CONVERGENCE

BLENDING GLOBAL FINANCE

# G24 TECHNICAL SESSION 3:

## MOBILIZING PRIVATE FINANCE FOR SUSTAINABLE AND INCLUSIVE DEVELOPMENT

## INCREASING THE NUMBER OF SDG AND CLIMATE PROJECTS IMPLEMENTED BY MOBILIZING PRIVATE INVESTMENT THROUGH BLENDED FINANCE

February 28, 2023

# EXECUTIVE SUMMARY

- Sustainable Development Goals and Paris Agreement launched in 2015: **importance of mobilizing private sector expertise and investment**
- **Legacy business models continue with very low levels of private investment mobilization**: Multilateral Development Banks (MDBs), national Development Finance Institutions (DFIs), Official Development Assistance and Climate Finance similar activities to pre-2015
- Gross annual MDB & DFI commitments ~ $140 billion **(3% of annual SDG and Climate Investment needs)**
- MDBs & DFIs mobilize $20 billion of private investment annually (**0.4% of SDG Investment Needs**)
- Private investment mobilization will remain low without changes to **governance** of MDBs, DFIs, ODA and Climate Finance: **Mobilization must be prioritized (Key Performance Indicators) and investment risk must be de-risked to within fiduciary / regulatory risk limits**



Source: Convergence 2022

# EXECUTIVE SUMMARY

- Annual SDG Investment needs in Low-Income and Middle-Income Countries estimated at $4 - 4.5 trillion. Actual only one-third. (UNCTAD and OECD)
- **SDG Investment Gap ~ $3.5 trillion (Climate Investment Gap ~ $1 trillion)**
- Annual cross border **net flows** to LICs & MICs (ex-China):
  - **Private sector ~ 10% of Investment needs**: $308 billion Net Foreign Direct Investment, $115 billion Net Long term Debt and NIL Net Portfolio Investment
  - **Public sector ~ 3% of Investment needs**: $58 billion Net Long Term Debt and one-third $180 billion ODA
- **Global financial assets: $479 trillion, but only 4% in LICs & MICs (ex-China)**
- **Action Plan for Climate and SDG Investment Mobilization: How to increase investment and mobilization from $240 billion to $530 billion using existing resources.**



Source: Convergence 2022

# ANNUAL SDG INVESTMENT NEEDS $4 – 4.5 TRILLION (UNCTAD & OECD) ACTUAL GAP ESTIMATED AROUND $3-3.5 TRILLION

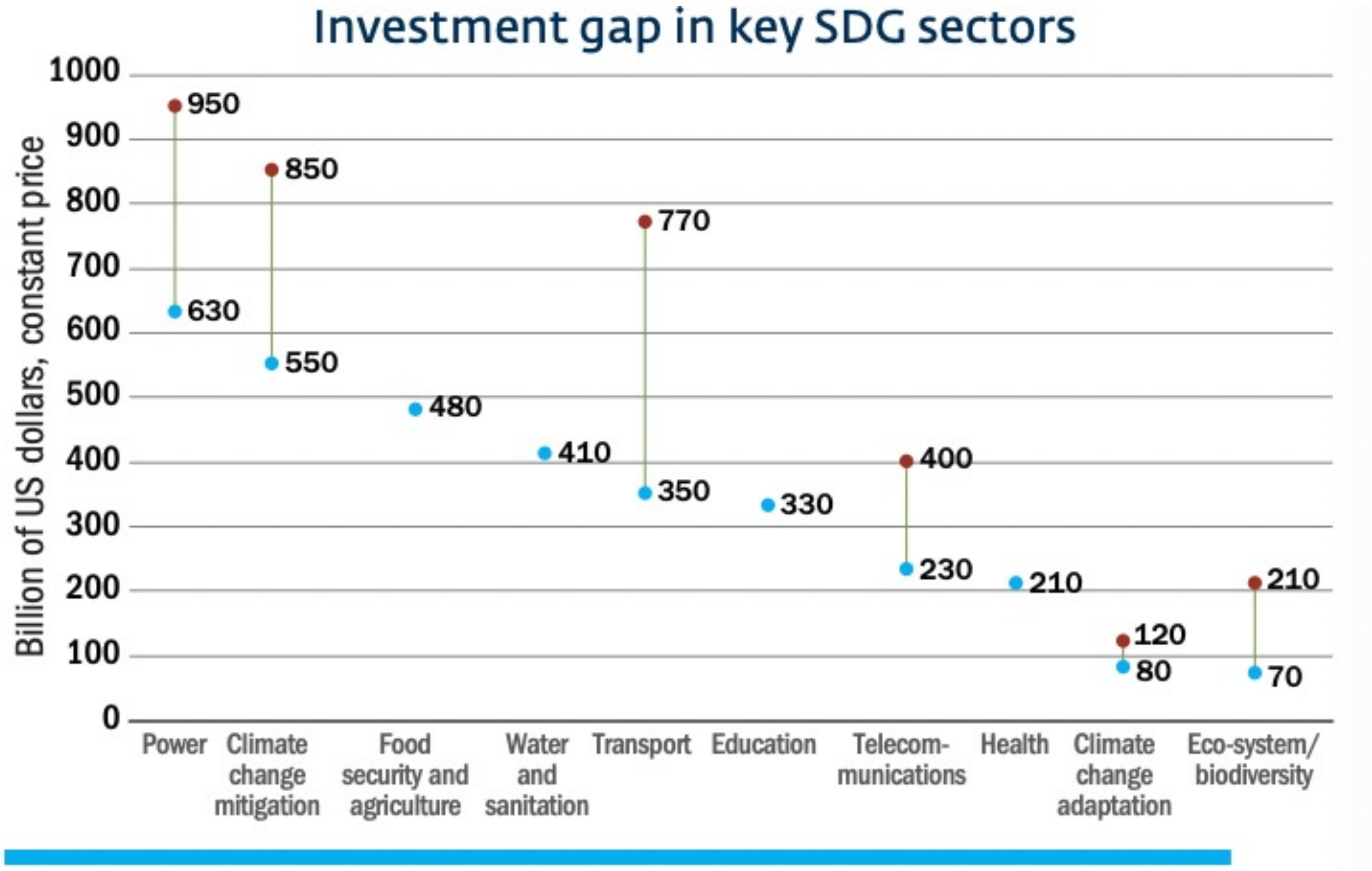



**FIGURE 2** Investment gap for developing countries

# TRADITIONAL ODA CRITICAL BUT CAN SOME DEVELOPMENT RESOURCES BE USED TO MOBILIZE PRIVATE INVESMENT?

- **Most development needs in LICs & MICs require traditional aid/grants and sovereign low-cost loans**
- Blended finance good development tool if:
  1. Goal to increase SDG and Climate investment that would otherwise not happen
  2. Total development funds & mobilized private investment higher impact
  3. Adheres to best practices (five OECD Blended Finance Principles)
  4. Ideally auctioned to maximize development / climate impact with minimal concessionality


**Allocate small percent of ODA and ODA-like (5%?) and public climate finance (20%?) to mobilize private investment?**

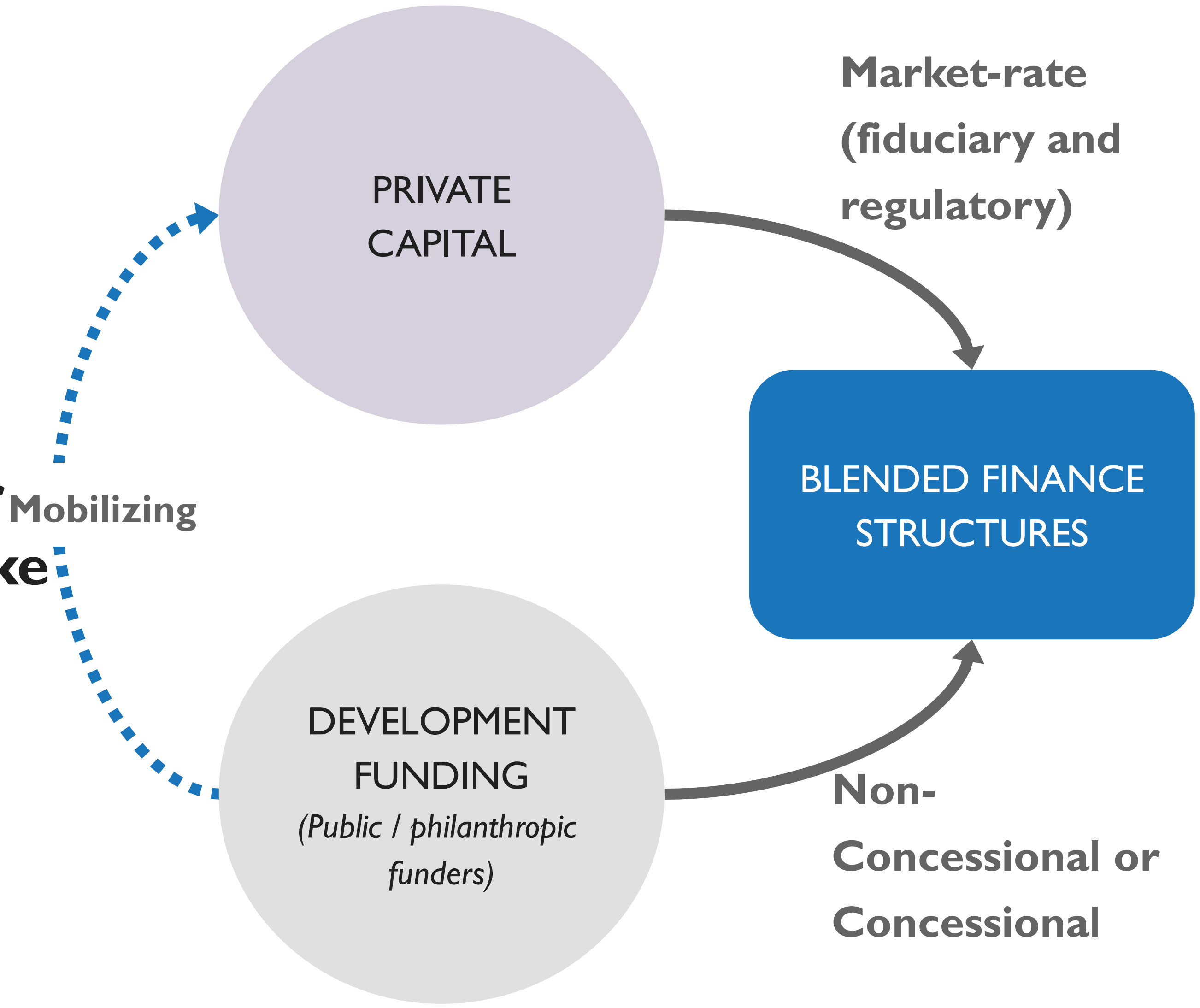
# BLENDED FINANCE 101

# BLENDED FINANCE TO MOBILIZE PRIVATE INVESTMENT

Use of **catalytic capital** from public or philanthropic sources to mobilize **private sector investment** in sustainable development.

Public sector resources can be deployed at **market terms (e.g., MDB resources) or concessional terms (e.g., ODA, ODA-like and climate finance)**

**Very low amounts of MDB, ODA and climate finance allocated to mobilize private investment**

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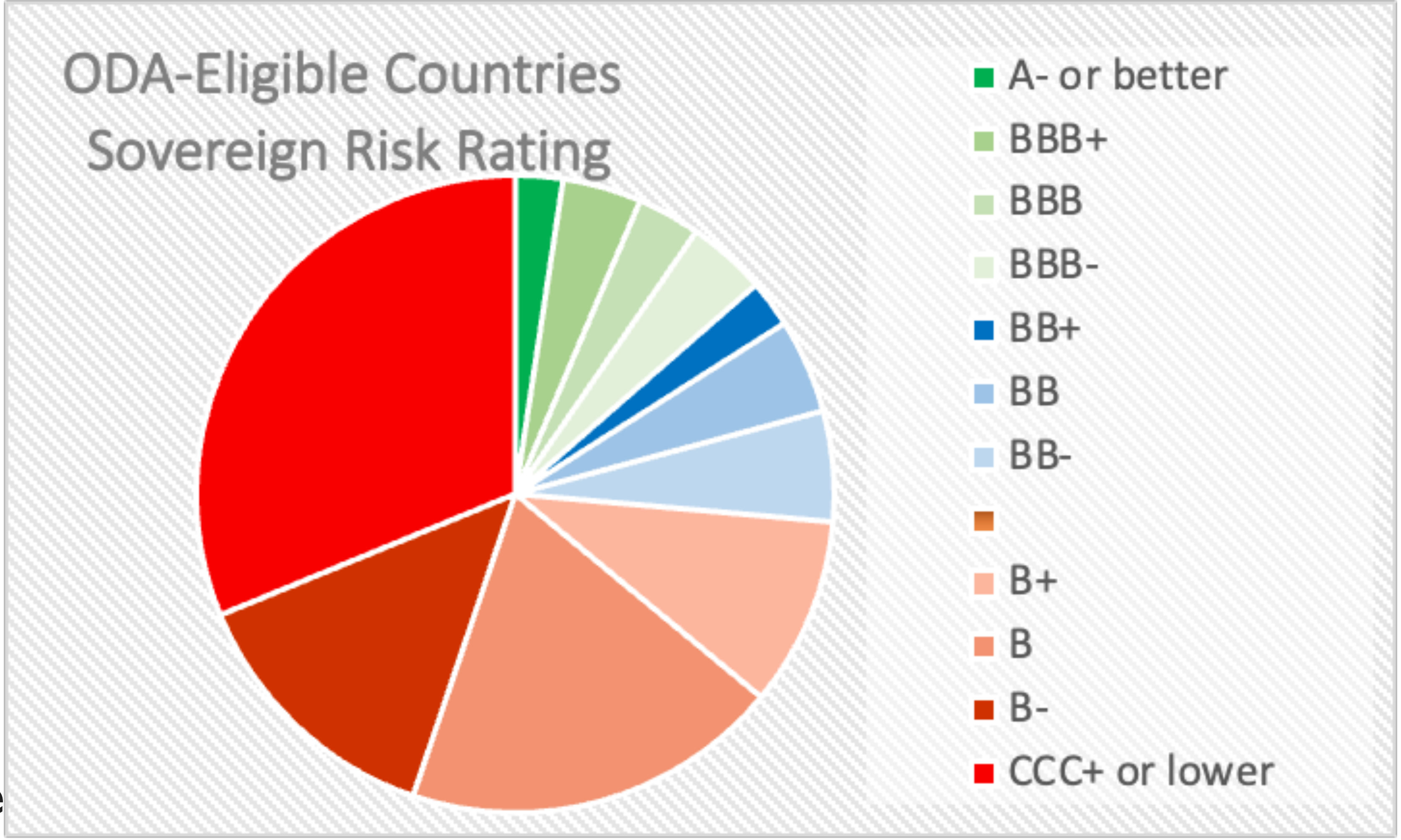
# HIGH COUNTRY RISK IN EMDES:
# RISK TOO HIGH FOR MOST INVESTORS IMPEDING INVESMENT

140 LICs AND MICs:
11% rated Investment Grade
13% rated BB
76% rated B or lower
Median sovereign risk  is "B"
Majority of private sector "B" or "CCC"

***"Highly Speculative"***

**Most debt investment opportunities beyond fiduciary and regulatory risk limits for most private investors**




Source: Compiled by Convergence from  Fitch, Moody's, S&P and OECD ECA ratings, 2022

# MOBILIZATION AT SCALE: DE-RISKING INVESTMENT RISK REQUIRED

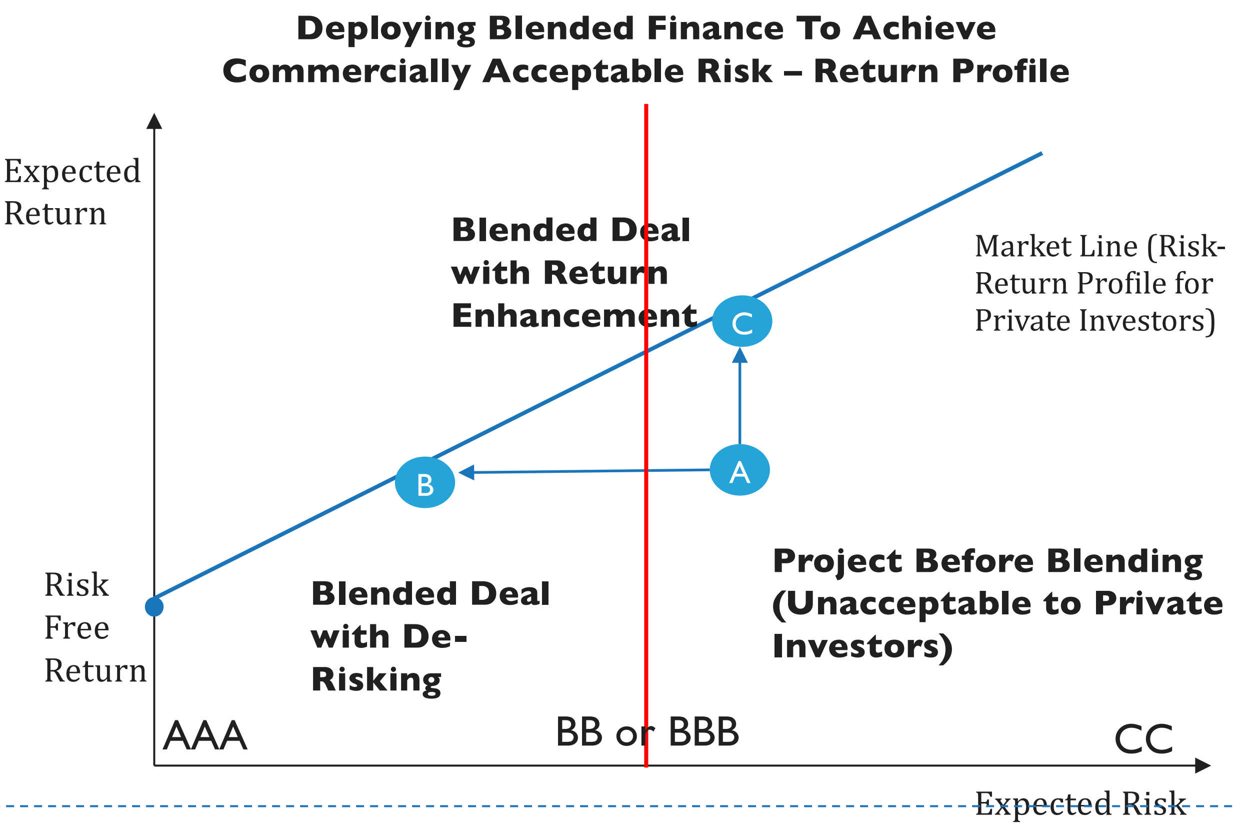
- **Scale investment mobilization only possible if (i) risk meets investors' fiduciary and regulatory investment obligations and (ii) risk-return is market-equivalent**
- **MDBs not in business of de-risking investment risk for private investors**
- Almost all MDB mobilization activity to mobilize private investment at same risk level (*pari passu*)
- MIGA only MDB whose primary business is to de-risk private investment
- **Generally: MDBs can mobilize at same risk profile in 24% of EMDEs rated "BB" or better, but very difficult for other 76% of EMDEs**
- If scale mobilization is objective:
  - Governance of MDB, DFI, ODA and climate finance: Mobilization top priority (KPIs)
  - Critical mass of MDB and DFI commitments to de-risk investment risk
  - Some concessional ODA and climate finance to de-risk investment risk



Source: Convergence 2022

# BLENDED FINANCE CAN CREATE INVESMENTS THAT MEET INVESTORS' REGULATORY AND FIDUCIARY OBLIGATIONS

- Blue line is the CAPM efficient range of risk & return combinations available to debt investors
- Red line is "maximum acceptable risk" for an investor (e.g., Investment Grade)
- Investments below blue line and right of red line not acceptable to fiduciary investors
- **Developing Countries risk high: B & CCC**
- **Reducing risk to left had side of red line is critical**
- Convergence Historical Deals Database: 500+ transactions demonstrate how concessional funds deployed to mobilize private investment
- No innovations required




**Goal of Blended Finance : Create "market equivalent" investments at acceptable risk to mobilize private sector investment to SDG AND CLIMATE projects in Developing Countries**

Source: Convergence 2022

# MOBILIZATION BY MDBS AND DFIS

# MULTILATERAL COMMITMENTS TO LICS & MICS

Mutlilateral commitments remained steady ~ $90 million until Covid: $60-65 billion public sector and $25-30 private sector

Post-2015 increase only during Covid

Commitments equal ~ 2.5% of annual SDG and Paris Agreement investment requirements.

**Figure O.15 Commitments to Low- and Middle-Income Countries from Multilateral Institutions, 2010–21**

*US$ (billion)*


Source: World Bank, International Debt Report 2022

# MDB AND DFI REPORT: MOBILIZATION TO LICS & MICS:
# $20.6 BILLION OF PRIVATE DIRECTION MOBILIZATION: 0.4% of SDG NEEDS

Mobilization of Private Finance by MDBs & DFIs Report (2021)

0.5% of annual SDG and Climate investment needs

| Private Co-Financing/Mobilization | Private Direct Mobilization |
|---|---|
| The investment made by a private entity, which is defined as a legal entity that is<br>• Carrying out or established for business purposes and<br>• Financially and managerially autonomous from national or local government.<br>Some public entities that are organized with financial and managerial autonomy are counted as private entities. Other examples include registered commercial banks, insurance companies, sovereign wealth funds, and other institutional investors investing primarily on a commercial basis. | Financing from a private entity on commercial terms due to the active and direct involvement of an MDB leading to commitment. Evidence of active and direct involvement includes mandate letters, fees linked to financial commitment, or other validated or auditable evidence of an MDB's active and direct role leading to commitment of other private financiers. PDM does not include sponsor financing.<br>**Private Indirect Mobilization**<br>Financing from private entities provided in connection with a specific activity for which an MDB is providing financing, where no MDB is playing an active or direct role that leads to the commitment of the private entity's finance. PIM includes sponsor financing, if the sponsor qualifies as a private entity.[19] |

**Private Direct Mobilization + Private Indirect Mobilization = Private Co-Financing/Mobilization**

**TABLE A.4** LIC and MIC — Long-Term Financing

| | PCf (US$, millions) | PDM (US$, millions) | PIM (US$, millions) |
|---|---|---|---|
| **ADB** | 7,785.0 | 1,726.9 | 6,058.1 |
| **AfDB** | 1904.1 | 849.1 | 1,054.9 |
| **AIIB** | 1,052.4 | 452.6 | 599.8 |
| **EBRD** | 7,632.3 | 370.4 | 7,261.9 |
| **EDFI** | 6,366.0 | 1,809.0 | 4,557.0 |
| **EIB** | 10,768.1 | 3,284.9 | 7,483.1 |
| **IDB Group** | 4,060.0 | 848.0 | 3,212.0 |
| **- IDB** | 244.0 | 0.0 | 244.0 |
| **- IDB Invest** | 3,816.0 | 848.0 | 2,968.0 |
| **ICD** | 0.0 | 0.0 | 0.0 |
| **World Bank Group** | 25,697.0 | 11,292.7 | 14,404.3 |
| **- MIGA** | 2,671.7 | 1,651.9 | 1,019.8 |
| **- WB** | 2,648.0 | 1,102.0 | 1,546.0 |
| **- IFC** | 18,757.2 | 8,538.8 | 10,218.4 |
| **TOTAL** | **65,264.8** | **20,633.6** | **44,631.1** |

# MDB & DFI MOBILIZATION STILL VERY LOW

MDBs and DFIs report mobilization of $19 billion average post-2015. Amounts continue to be low: no/low governance for mobilization, legacy business models, no/low prioritization and no de-risking

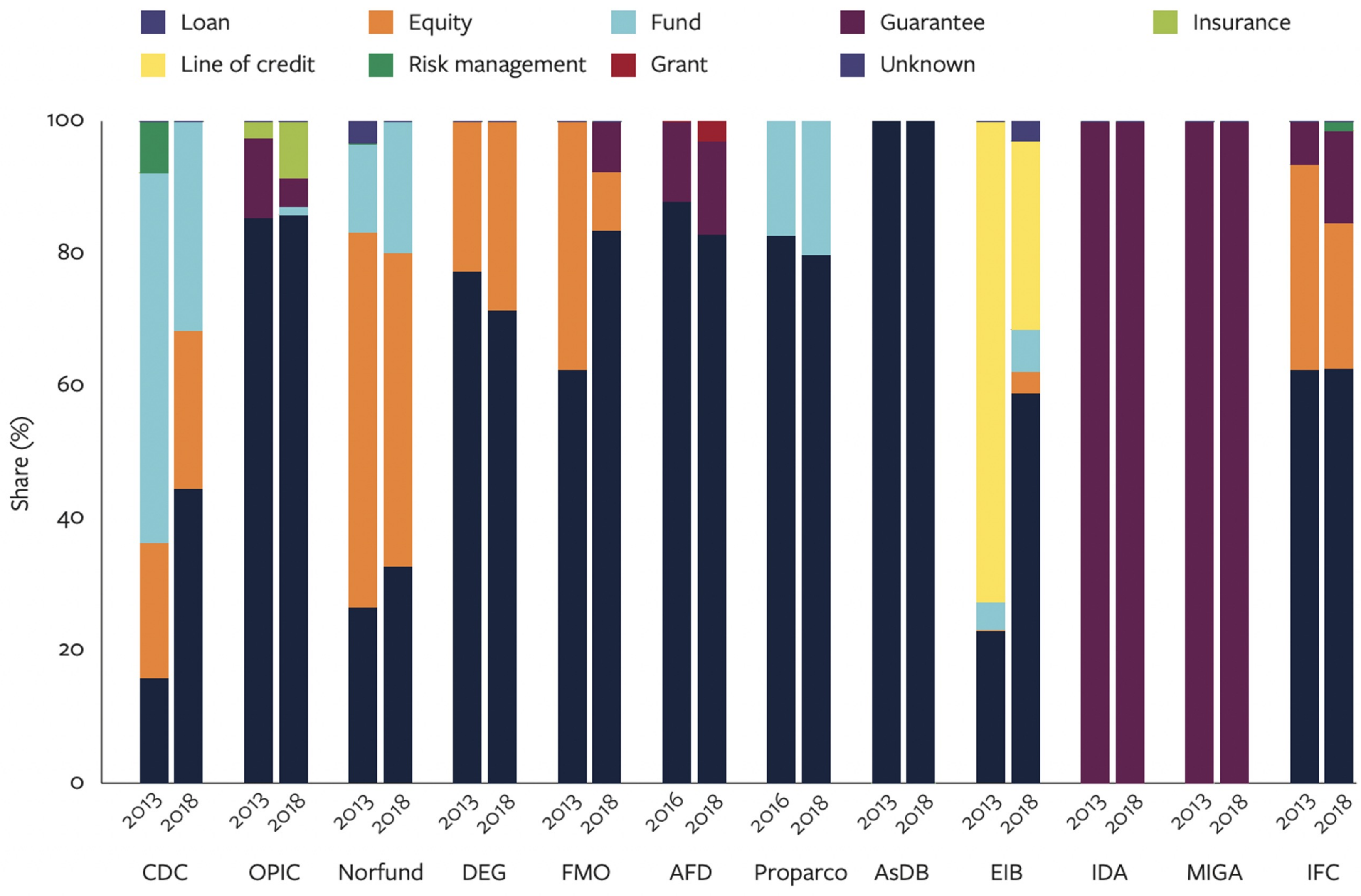
| MDB & DFI Private Investment Mobilization in Low and Middle-Income Countries | | | | | |
|---|---|---|---|---|---|
| **Long Term Financing (USD Millions)** | | | | | |
| | **2016** | **2017** | **2018** | **2019** | **AVE** |
| **Direct Mobilized** | **16,500** | **19,132** | **20,100** | **20,600** | **19,083** |
| Direct - LICs | 1,000 | 1,600 | 2,300 | 1,900 | 1,700 |
| Direct - MICs | 15,500 | 17,600 | 17,800 | 18,700 | 17,400 |
| | | | | | |
| **Indirect** | **54,600** | **40,276** | **49,300** | **43,000** | **46,794** |
| Indirect - LICs | 4,900 | 3,700 | 3,200 | 4,800 | 4,150 |
| Indirect - MICs | 49,700 | 36,500 | 46,100 | 38,200 | 42,625 |
| | | | | | |
| **Direct as Percent of Total** | 23% | 32% | 29% | 32% | 29% |

SOURCE: ODI 2021 REPORT

# INSTRUMENTS MDBs AND DFIs USE TO MOBILIZE

- Almost all private investment mobilization for private sector operations – virtually none for public sector operations
  - MDBs try to mobilize private investment at same/equal risk terms for private sector debt and equity - but de-risking is required
  - Guarantees only materially deployed at MIGA (and slightly at IBRD)

**Figure 14** Instrument shares of mobilising commitments, by DFI and MDB, 2013 and 2018



# TWO GOLD STANDARD EXAMPLES OF MOBILZING PRIVATE INVESMENT AT SCALE TO MDB LOANS

## ILX PRIVATE CREDIT FUND:

- Mobilizing private investment into MDB A-B loans: No concessional funds nor de-risking required
- $1 billion of private investment mobilized – portfolio diversification with multiple MDBs
- Investment risk will be loans rated "BB-" or better: Well-rated Middle-Income Countries

## IFC-SIDA MCPP INFRASTRUCTURE FUND:

- Mobilizing private investment into MDB A-B loans: Concessional and non-concessional funds de-risk investors
- $1.5 billion of private investment mobilized – portfolio diversification with IFC
- Investment risk will be loans rated "BB" and "B": MICs and LICs
- Thanks to de-risking, diversification, and IFC track record, investors modelled invest at Investment Grade "BBB"



Source: Convergence 2022

# ILX – SDG & Climate Focused EM Private Credit Fund

**ILX Management** is an Amsterdam-based specialist SDG and Climate-focused Private Credit Asset Manager. The company focusses on Global Development Finance co-investment strategies and partners with the leading Multilateral Development Banks and Development Finance Institutions such as the IFC, IDB-Invest, EBRD, ADB, AfDB and FMO. The company is AIFMD Licensed and Regulated.

## Active Fund

### ILX Fund I

- Investor commitments of USD 1.05 billion
- 1st close in Jan 2022
- Invests in MDB/DFI-originated USD & EUR loan participations
- Invested >USD 300 mil in 2022
- Invested 50% in Climate Finance
- SFDR Article 9 (Dark Green) Fund
- Invests across all regions and sectors in Emerging Markets
- Investment Strategy generates:
  - Attractive risk-return
  - Highest ESG safeguarding standards
  - Direct, measurable, positive SDG- and Climate-related impact

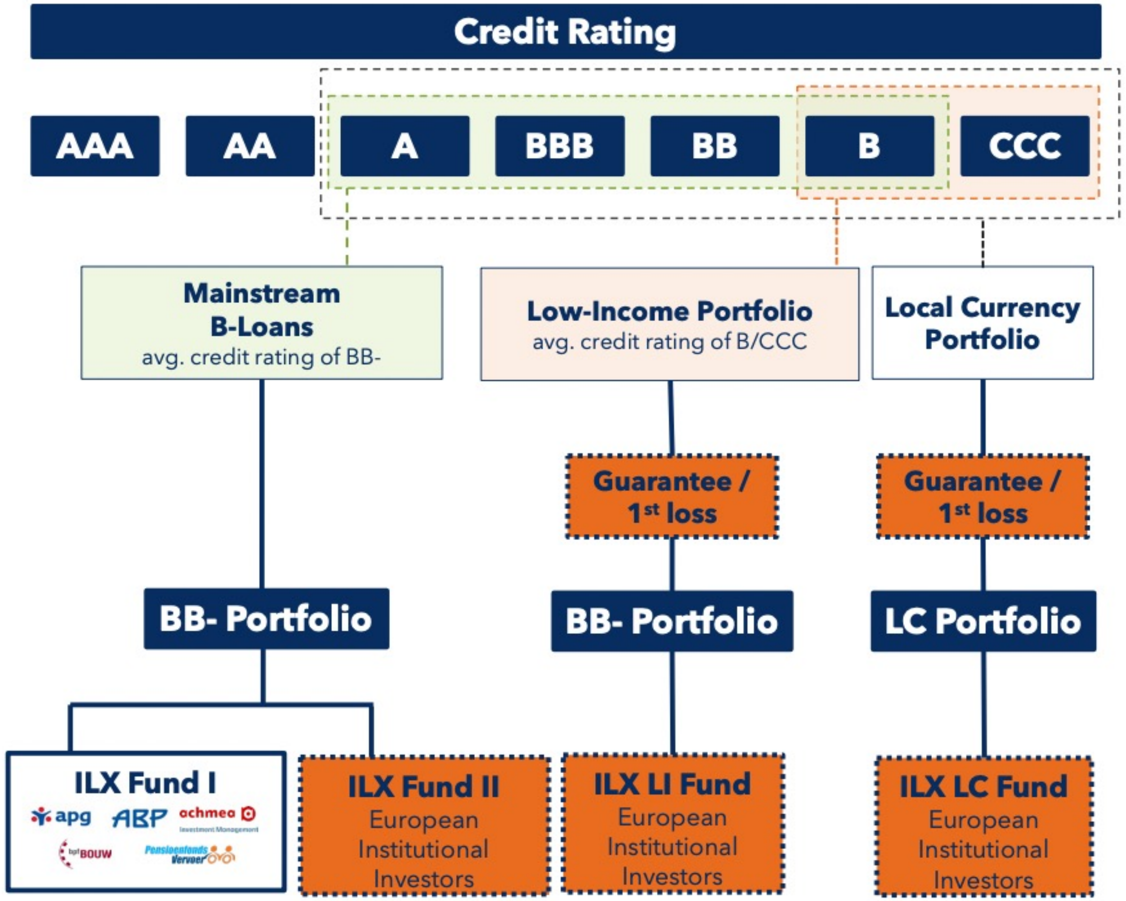
## Follow-On Funds & Strategy

### ILX Fund II

- Target Investor Commitments of USD 2 billion
- Target 1st Close in Q4 2023 – Q1 2024
- Similar scale-up strategy to ILX Fund I

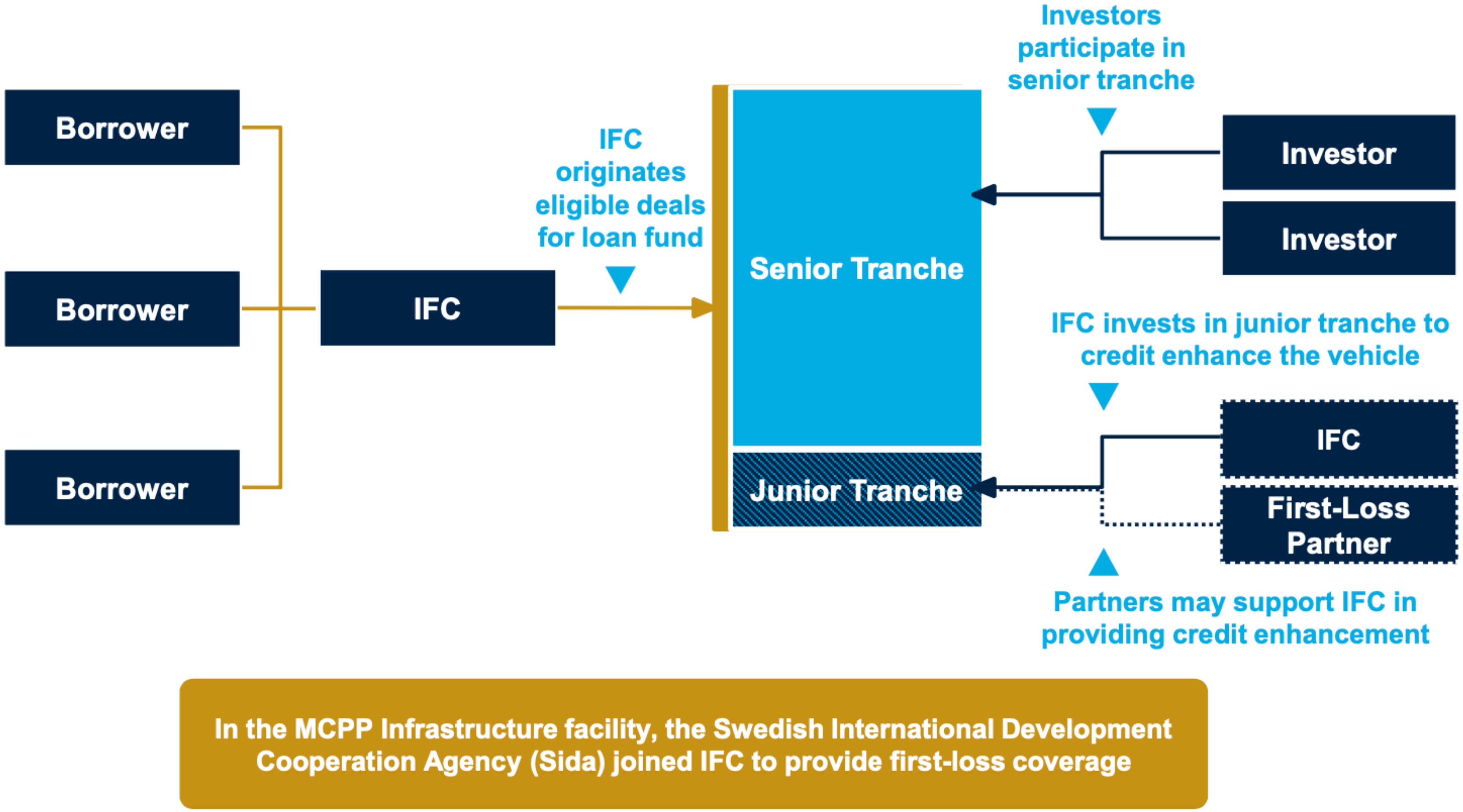
### ILX Low-Income / Local Currency Fund

- High-risk LI/LC strategies with blended structure i.e., guarantee, first-loss
- Target 1st Close in H1 2024
- Fund strategy Examples:
  - *Diversified high impact DFI investments in Low-Income Countries*
  - *Diversified Local Currency DFI Infrastructure and Renewable Energy investment across Emerging Markets*



# IFC & SIDA MCPP INFRASTRUCTURE PROGRAM

- IFC arranges portfolio of senior loans to infrastructure projects
- Loans priced ca. Libor + 3.6%
- Transfer 50% of each loan to Fund
- Fund capitalized 90% by senior notes & 10% junior capital
- $1.5 billion Senior Notes modelled at BBB/BBB+ invested by Alliance, Axa and Prudential
- Transaction is a unicorn – No MDB has replicated
- **Scale: Create one Fund - same structure for all MDBs and DFIs**



# MAIN MDBS: LOTS OF CAPACITY TO ARRANGE MORE AND DE-RISK

Table replicated from G20 Independent Capital Framework Review

Fifth column: Approximate maximum leverage of equity for each MDB to maintain AAA rating

Capital utilization around 40%

Lots of headroom (~$1.25 trillion) for more commitments and de-risking

If shareholders prepared to govern MDBs at AA, ~ 50% extra possible.

Analysis does not include national DFIs.

| MDB | Shareholders Equity | Development Assets | Actual Leverage | Likely Leverage Possible | Maximum Development Assets | Head Room | Capital Utilization: Actual Relative Maximum |
|---|---|---|---|---|---|---|---|
| AfDB | 11 | 34 | 3.1 | 5.0 | 55 | 21 | 62% |
| ADB | 53 | 133 | 2.5 | 5.5 | 292 | 159 | 46% |
| AIIB | 20 | 8 | 0.4 | 6.0 | 120 | 112 | 7% |
| CAF | 13 | 29 | 2.2 | 6.0 | 78 | 49 | 37% |
| CDB | 1 | 1 | 1.0 | 5.0 | 5 | 4 | 20% |
| EBRD | 22 | 41 | 1.9 | 5.5 | 121 | 80 | 34% |
| IDB | 34 | 106 | 3.1 | 6.5 | 221 | 115 | 48% |
| IBRD | 40 | 211 | 5.3 | 6.5 | 260 | 49 | 81% |
| IDA | 168 | 168 | 1.0 | 4.0 | 672 | 504 | 25% |
| IDB Invest | 2 | 4 | 2.0 | 4.0 | 8 | 4 | 50% |
| IFC | 25 | 47 | 1.9 | 4.0 | 100 | 53 | 47% |
| IsDB | 13 | 25 | 1.9 | 5.0 | 65 | 40 | 38% |
| NDB | 10 | 7 | 0.7 | 6.5 | 65 | 58 | 11% |
| **Total** | **412** | **814** | **2.0** | | **2,062** | **1,248** | **39%** |

Source: G20 2022 Independent Capital Review

Likely Leverage Possible while maintaining current risk ratings: Discussions with Big 3 Rating Agencies and MDB investor materials

Does not include EIB since only 10-14% of its balance sheet is for LICs and MICs

# MOBILIZATION BY ALL OFFICIAL DEVELOPMENT FINANCE

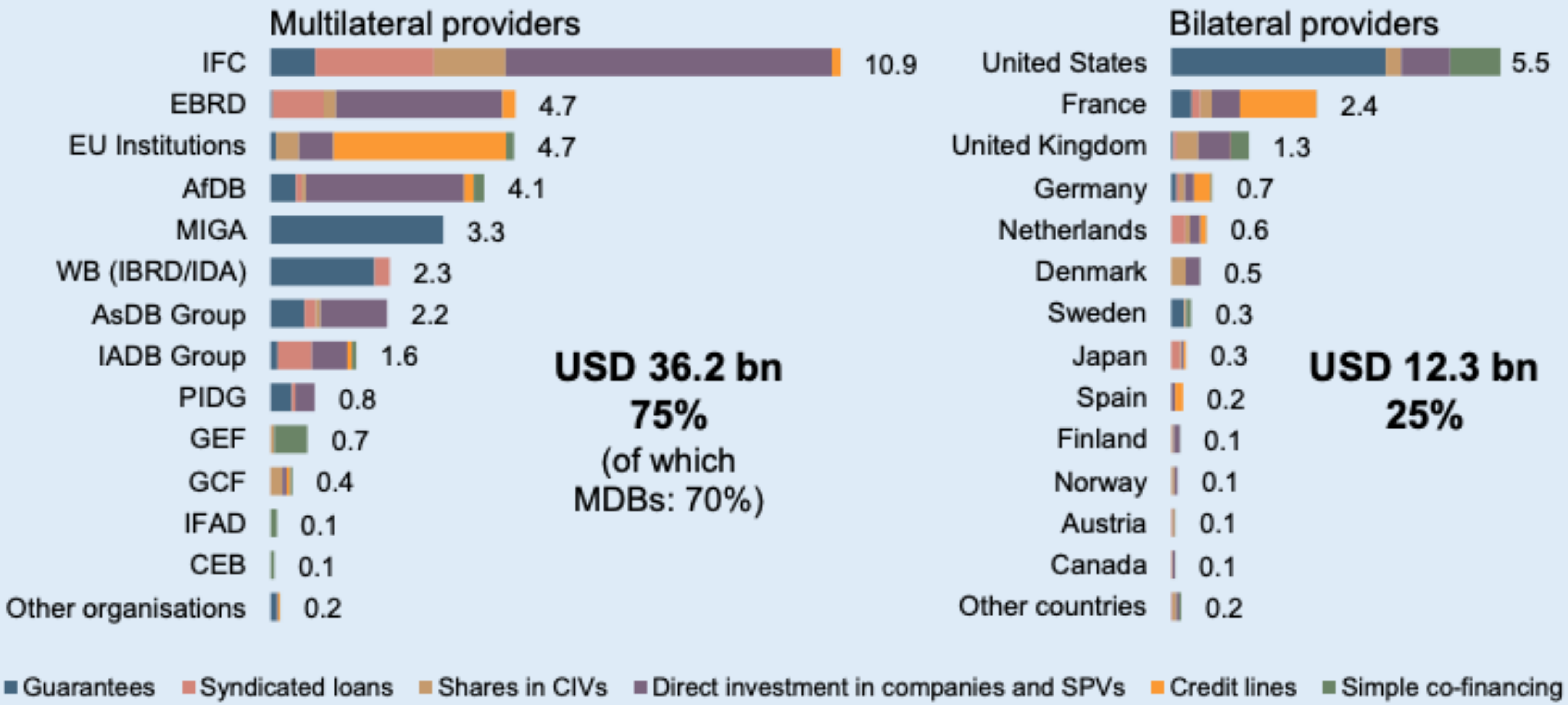
# PRIVATE INVESTMENT MOBILIZED BY OFFICIAL DEVELOPMENT FINANCE: OECD 2022 MOBILIZATION REPORT (AVERAGES 2018-20)

Official Development Finance mobilized $48 billion

**Only 1% of annua SDG Investment Needs.**

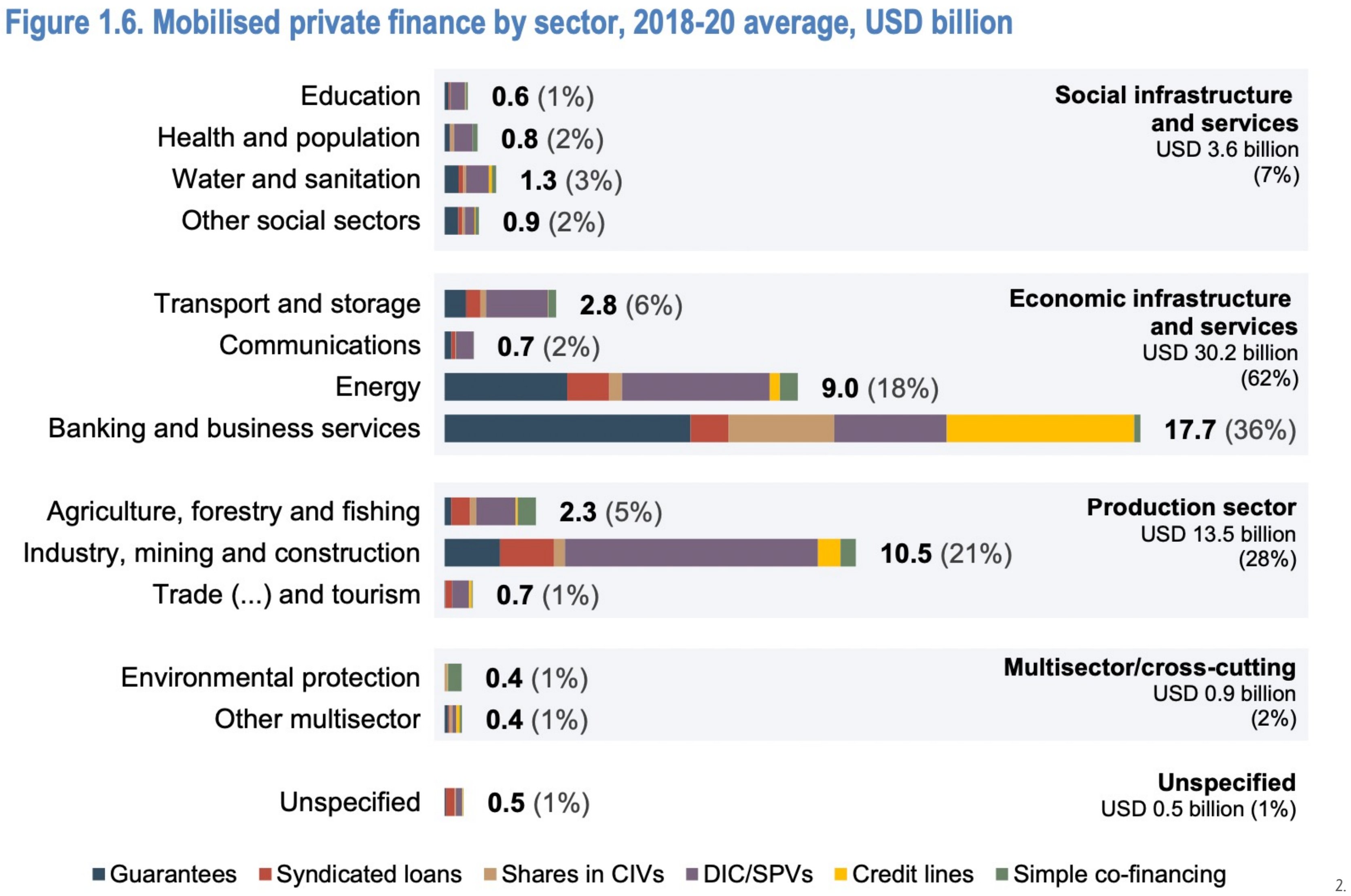
**Almost all in private sector operations**

**Around 75% of concessional public funds flow thru MDBs & DFIs with no/low mobilization**




Source: OECD, Amounts mobilized from the private sector for development, 2022

# OECD 2022 MOBILIZATION REPORT:
## BANKING/FI, INDUSTRY & ENERGY DOMINATE

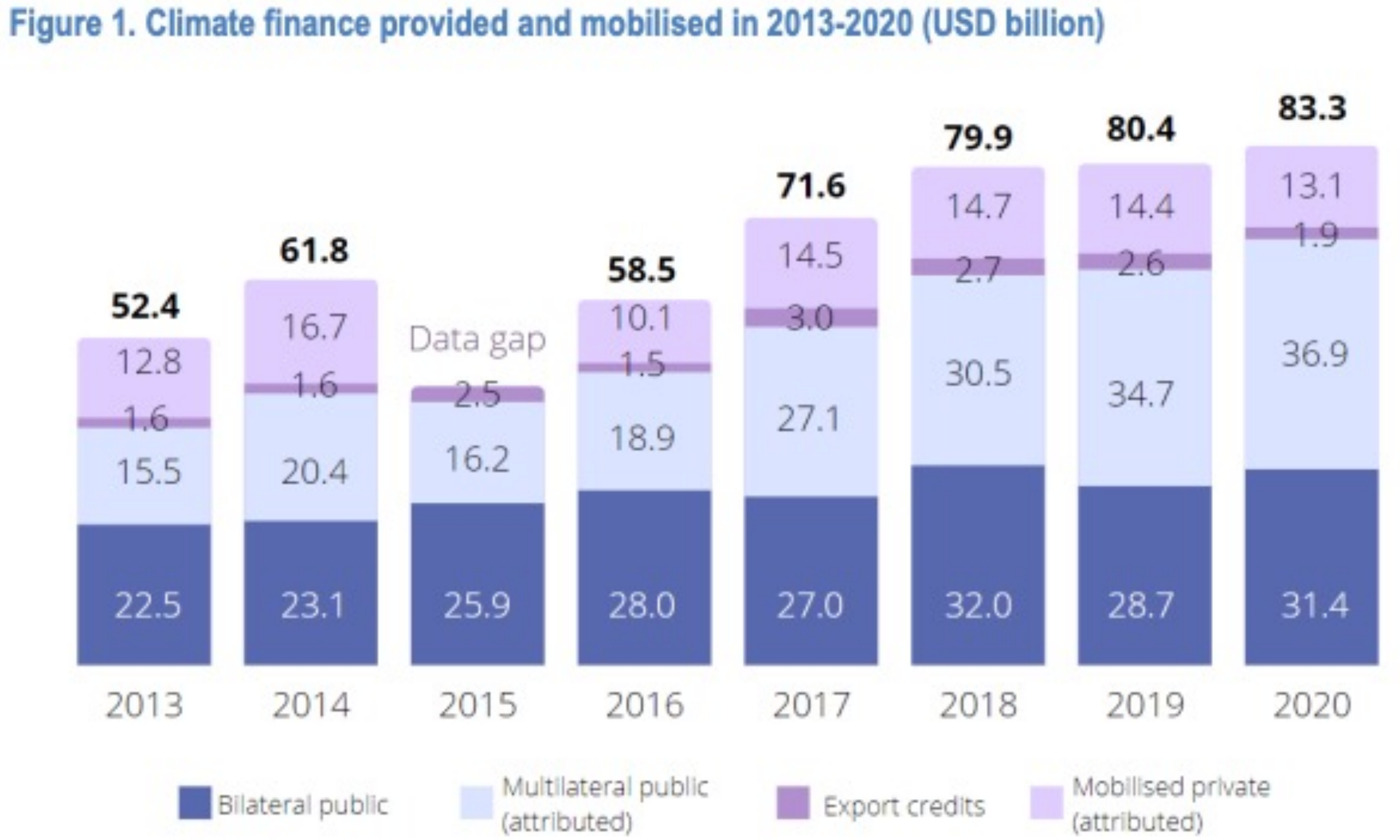


# CLIMATE FINANCE TO DEVELOPING COUNTRIES: OBJECTIVE TO PROVIDE/MOBILIZE USD 100 BILLLION ANNUALLY

2010: Developed Countries goal to provide and mobilize USD 100 billion per annum for climate action in developing countries.

2022 OECD report: Actual only $83 billion with $13 billion mobilized.

**Private mobilization flat at $13-14 billion.**




Source: OECD, Aggregate Trends of Climate Finance Provided and Mobilised by Developed Countries in 2013-2020, 2022

# ACTION PLAN FOR CLIMATE & SDG INVESTMENT MOBILIZIATION:

## FIVE PILLARS AND TWO COMPLEMENTARY ACTIVITIES: $530 BILLION POSSIBLE

| # | Description | Content |
|---|---|---|
| 1 | **Strategic Deployment of Catalytic Funding** | Must de-risk investment opportunities to within investors' fiduciary limits<br>Catalytic Funding: Catalytic Grants and Catalytic Capital<br>Critical mass of $13-15 billion of Catalytic Capital deployed in five Use Cases |
| 2 | **MDBs and DFIs: Governance and Business Model** | Shareholders to govern MDBs & DFIs to maximize their contributions to Climate and SDG Investment (maintain prudent risk ratings)<br>Double net Commitments and 10-fold increase in mobilization<br>Mezzanine investments required to de-risk private investors at scale<br>Key Performance Indicators. If implemented, two blended finance funds to support higher mobilization |
| 3 | **Collaboration: Investment & Mobilization** | Optimize limited Catalytic Capital to de-risk investors within fiduciary limits<br>Five Use Cases: Competitive Calls for Proposals to fund global best ideas |
| 4 | **Open access Hub to best resources** | Centralized, curated hub to house best data, information, knowledge building, standardisation, Catalytic Funds and investment assets |
| 5 | **Local capital markets & fincl intermediation** | Improve, deepen and broaden Local Capital Markets & Domestic Financial Intermediation: (i) Fund projects of $10 million and less and (ii) Sustainability |

# SUPPLEMENTARY SLIDES

# EMDES IMPLEMENTATION OF BLENDED FINANCE

# GOOD PRACTICE BLENDED FINANCE IMPLEMENTATION BY OECD DAC MEMBERS (MINISTRIES &DEVELOPMENT AGENCIES)

OECD agreed five Blended Finance Principles

In 2021, experts co-developed five guidance documents: https://www.oecd.org/dac/financing-sustainable-development/blended-finance-principles/guidance-and-principles/

**PRINCIPLE 1 :** ANCHOR BLENDED FINANCE USE TO A DEVELOPMENT RATIONALE

**PRINCIPLE 2 :** DESIGN BLENDED FINANCE TO INCREASE THE MOBILISATION OF COMMERCIAL FINANCE

**PRINCIPLE 3 :** TAILOR BLENDED FINANCE TO LOCAL CONTEXT

**PRINCIPLE 4 :** FOCUS ON EFFECTIVE PARTNERING FOR BLENDED FINANCE

**PRINCIPLE 5 :** MONITOR BLENDED FINANCE FOR TRANSPARENCY AND RESULTS

Source: World Bank, International Debt Report 2022

# SOUTHERN VOICES RESEARCH IN BLENDED FINANCE

- 2019: SV published five reports on blended finance: EMDEs' ownership of blended fiance and countries (Bangladesh, Nepal, Senegal % Uganda)
- Four highlights for beneficiary countries:
  1. If blended finance is to be used to leverage private investment, must be able to **exercise ownership effectively**.
  2. **More consistent and better organised information** on deploying blended strategies and practices, and accessing concessional finance
  3. **Right institutional frameworks** to analyse and structure blended transactions that share risks and rewards fairly; and to deploy blended strategies where and when they are appropriate
  4. Need to be able to **co-ordinate different development initiatives** and ensure their coherence.

Sources: Convergence 2022

# POSSIBLE G24 MEMBERS ENGAGEMENT WITH MOBILIZATION AND BLENDED FINANCE??

- Increase knowledge of mobilization and blended finance
- As shareholders of MDBs, **champion changes to MDB governance**:
  - Mobilization will remain low unless prioritized (KPIs) and percent of commitments de-risk investment risk
  - Must increase mobilization for public sector projects from nil
- As national governments:
  - Use public resources to **increase universe of investible projects** (project development prioritized over "project preparation")
  - Use public resources and NDBs to **de-risk investment risk** to within fiduciary and regulatory limits

Sources: Convergence 2022

# BLENDED FINANCE: ARCHETYPES AND APPROACHES
# CASE STUDIES

# GOOD PRACTICE BLENDED FINANCE: DEVELOPMENT OBJECTIVE DRIVES APPROACH

| Development Objectives | Primary Archetype(s) |
|---|---|
| Mobilize additional financing by creating market risk-return acceptable to private investors | Funded Risk Participation & Unfunded Risk Participation |
| Reduce up-front or ongoing costs to make an SDG project affordable | Viability Gap Funding & Smart Subsidies |
| Pay for "social" outcome the project or market can not afford (or will not pay) | Smart Subsidies & Performance Payments |
| Support success of SDG project by covering part of the costs or achieve systemic impact beyond individual project | Technical Assistance |
| Increase number of SDG related projects | Viability Gap Funding, Project Preparation & Design Funding |
| Incentivize innovation and investment into SDGs by committing to pay for results/outcomes (advanced market commitments) | Results Based Financing, Outcome Funding & Pay for Success |

# BLENDING AT DIFFERENT LEVELS: FUND MOST EFFECTIVE FOR MOBILIZATION

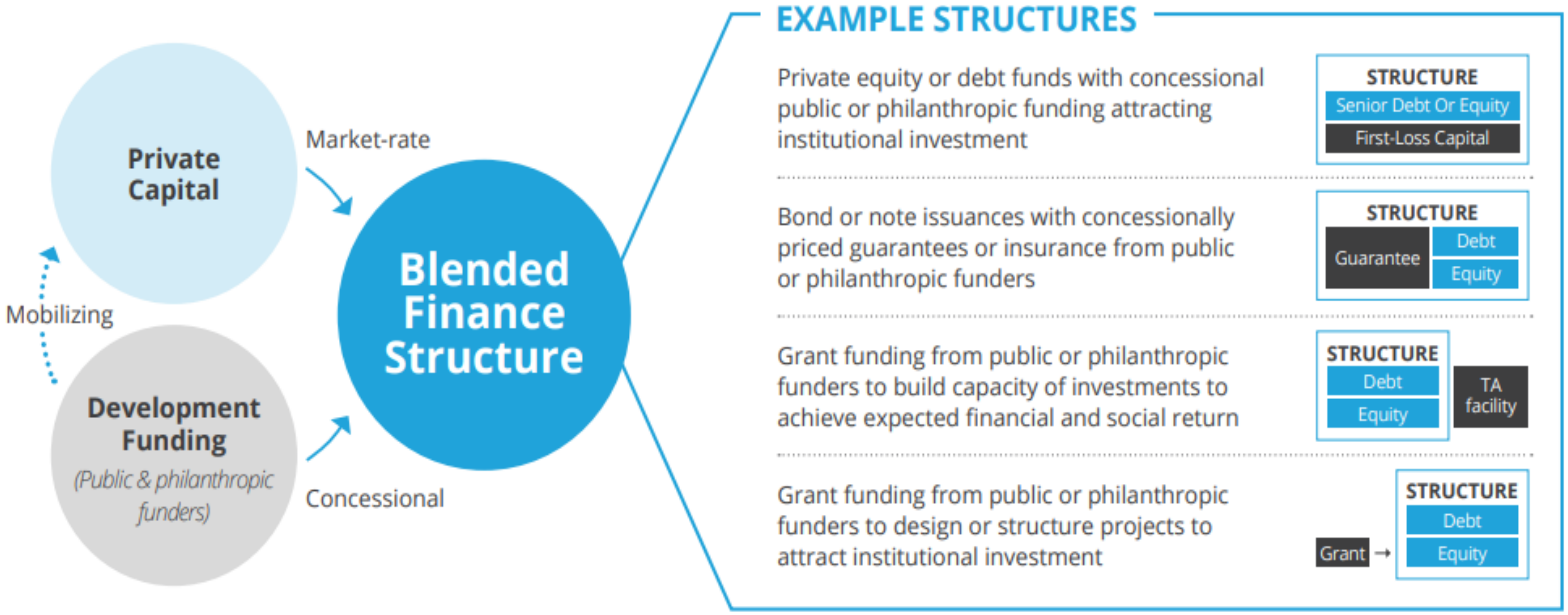
**1) Project Level -** Public & private capital blended within a single project or company's financial structure

**2) Fund Level -** Public and private investors pool resources to be invested in multiple projects or companies

**3) Fund-of-Funds -** Funds that invest in other funds

| Examples of Blending Across Different Levels | |
|---|---|
| **Project Level** | • M-KOPA Solar<br>• Kigali Bulk Water Project |
| **Fund Level** | • Climate Investor One<br>• African Local Currency Bond Fund |
| **Fund-of-Funds** | • Sarona Frontier Markets Fund 2<br>• Global Energy Efficiency & Renewable Energy Fund |

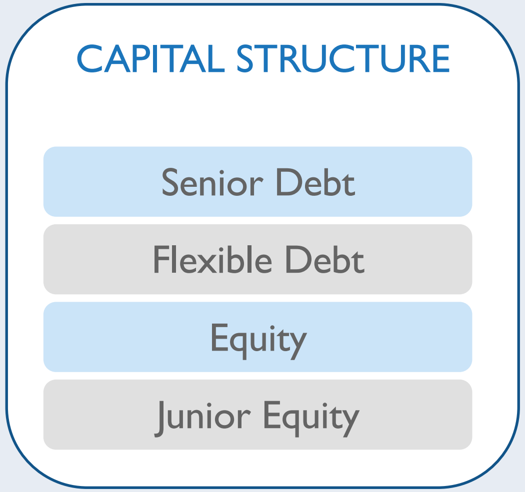
# COMMON ARCHETYPES OF BLENDED FINANCE



# FIVE MOST COMMON ARCHETYPES OF BLENDED FINANCE (1/2)

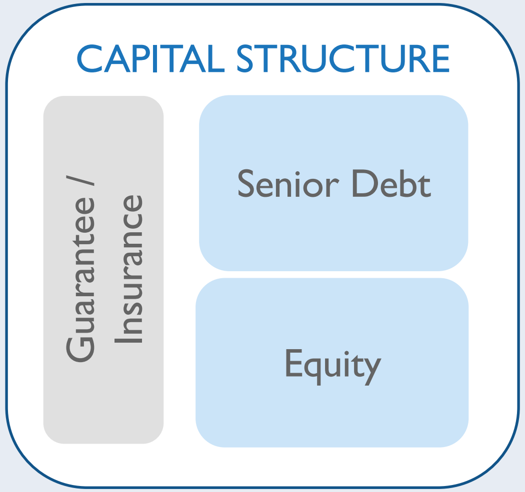
## CONCESSIONAL DEBT OR EQUITY

- Public or philanthropic investors are in the permanent capital structure
- Bear non-market-rate levels of risk and accept lower returns compared to private sector and MDB/DFI co-investors




## GUARANTEE/ INSURANCE

- Risk reduction tools protecting investors against loss of capital
- Helps to narrow gap between real and perceived risk
- Can cover all risks or a sub-set

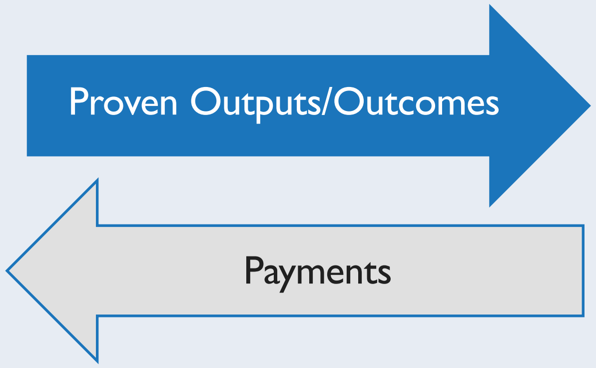



= concessional capital = commercial capital

# FIVE MOST COMMON ARCHETYPES OF BLENDED FINANCE (2/2)

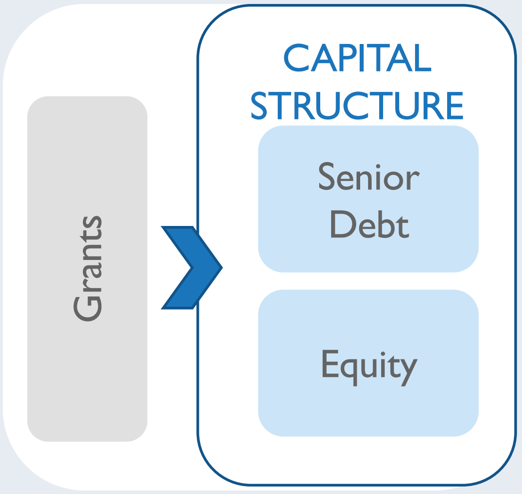
## RESULTS BASED FINANCING

- Ties payment to achievement of pre-agreed measurable outputs and outcomes
- Donors pay for outputs and not inputs (the latter typical for grants)
- Examples include Development & Social Impact Bonds



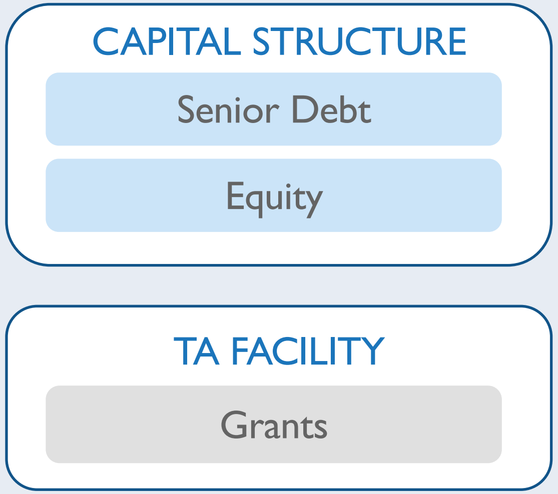

## DESIGN / PREPARATION STAGE GRANT

- Grant funding supporting costs and activities that lead to bankability and investability of projects
- Typically provided by those with a higher risk tolerance (eg: donor agencies and foundations)




## TECHNICAL ASSISTANCE SUPPORT

- Funding to supplement the capacity of investees
- Aim is to maximize quality of project implementation




= concessional capital = commercial capital

# 1. FUNDED RISK PARTICIPATION: CONCESSIONAL DEBT & EQUITY (1/2)

- Concessional debt or equity provide **favorable terms** of rates relative to market pricing; developmental capital bears non-market risk-return
- Subordinated (debt) or junior (equity) **protects** senior investors by taking first losses on the value of the security
- The use of direct investment instruments on concessional terms helps shift the risk-return ratio for private investors to an acceptable level
- Concessional finance can help bring down the **weighted average cost of capital** for a project

**Capital Structure**

- Senior Debt
- Subordinated Debt
- Mezzanine Capital
- Equity
- Junior Equity

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# I. FUNDED RISK PARTICIPATION: CONCESSIONAL DEBT & EQUITY (2/2)

| Concessional risk participation to enhance private investor <u>debt</u> | Concessional risk participation to enhance private investor <u>equity</u> |
|---|---|
| Fund a junior tranche to enhance senior tranche – | Two tiers of equity – “senior” equity versus “junior” equity |
| Subordinate return of principal until all private principal returned | Subordinate return of principal until all private equity returned |
| Longer maturities versus shorter maturities | Pari passu for investment but asymmetrical returns |
| Low interest debt to increase IRR for investors | Returns into reserve to create larger risk cushion for private investors |
| **Caveat: Concessional participants should target <u>mobilizing</u> private investment and not <u>subsidizing</u> private sector** | |

# 2. UNFUNDED RISK PARTCIPATION: GUARANTEES (1/2)

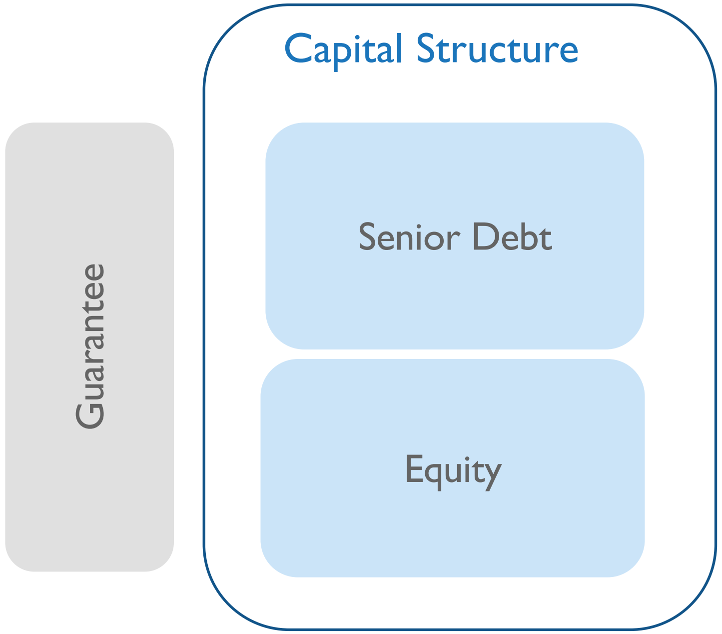
- Agreements that commit a guarantor to

  (1) pay all/part of an underlying financial instrument (usually a bond or a loan) to the investor of the instrument; or

  (2) make payment on behalf of the primary obligor that has not made the payment

- Provides investors **secondary level of comfort** that investment will be repaid if obligor not able to fulfill contractual obligations (payments)

- Helps narrow gap between **real and perceived risk** & typically requires no immediate outlay of cash/capital




**USAID (now DFC), Sida and EC are active issuers of guarantees for development**

## MOST EFFECTIVE BLENDED FINANCE STRUCTURES:

# FOUR MOST EFFECTIVE BLENDED FINANCE STRUCTURES TO MOBILIZE INVESTMENT AT SCALE – IDENTIFIED AND PREFERRED BY INVESTORS

Portfolio Level (e.g., fund)

1. **Mobilize Debt Investors at Portfolio Level:** Fund structure with development funds in subordinate position (e.g., first loss) reducing probability of default and expected loss
2. **Mobilize Equity Investors at Portfolio Level:** Fund structure with development funds in junior position in rank and distribution waterfall to increase IRR and reduce negative variance
3. **Aggregation Vehicle to invest in multiple Portfolio Level funds** described above to achieve scale

Project Level

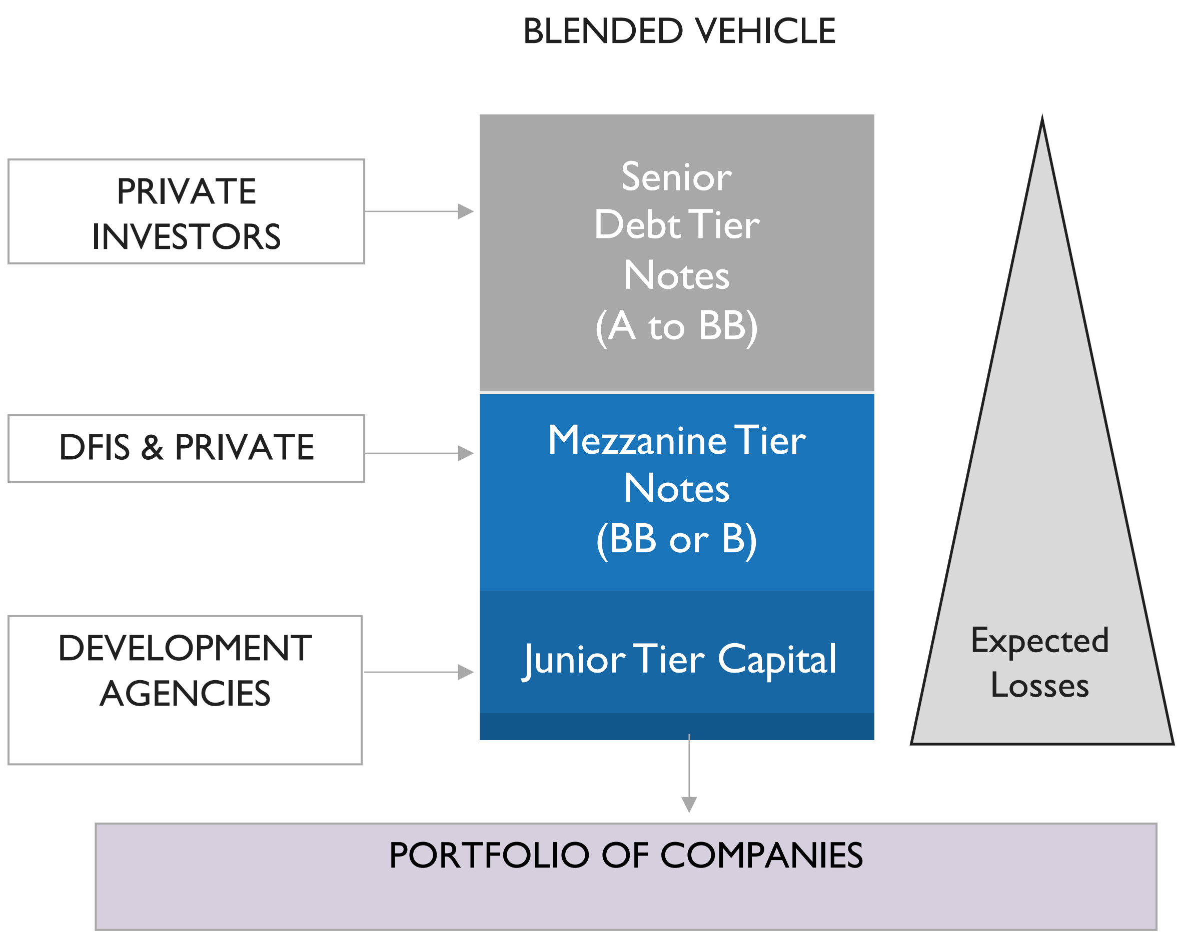
4. **Mobilize Debt and Equity Investors at Project Level:** Example Guarantee to reduce expected loss

Source: Convergence, How to Mobilize Private Investment in Blended Finance, 2020

MOST EFFECTIVE BLENDED FINANCE STRUCTURES:

# STRUCTURE 1:
# BLENDED FINANCE VEHICLE PREFERRED BY DEBT INVESTORS

1. Establish Blended Finance Fund with 3 capital tiers
2. Fund with experienced fund manager
3. Fund invests in portfolio of debt investments (loans) typically rated BB and 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 Notes can achieve Investment Grade (e.g., A or BBB) and Mezzanine Notes good-quality non-investment grade investment (e.g., B)
6. Investment grade rating allows a large universe of investors restricted by investment grade mandate




Source: Convergence 2020

## MOST EFFECTIVE BLENDED FINANCE STRUCTURES:

# STRUCTURE 1:
# BLENDED FINANCE VEHICLE FOR DEBT INVESTORS

- Assume Portfolio 30+ loans to borrowers with "B" risk rating
- Portfolio diversification can enhance risk to "BB-"
- Portfolio funded by three tiers of capital: (1) Senior Notes for 85%, (ii) Mezzanine Notes for 10% and Junior for 5%
- Can credit enhance Senior Notes to "Investment Grade" "BBB"
- Junior and Mezzanine must be large enough to absorb at least the "expected losses" - in this case between "BB-" and "BBB" or 0.63% per year (i.e., 0.79% less 0.16%)
- Possible Investment Grade "BBB" for Senior Notes with around of 15-20% of subordinate capital (for 10-year tenor)

| **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% |

Subordination

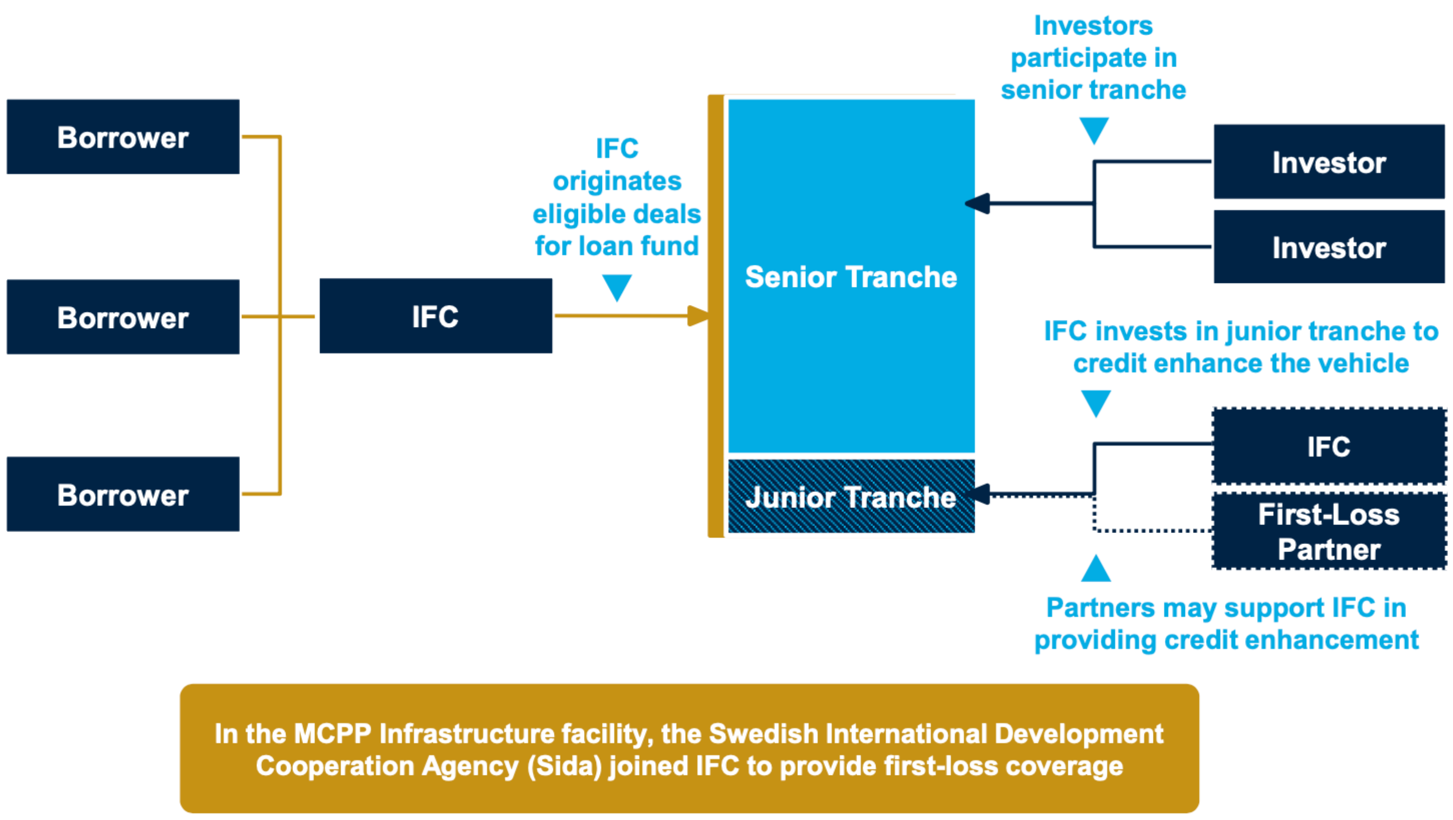
Diversification

Source: Convergence 2020

# EXAMPLE: IFC & SIDA MCPP INFRASTRUCTURE PROGRAM

- IFC arranges portfolio of senior loans to infrastructure projects
- Loans priced ca. Libor + 3.6%
- Transfer 50% of each loan to Fund
- Fund capitalized 90% by senior notes & 10% junior capital
- $1.5 billion Senior Notes modelled at BBB/BBB+ invested by Alliance, Axa and Prudential

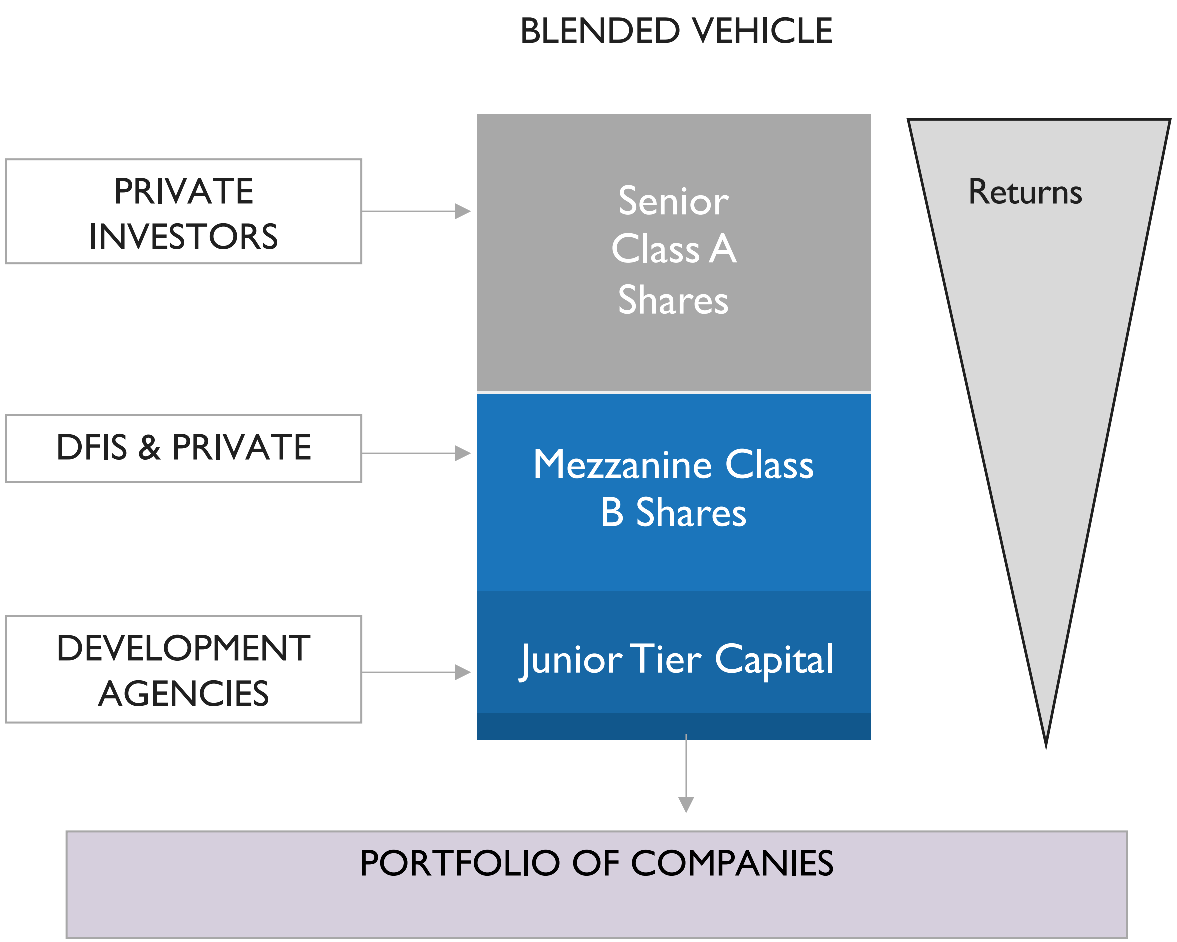
- Transaction is a unicorn – No MDB has replicated
- Scale: Repeat – Create one Fund - same structure for all MDBs and DFIs



## MOST EFFECTIVE BLENDED FINANCE STRUCTURES:

# STRUCTURE 2:
# BLENDED FINANCE VEHICLE PREFERRED BY EQUITY INVESTORS

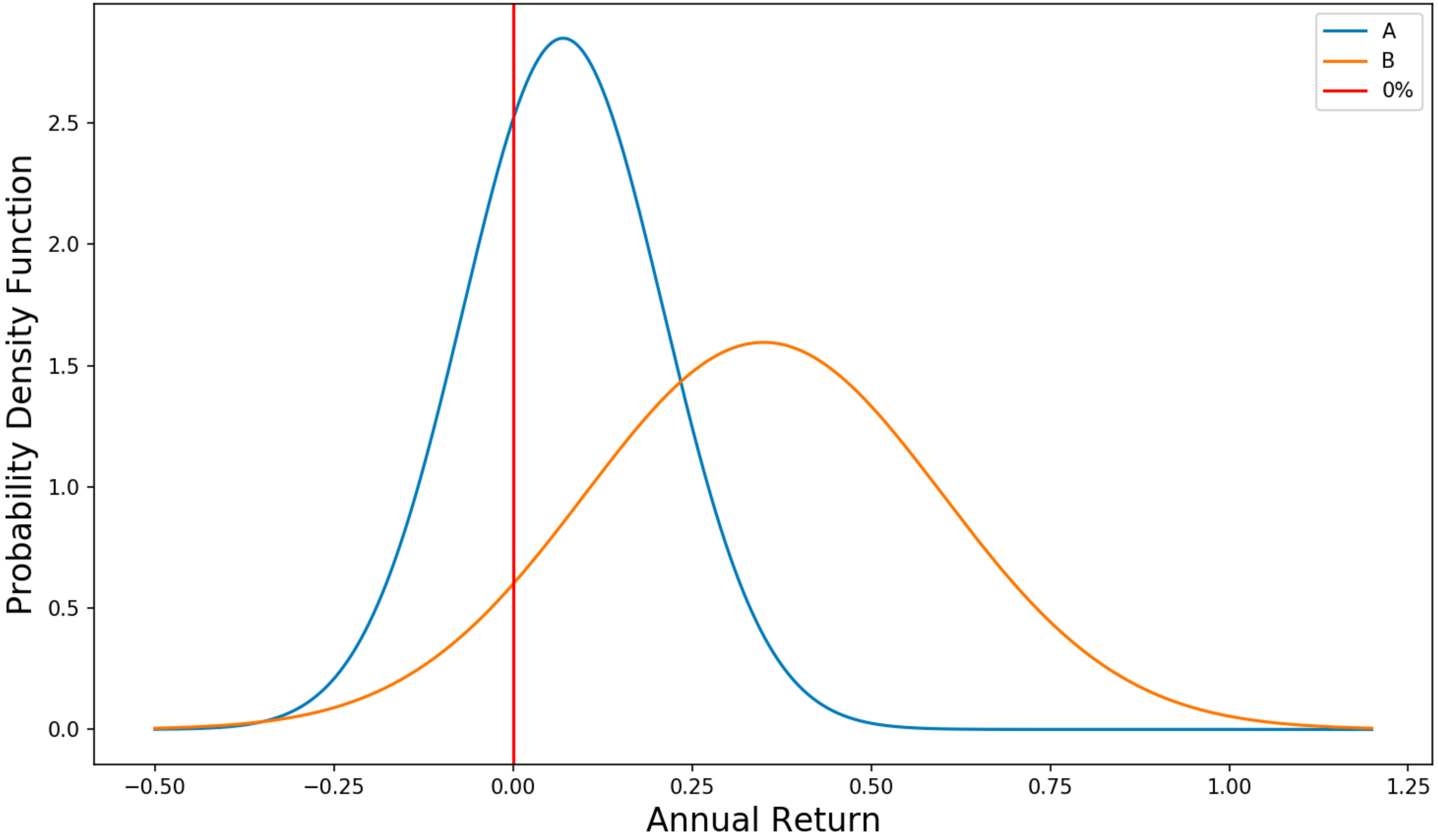
1. Establish Blended Finance Vehicle with 2-3 capital tiers
2. Vehicle typically a fund with experienced fund manager
3. Vehicle invests in portfolio of equity investments in investee companies.
4. Prioritization of waterfall of distributions:
    1. First distributions to Class A until IRR of 0-5%
    2. Second distribution to Class B until IRR of 0%
    3. Third distribution to Junior Capital until IRR of 0%
    4. 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




Source: Convergence 2020

# STRUCTURE 2:
# BLENDED FINANCE VEHICLE FOR EQUITY INVESTORS

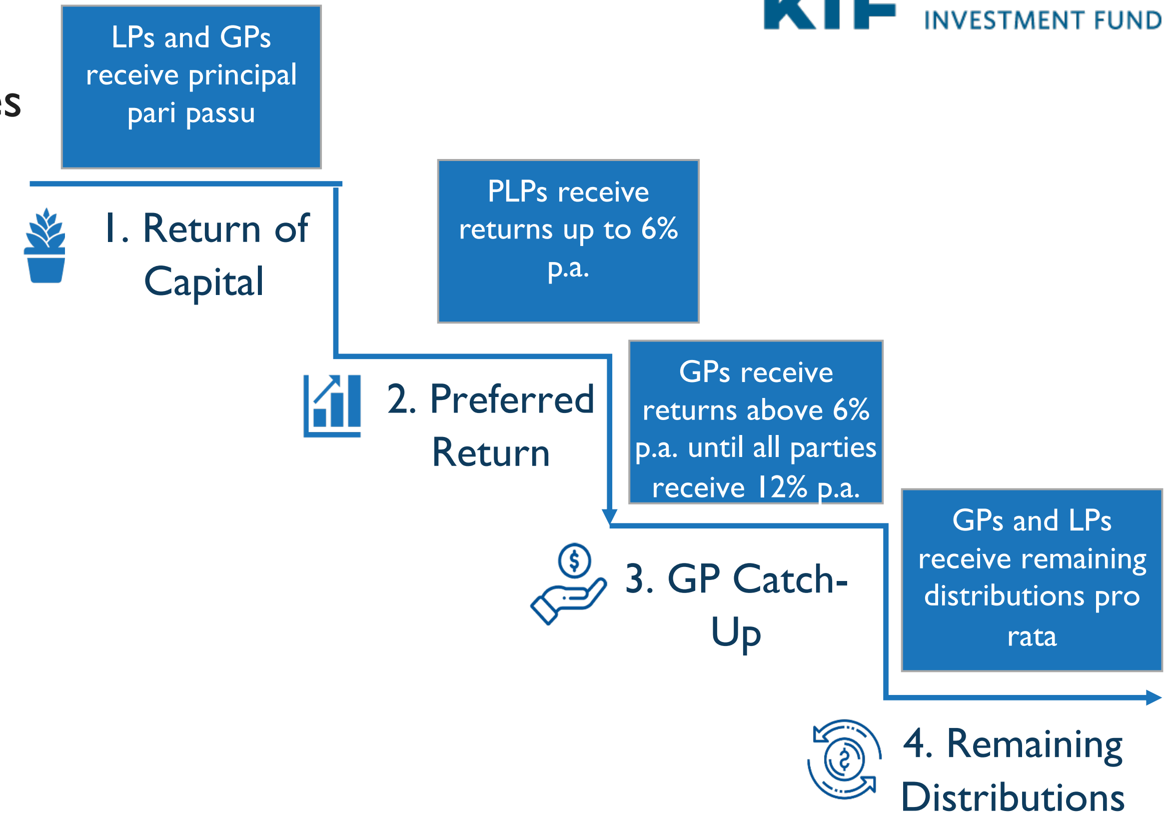
- Investment in conventional private equity fund depicted by blue line: Too much distribution with negative returns and expected return too lov
- Introduce catalytic concessional funding – senior investors enhanced by junior investors
- Investors' returns in blended finance structure (orange line): Less distribution with negative return anc higher expected return consistent with developed countries




Source: Convergence 2020

# EXAMPLE: DANISH CLIMATE INVESTMENT FUND

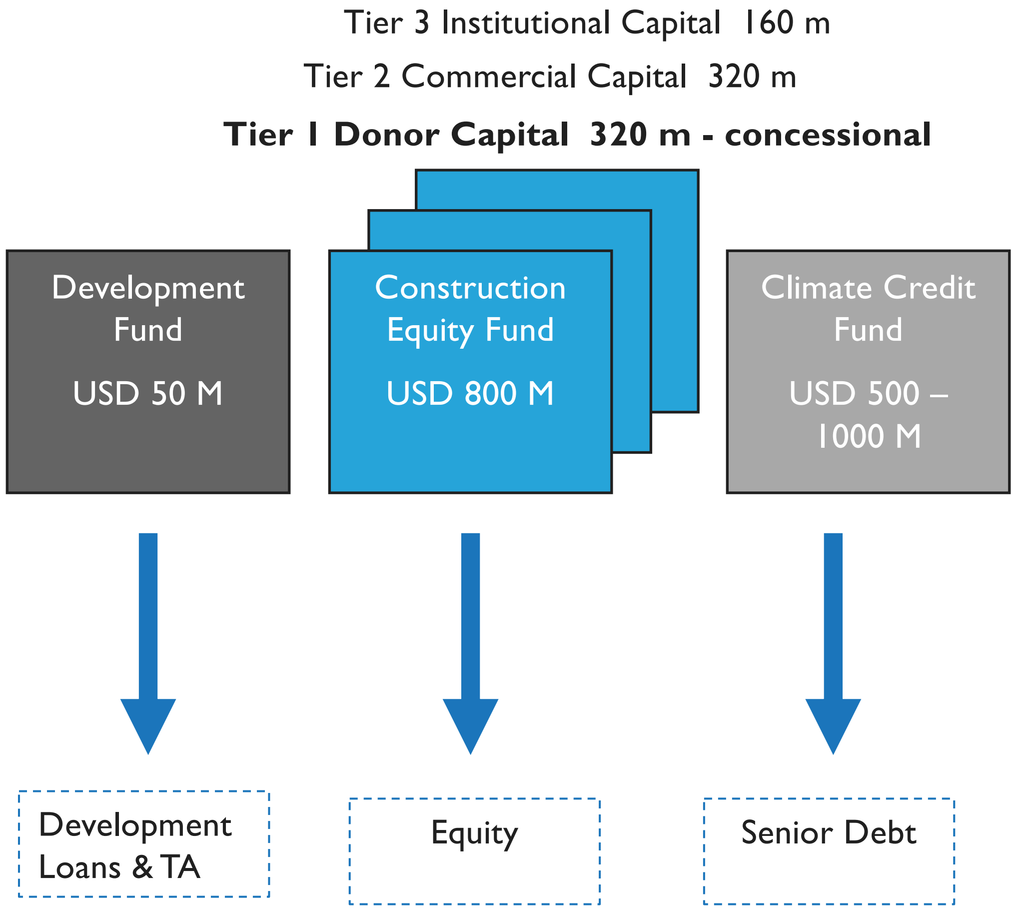
- Danish Climate Investment Fund (KIF) is a private equity fund (USD $220 million) established by the Danish State and IFU
- Mandate is to invest in projects that reduce greenhouse gases and/or adapting to climate change in developing countries.
- KIF uses a preferred return structure to ensure acceptable risk/return structure for institutional investors:
  - Overall IRR target: 12% per annum (p.a.), with preferred return schedule:
  - All parties receive distributions until invested amounts are returned
  - Returns above 12% p.a. distributed pro rata, with premium to Danish State




Source: Danish Climate Investment Fund Case Study, Convergence, 2017

# CLIMATE CREDIT FUND:
# REFINANCING INCOME GENERATING PROJECTS DEVELOPED BY CLIMATE INVESTOR ONE AND CLIMATE INVESTOR TWO

- Climate Investor One invests in **renewable energy projects** in emerging countries
- Provide life-cycle support through **three funds** that are designed to address barriers specific to each stage
- Mobilizes private sector financing through **catalytic public sector funding**; investors and donors can participate in a fund and a tranche according to their risk-return profile
- Development Fund comprised of **non-repayable donor contributions** while Construction Fund has **first-loss tranche** (Tier1) that is capitalized by donor contributions
- Reached final financial close at USD 850 million in June 2019. Investors included NWB Bank, Aegon Asset Management, KLP, Triodos Bank, and others.




Source: Convergence Case Study, December 2021

# FUNDRAISING EXAMPLE: ACTIAM CLIMATE CREDIT FUND

## Fund Summary

## Climate Credit Fund

- Private debt
- Renewable energy in Emerging Markets
- Long term offtake agreements
- Long term stable cashflows
- Well structured project finance underlying assets

- Refinancing operational young, large-scale assets; wind-power, solar-power, hydro-power and waste-to-energy

- Assets originally developed, constructed and (co)-owned by CFM (equity investor)

- Built and serviced by Tier 1 equipment makers and maintenance players

- Co-invest debt with development finance institutions (DFI's)

actiam
Fund Manager

- Oversight and approval
- Investment Committee
- Fund Management

CLIMATE FUND MANAGERS
Advisory

- RE Pipeline
- EM Presence
- Investment Advisory

Solar
Wind
Hydro
Waste/Bio-to-Energy


**Fund Facts:**

- Expected fund size USD 500mn – 1bn
- USD denominated
- Closed end
- Spread duration 6-7 years
- Lifetime fund 15 years
- Expected net returns
  - SOFR plus 3%-4%
  - Current absolute equivalent 7%-8%
- EL 30 bp annualized

**Impact:**

- 100% clean energy, avoid emission growth
- 100% EU taxonomy aligned, SFDR 9.

**Key SDG's**

- 7 - affordable and clean energy
- 13 - climate action & sustainable livelihoods
- 8 - decent work and economic growth
- 9 - industry, innovation, infrastructure

actiam
Part of Cardano Group

CLIMATE FUND MANAGERS

Source: Convergence 2023

# ACTIAM CLIMATE CREDIT FUND

## Fund Characteristic

- Fund size: USD 500mn – USD 1bn
- Lifetime: 15 years
- Investment Period: 3 years
- Investments: 15-25
- Currency: USD, Floating rate
- Format: Fund for joined account, closed end

## Risk/Return

Risk

- Liquidity: Low
- Spread Duration: 6-7 years
- Rate duration: 0,25-0,5
- Credit risk: EL 30 bp annualized over fund life

Return

- (SOFR) +3% - 4% net

  Currently Equivalent 7% - 8%

## ESG & Impact

- Increase share of renewables in energy mix and access to power
- Avoid growth in GHG emissions
- Support decent jobs and economic development
- EU Taxonomy aligned (100%)
- SFDR article 9
- Full impact measurement and reporting

# ACTION PLAN FOR CLIMATE AND SDG INVESTMENT MOBILIZATION

# EXISTING OFFICIAL DEVELOPMENT AND DEVELOPMENT FINANCE ARCHITECTURE: GOOD IMPACT BUT LOW TOTAL SDG INVESTMENT

- OECD DAC members, MDBs and DFIs pursue **legacy business practices.**
- **Individual projects have good development and climate impact, but aggregate amounts only 5% of annual SDG and Climate investment needs**
- Since 2015 (SDGs & Paris Agreement), lots of mention of mobilizing private investment and expertise, but **very low prioritization, limited budgets and limited mobilization**
- Less than 2% of ODA allocated towards mobilization, with 75% through MDBs & DFIs



Source: Convergence 2022

# ACTION PLAN DRIVERS

- **Great Disconnect: Addis Ababa Action Agenda (SDGs) and Paris Agreement emphasize mobilization, but reality limited budget, priority, activities and results**
- <u>OECD DAC members</u>: In principle, want to increase total investment in LICs & MICS. But in reality a tertiary activity: low/no budget, no coordination and low skill
- <u>MDB and DFI Management</u>: After 7 years of SDGs and Paris, mobilization similar to pre-2015 (they only mobilize $21 billion annually – 0.5% of investment needs)
- **Objective of Action Plan: Increase quantity & quality of climate and SDG investment in LICs & MICs – Double with a more strategic, collaborative approach?**
- <u>Constraints</u>: No changes to existing Official Development Finance architecture, no appetite for higher funding or new institutions and limited appetite for new MDB & DFI capitalization



Source: Convergence 2022

# ACTION PLAN – DESIGNED TO HAVE HIGH ALIGNMENT WITH INVESTOR RECOMMENDATIONS (1 OF 2)

| Private Investors Recommendation (Primary – Most Common) | SMI ILN | GISD | NZ | Action Plan Pillars |
|---|---|---|---|---|
| Development Community Strategy & Action Plan to increase SDG & Climate investment | | Y | | Yes – Action Plan (AP) |
| MDBs & DFIs: Improved governance and amended business model (mobilization) | Y | Y | Y | Yes – Pillar 2 (P2) |
| Mobilization at scale to attract institutional investors | Y | Y | Y | Yes – AP, P1, P2, P3 |
| Donor collaboration to jointly fund most effective blended finance vehicles | | Y | Y | Yes – P1, P3 |
| Standardize blended finance vehicles and investment assets | | Y | Y | Yes – P1 and P3 |
| Increase investor access to database of blended finance investments | Y | Y | | Yes – P4 |
| Investment data for developing countries: Aggregate and fund best sources | | Y | Y | Yes – P4 |
| Increase collaboration: Donors, investors and fund managers/intermediaries | Y | | Y | Yes – P3 |
| Increase use of guarantees and insurance | Y | | Y | Yes – P1 and P3 |

# ACTION PLAN – HIGH ALIGNMENT WITH INVESTOR RECOMMENDATIONS (2 OF 2)

| Private Investors Recommendation (Secondary) | SMI ILN | GIS D | NZ | Action Plan Pillars |
|---|---|---|---|---|
| Align investment assets to investor priority interests (e.g., ESG) | | Y | | Yes – P3 |
| Amend ODA Rules: Investment in blended finance vehicles and guarantees | | | Y | Yes - P1 |
| Enhance universe of investable / bankable projects | | | Y | Yes – P1 Use Case 4 & CA1 |
| Increase equity financing | | | Y | Yes – P1 & P3 Use Case 2 |
| Build capacity of local governments | | | Y | Yes - CA2 |
| Increase blended finance knowledge of investors | | | Y | Yes – P4 |
| Establish rating methodology for blended finance structures | | | Y | Yes – P3 & P4 |
| Create virtual tool-box to group all risk mitigants | | | Y | Yes – P4 |
| Blended finance to mitigate currency risk | Y | | | Yes – P4 Use Case 5 |

# ACTION PLAN FOR CLIMATE & SDG INVESTMENT MOBILIZIATION: COLLABORATING ORGANIZATIONS

**Increasing the quantity and quality of sustainable investment at scale requires an action plan and collaboration.**

| Organization Type | Examples |
|---|---|
| OECD DAC members | US, Canada, Norway, Sweden, Denmark, Switzerland, Japan, Korea, France, Germany, Italy, Australia |
| Five Private Investor Groups | GFANZ, NZAOA, GISD, SMI and ILN |
| Investors | CDPQ, Allianz, Citibank, Societe Generale, HSBC, Newmarket and six others |
| Philanthropic Foundations | Rockefeller, Gates, GEAPP, Soros Open Foundation, Ford, Shell |
| Others | OECD DCD team |



Source: Convergence 2022

# ACTION PLAN FOR CLIMATE & SDG INVESTMENT MOBILIZIATION:

## FIVE PILLARS AND TWO COMPLEMENTARY ACTIVITIES: $530 BILLION POSSIBLE

| # | Description | Content |
|---|---|---|
| 1 | **Strategic Deployment of Catalytic Funding** | Must de-risk investment opportunities to within investors' fiduciary limits<br>Catalytic Funding: Catalytic Grants and Catalytic Capital<br>Critical mass of $13-15 billion of Catalytic Capital deployed in five Use Cases |
| 2 | **MDBs and DFIs: Governance and Business Model** | Shareholders to govern MDBs & DFIs to maximize their contributions to Climate and SDG Investment (maintain prudent risk ratings)<br>Double net Commitments and 10-fold increase in mobilization<br>Mezzanine investments required to de-risk private investors at scale<br>Key Performance Indicators. If implemented, two blended finance funds to support higher mobilization |
| 3 | **Collaboration: Investment & Mobilization** | Optimize limited Catalytic Capital to de-risk investors within fiduciary limits<br>Five Use Cases: Competitive Calls for Proposals to fund global best ideas |
| 4 | **Open access Hub to best resources** | Centralized, curated hub to house best data, information, knowledge building, standardisation, Catalytic Funds and investment assets |
| 5 | **Local capital markets & fincl intermediation** | Improve, deepen and broaden Local Capital Markets & Domestic Financial Intermediation: (i) Fund projects of $10 million and less and (ii) Sustainability |

# PILLAR 1: STRATEGIC DEPOLYMENT OF CATALYTIC FUNDING

- **Large pool of Catalytic Capital required to de-risk investment opportunities to create fiduciary investment assets for private investors:**
  - Acceptable risk: For debt investors, mostly BBB and BB
  - Market-equivalent risk-adjusted returns
- Size: $13-15 billion per year for 2023-2030
- Three big sources: (i) ODA and ODA-like, (ii) Public-Sector Climate Finance funds and (iii) philanthropic foundations. OECD DAC members commit 5% of ODA funds
- Commit scarce and powerful resource to maximize mobilization:
  - Five Use Cases to address specific risks and optimal mobilization structures
- How to commit efficiently and effectively?:
  - All Catalytic Funding Providers: Members of new Catalytic Funding Network
  - Public sector funds committed through centralized Mobilization Facility(ies) with professional Investment Committee (impact and mobilization Terms of Reference)

Sources: Convergence 2022

# PILLAR 2: MDB & DFI GOVERNANCE AND BUSINESS MODELS

- MDBs and DFIs have HUGE comparative advantages to realize the SDG and Climate agendas
- Strong history of financial asset arranging and management
- Shareholders must modernize governance to align to Climate & SDG objectives: e.g., in 2021 World Bank Group does not have mobilization targets
- **Shareholders govern by Key Performance Indicators to increase gross financial commitments, financial additionality and mobilization**
- MDBs & DFIs must invest in mezzanine investments in blended finance structures (Catalytic Capital in junior) to create fiduciary investment assets for private investors to invest in senior [and mezz]

Sources: Convergence 2022

# PILLAR 2: MDB & DFI KEY PERFORMANCE INDICATORS

*Table 2.4: Proposed Key Performance Indicators MDBs and DFIs*

| | Objective | Metric |
|---|---|---|
| **Priority Objectives** | | |
| A | Increase Annual Business Volume Commitments | Minimum increase in financial commitments from 2019 levels by 2023, (iii) 100% by 2024, and (iii) 200% by 2028. |
| B | Maximize deployment of shareholders' equity in Development Assets | Minimum 90% of Capital deployed in Development Assets |
| C1 | Increase Private Investment Mobilization by crowding in the private sector to share and spread risk | Target 1:1 public/private ratio of public sector A-B loans<br>Target 1:3 public/private mobilization ratio of private sector l |
| C2 | | Minimum of 20% of Capital deployed in Mezzanine Invest Blended Finance Structures mobilizing private investment) |
| **Secondary Objectives** | | |
| D1 | | Minimum 35% of Capital deployed in LICs and LDCs |
| D2 | Increase Financial Additionality of Development Assets | Maximum 30% of Capital deployed in UMICs |
| D3 | | Minimum 50% of Capital deployed in High Financial Add Assets |
| E1 | Optimize key sector support | Minimum 35% of Capital deployed in Climate Finance assets |
| E2 | | Minimum of 20% of Capital Deployed in Domestic Intermediation |

Sources: Convergence 2022

# PILLAR 3: STRATEGY AND COLLABORATION TO MAXIMIZE SDG & CLIMATE INVESTMENT

- Deploy Catalytic Capital to maximize mobilization and increase sustainability
- Allocate Catalytic Capital to Five Use Cases
- All Use Cases: Awarded by competitive Calls for Proposals to best proposals globally
- Catalytic Capital committed in two paths:
  - Public-sector establish Facility(ies) with professional investment committees to award at speed of market
  - Others (e.g., foundations): Join Catalytic capital Network
- Catalytic Capital Providers agree to fund quickly through open process

Sources: Convergence 2022

# PILLAR 3: STRATEGY AND COLLABORATION TO MAXIMIZE SDG & CLIMATE INVESTMENT

*Table 3.1: Catalytic Capital Five Use Cases - Mobilize private investment through competition*

| Use Case | Investment Channel in LICs & MICs |
|---|---|
| 1 | **Project-level risk mitigation:**<br>Loans and equity investments arranged by private sector, MDBs and DFIs |
| 2 | **Portfolio-level risk mitigation for loans to private sector borrowers:**<br>Loans arranged by MDBs, DFIs and private sector financial intermediaries |
| 3 | **Portfolio-level risk mitigation for equity investments to private sector (and PPP) projects, companies and financial institutions:** Investments arranged by private sector, MDBs and DFIs |
| 4 | **Portfolio-level risk mitigation for loans to public sector borrowers (sovereign and sub-sovereign):**<br>Loans arranged by MDBs |
| 5 | **FX risk mitigation:**<br>Loans and equity investments arranged by private sector, MDBs and DFIs |

Sources: Convergence 2022

# PILLAR 4: OPEN HUB FOR BEST INVESTMENT DATA AND RESOURCES

- Create a centralized hub / web site with best data, information and resources for investing in LICs and MICs
- Investment Data: GEMS and other best information to narrow the gap between perceived and actual risk – improve analytics
- Inventory and access to all sources of Catalytic Funding from Network Members
- Access to all investment assets produced by blended finance and development finance

Sources: Convergence 2022

# PILLAR 5: LOCAL CAPITAL MARKETS & FINANCIAL INTERMEDIATION

- Climate Finance due to existential threat and immediate requirements – Around 40% of blended finance is already mobilized to climate
- Domestic Financial Intermediation in LICS and MICS:
  - Cross-border debt and equity investment flows to large projects, companies and financial institutions
  - Large majority of SDG investment require financing of $10 million or less – thousands of local banks and non-banks already in place best positioned to fund these projects
  - Those financial intermediaries need more equity, local current loans and risk-sharing to fund the SDG projects

Sources: Convergence 2022

# Bridgetown and G20 MDB CAF Review: Structures to Mobilize Private Investment to MDB and DFI arranged loans

Create one Public Sector Loan Fund and one Private Sector Loan Fund

MDBs and DFIs continue their existing business model: Simply double loan arranging volumes

Each project has A loan and B loan – B loan transferred to Fund

Funds capitalized by three tiers of notes: Private sector investors, MDBs and OECD DAC members.

Simple solution allowing all MDBs and DFIs to participate.

Notes rated and publicly listed – Huge demand by investors

| Item | Public Sector Sovereign Fund | Private Sector Fund |
|---|---|---|
| Underlying Assets | Loans to public sector borrowers (sovereigns only) | Senior Loans to private borrowers (e.g., projects, companies and banks) |
| Arrangers of Assets | Participating MDBs (e.g., IBRD, ADB and AfDB) | Participating MDBs and national DFIs (e.g., IFC and UK BII) |
| Indicative Transaction | IBRD provides $100 million loan to Tanzania Government for climate mitigation project: (i) $50 million A loan at regular MDB sovereign loan terms and (ii) $50 million B loan at “slight discount” to market interest rate. | IFC provides $80 million loan to Independent Power Project (solar) in Kenya for climate mitigation project: (i) $50 million A loan at regular MDB/DFI private loan terms and (ii) $50 million B loan at “slight discount” to market interest rate. |
| Fund Portfolio | $10 billion of B loans diversified across [50] LIC & MIC governments | $8 billion of B loans diversified across [60] borrowers in LICs & MICs. |
| Capitalization of Fund | Senior: 90% notes rated “BBB” invested by pension funds<br>Mezzanine: 5% notes rated “B” invested by MDBs<br>Junior: 5% notes rated “CC” invested by OEDC governments | Senior: 85% notes rated “BBB” invested by pension funds<br>Mezzanine: 7.5% notes rated “B” invested by MDBs<br>Junior: 7.5% notes rated “CC” invested by OEDC govs |
| MDB issue | Transfer Preferred Creditor Status to Fund? Both easily feasible | |