in the Financial Times on 2023-01-26: '*The Magic of an SDR-denominated bond – How to funnel stagnant SDRs where they're actually needed*' by S. Paduano and B. Setser.

[15] Shipping levy (as championed by France, Bridgetown and others): This would be global levies on greenhouse gas emissions in the shipping sector as an innovative source of climate financing, to make the shipping sector carbon-neutral.

[16] National development banks typically extend finance in local currency, and can also offer concessional finance, which is important to a range of climate-related projects. [Source: Songwe V, Stern N, Bhattacharya A: (2022), p. 55].