Sustainable Markets Initiative

Seizing a New Bretton Woods Moment

Leveraging the private sector in support of Nature, People and Planet

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Contents

Introduction

The Bretton Woods system was established in the wake of the Second World War to help restore and sustain the benefits of global integration by promoting international economic cooperation. Since that time, we have seen a growing number of multilateral development banks (MDBs) established to help meet global and regional development and economic goals.

Today, in the wake of the coronavirus pandemic that has impacted lives and economies across the world, we must urgently seize the current window of opportunity to build back better and accelerate a green recovery. These efforts must also align with global agendas around Nature (including biodiversity and natural capital), People (the focus on a just transition) and Planet (The Paris Agreement).

As outlined in the most recent IPCC report, millions of people, particularly in climate vulnerable states, are already feeling the consequences of climate change. These effects are also being felt in the real economy as interconnected global systems are impacted by the pandemic, insecurity, floods, drought, fire, and extreme wealth events. To advance a global transition, the OECD estimates that that USD 6.9 trillion a year is required up to 2030 to meet climate and development objectives[1]. While estimates vary, in the coming decades there will be trillions of dollars needed for investment in infrastructure in emerging and frontier economies. IRENA further estimates that in the power sector, the global energy transformation, would require investment of nearly USD 22.5 trillion in new renewable installed capacity through 2050[2].

Today, institutional assets under management are of a scale that was almost incomprehensible at the Bretton Woods Conference. This is a fundamental difference between the global economy of yesterday and today and represents an urgent need to update the development finance model to leverage what is estimated will be over $145 trillion in assets under management by 2025[3].

Private financing and institutional investors have the financial resources to support and accelerate a sustainable transition, at the scale and speed required, and in a way that the public sector and the MDBs cannot do on their own. And while there are an emerging number of climate finance and blended finance mechanisms, many led by MDBs, the private sector has not invested through them to the extent required. This is largely due to structural factors and impediments—including the availability of 'bankable' and genuinely sustainable projects and, very often, an unfavorable risk-return nexus. Increasingly there is a need to move beyond a grants-based system to one focused on transition aligned foreign direct investment, economic growth, and trade. To move in this direction requires innovation, co-creation, and engagement across a broader range of experts from both public and private sectors.

With an urgent need to accelerate economy-wide decarbonization, this white paper summarizes the impediments to and opportunities for accelerating the investment of private capital alongside public development finance to build a more sustainable world.

While significant investment is needed, where that investment is deployed, what is considered 'bankable' and how the investment aligns with the sustainable transition needs more definition. To make progress, we need to

[1] policy-highlights-financing-climate-futures.pdf (oecd.org)
[2] Investment Needs (irena.org)
[3] https://www.pwc.com/ng/en/press-room/global-assets-under-management-set-to-rise.html

start aligning country, industry and investment roadmaps to build out the ‘investment to investables’ pipeline in real terms. With the levels of investment required at such an unprecedented global scale, it is more critical than ever that the public, private and multilateral sectors work together to accelerate results.

Mobilizing the private sector to accelerate the transition to a sustainable future lies at the heart of the Sustainable Markets Initiative (SMI) and its guiding Terra Carta framework. The proposals in this white paper complement those being made by other organizations and groupings, including the Investor Leadership Network (ILN), and the Glasgow Financial Alliance for Net Zero (GFANZ) in that they provide for specific instruments and goals and a timeline on which to achieve them.

To facilitate this work, the SMI, in partnership with ILN and other key organizations, have established an Expert-Level Task Force with representatives from the private sector and the MDBs, and in consultation with key shareholder governments, to explore and action ways to rapidly increase the mobilization of private capital into development finance. This Task Force will coordinate as appropriate with other conversations happening around the issues of private sector and MDB collaboration to accelerate the the mobilization of private capital in sustainable development, in particular GFANZ.

The Challenge

Public development finance alone cannot mobilize the trillions of dollars necessary to tackle climate change on the timeline required to achieve 1.5 C target. This challenge is even more acute in the emerging economies, where the public fiscal space is even more constrained. Further, even if developed countries immediately meet their pledge of contributing $100 billion a year to the developing world to achieve the goals of the Paris Agreement, that will still not be a sufficient mobilization of capital on its own.

With trillions of dollars under management and actively looking to align to climate and sustainability targets, the private sector must play an outsized role. However, there continues to be impediments to utilizing these resources at scale, particularly in emerging and frontier economies. These include:

- Macroeconomic factors including size and growth potential of the economy, economic stability (e.g. inflation), institutions and currency risk.

- A lack of public-private collaboration at scale, which prevent projects from being structured in a way that will result in increased amounts of private funding in later stages, a key contributor to scale.

- Investment opportunities are often hard to fit into the fiduciary mandates and risk appetites of institutional investors.

- The availability and structuring of investable projects – it is not only the number of potential projects, but given the fixed costs involved, the size of potential deals that is a key factor. Many important projects are simply too small on their own to attract institutional investment.

- Elements arising from deal execution and asset management. Impediments arising from these factors reflect issue regarding the institutional and legal framework and inadequate regulator frameworks that drive private sector investment.

- A lack of understanding of transition risk as economies restructure to manage climate change. With multi-sector transitions come significant risks that are poorly understood or poorly mitigated against or unidentified, which threatens and stymies progress. Effective risk management and risk financing solutions could help address these.

- Governance gaps, including the lack of explicit climate and sustainability mandates for many MDBs.

The Opportunity

The private sector increasing sees building a sustainable future as the growth story of our time. With over $100 trillion in assets under management, institutional investors have the capacity to direct capital, with speed and at scale, to enable the sustainable transition of economies around the world. The private sector and investment community want to be part of the solution.

As the Task Force begins work after the conclusion of COP26, it will build on, among other initiatives, the first two phases of the Scaling Private Sector Investments project launched by the SMI and Finance to Accelerate the Sustainable Transition – Infrastructure "FAST-Infra", developed under the auspices of the One Planet Lab.

Over the coming year, and targeting key global milestones, the Task Force will be charged with, in specific detail:

- Mapping the range of existing climate finance mechanisms across the MDB landscape.

- Identifying options to address outstanding impediments to scaling private investment into emerging markets – particularly those investments that are required to lower global greenhouse gas emissions in time to keep global temperature rise to 1.5 C.

- Identifying where common platforms, data sharing, and other mechanisms would be helpful to increase private sector engagement and investment across MDBs.

- Identifying how to generate a robust pipeline of genuinely sustainable, scalable and 'bankable' projects across MDBs. This includes an exploration around specific regions, foreign direct investment priorities and bundling and sourcing opportunities for scale.

- Identifying how to overcome concerns of debt to GDP ratios and investment returns which have been raised as barriers to private financing for many emerging and climate-vulnerable economies.

- Identifying the systems-level and operational opportunities to make climate, sustainability and public-private collaboration cores component of MDB mandates. This is viewed to be a catalytic opportunity to clearly set the ambition and to crowd-in greater levels of private-sector climate and sustainable finance.

- Identifying key messaging for MDB audiences that will help communicate the benefits and opportunities that are emerging through public private partnerships, blended finance and investment. This includes alignment with the wider global narratives around Nature (biodiversity and Natural Capital), People (SDGs and a just transition) and Planet (Climate).

The Solutions Mix

The Task Force will consider a range of potential solutions to unlocking private sector capital in partnership with the MDBs, described in greater detail in Appendix A, including, but not limited to:

- Systems-level solutions
  - Enhancing the role of the private sector
  - Adapting the MDB Business Model
  - Policy, Regulation, and Incentives
  - Measurement and Reporting
  - Governance and Mandates

- Accelerating private finance
  - Establishing First Loss and Second Loss Guarantee Pools
  - Restructuring Balance Sheets to Increase Lending Capacity
  - Addressing Currency Risk
  - Building Speed and Scale into the System
  - Insurance and Climate Risk

- Technical/Operational
  - Preparing Projects for Investment
  - Aligning Infrastructure Investment
  - Building On the Ground Capacity
  - Launching a Coordinated Project Database

Appendix A
A Solutions Mix – A Detailed Look

The issues and proposals outlined below are meant to be illustrative and starting points for further development. The Task Force will consider these and other issues and is not intended to be exhaustive or exclusive.

Big Picture/Systems Level

Private Sector

- The relationship between the MDBs and the private sector should be reimagined. The private sector should be seen as being an equal partner to the MDBs. In the medium and long-run this would necessitate a shift in the mind-set of all stakeholders in terms of the role of MDBs. Initiatives to build trust and develop new ways of working are crucial and should be outlined as a priority.
- Regulatory, policy, and legal constraints that prevent scaling of private investment should be identified comprehensively and a plan devised to overcome them in the short term. For example, Solvency II requirements make it very difficult for insurers to participate in MDB transactions, even when there is willingness.
- While governance amendments are important and will have a galvanizing effect, they should not distract from shorter-term measures to achieving meaningful progress.

Business Model

- Proposals should be developed to address the revenue, staffing and capacity implications that a significant refocus would imply.
- All proposals should preserve the essence of the MDBs and what make them different from other development institutions: they are, first and foremost, banks with a balance sheet that can project into the future, they can form and structure partnerships, and do not face the same profit goals as private sector banks.

Policy and Incentives – The Example of Carbon Pricing

- There is still a need to address the question of negative externalities – particularly by the catalytic potential of putting a price on carbon and pollution. A range of models and target prices have been put forward, getting behind a common approach will be critical to accelerating the economy in the right direction.

Measurement

- Common standards and metrics remain critical across and within industries and to measuring climate progress. As we increase private finance, outcome-oriented measures will be critical to the validating quality and impact of MDB outcomes.
- Specific targets should be set for funding climate-related projects.

Governance

- Shareholders of MDBs could explore how to update charters and articles of agreement to:

- Explicitly make mobilization of private sector financing of sustainable development and climate solutions a core mandate.
- Create a mechanism to improve collaboration and information/data sharing across MDBs and with private sector partners.

Financing

Restructuring Balance Sheets to Increase Lending Capacity

- Balance sheets of MDBs should be more dynamically managed. They currently hold de-risked assets on their balance sheets that would be of interest, either as individual assets or as pooled assets, to institutional investors. These should be sold to make space for new lending – for example, by focusing on during the construction phase and selling once projects become operational).
- Build on initiatives like IDA+ to better utilize capital base and benefit from the MDBs' unique balance sheet structure. For example, the IDA holds significant assets that can be considered its own equity. By categorizing it as such, it can be used to support borrowing activities and leverage supplemental funding.

Currency Risk

- A key major specific risk relates to currencies; volatility in EMs currencies are significant and valuations can diverge from fundamentals for prolonged period of time.
- For infrastructure investment in particular, but other also investments that are in local currency.
- Insurance can be obtained from markets, but it is often only for short term, limited to a few countries, and can be very expensive.
- A facility to provide some type of guarantees against FX risk, would be very helpful. It can be provided by MDBs in conjunction with G7 governments.

Build Speed and Scale into the System

- Shareholder governments should identify ways to exponentially increase capital injections to MDBs, especially regional MDBs.
- Identify mechanism to increase the rate at which capital is recycled through the MDBs and increase the pace of investment.
- Reconsider capital commitments and levels to be consistent with the enhanced mission.

First and Second Loss Guarantee Pool

- Set up a sizable pool of funds that can provide first loss or second loss guarantees; it can be a rolling pool.
- Establish a premium to access the pool but at a cost that does not impede deal execution.
- The speed with which access can be obtained, and the transparency of the operations of the pool will be critical; pool can provide a menu of guarantees.
- The pool can be set up and managed by G7/G20 in conjunction with MDBs and representatives of institutional investors.
- Potential sources of funding include:

    Proceeds from nature-based solutions such as the sale of carbon credits:

        - This pool of capital would serve as a first loss / junior capital tranche that can catalyze a significant multiple of private sector investment and financing. In EMs, where the skills, relationships, rights, and country expertise of Multilateral Development Banks/Development Finance Institutions are critical, MDBs/DFIs can co-invest or partner with the private sector investors in origination, structuring, and execution in more senior capital with this pool of capital providing the de-risking. In the near-term, the pool of capital formed from payment for the value of offsets or credits as we're describing would best be structured as a private-sector managed fund, given the likelihood that policy/governance changes may be required for MDBs/DFIs to manage such a fund. Over time, MDB/DFI organizational/policy mandates could be amended, and this pool or capital could potentially be managed by the MDBs/DFIs.

    - Special Drawing Rights (SDR) allocations/reallocations:
        - Developed countries can create greater fiscal space for developing countries by supporting a strategic reallocation of SDRs. Doing so would create greater fiscal space in countries with the some of the most urgent transition needs and the least capacity to finance them. Shareholder countries reallocating their SDRs could, for example, create fiscal space over 60 times that of the Green Climate Fund for developing countries.

Insurance and Climate Risk

- Insurance is underutilized in development finance despite its suitability to manage the long-term impact of climate risks. Frequently, both beneficiary countries and international donors do not see the value of insurance – which always seems like an unnecessary cost rather than a source of contingent capital.
- Insurance can play a key role pin driving climate adaptation measures and helping at-risk communities build resilience for their communities on a long term and sustainable basis.
- Risk transfer is an essential component of any climate finance strategy; the most impactful contingent risk management solutions will co-ordinate investment in ex-ante vulnerability reduction, risk transfer and ex-post risk management strategies.
- It can also help drive financial inclusivity when partnered with the right innovative distribution strategies e.g. using mobile technology for the transfer of funds.
- To enable this approach, greater collaboration is needed between donors / investors, insurance companies and beneficiaries. Where each stakeholder collaborates in their area of expertise, and where MDBs can serve as natural intermediaries between these parties helping identify the problem definitions, alongside supporting the sovereigns and their decision making.
- The ability for sovereigns to build effective problem statements and finance the solutions are historically a barrier to building solutions in developmental finance at scale. The insurance industry offers solutions across the entire risk management chain that can support not only the sovereign buyers, but which could also be leveraged by development finance to sustainably manage the long-term impact of climate risks.

Technical / Operational

Preparing Projects for Investment

- MDB expertise on the ground is unmatched. Networks of experts withing the MDBs should form consultancy-like teams to identify the highest-possible-impact investments in countries.
- A wider program can build upon the SMI's work to develop a regional Project Development Unit network that will work directly with countries to identify and prepare projects for investment.

Aligning Infrastructure Investment

- MDBs could commit to aligning their infrastructure finance with the FAST-Infra label, which is a more advanced and inclusive version of the IFC performance standards. In addition, MDBs could build on their existing SOURCE platform (which is funded by the MDBs) to accelerate the development of the end-to-end platform as proposed by FAST-Infra. And they should also consider providing first loss to the warehousing facility and the liquidity guarantee mechanism developed by FAST-Infra.

Building On the Ground Capacity

- Key to building a pipeline of bankable projects is building expertise and skills in local communities.
- Rapidly scale programs like the ILN Sustainable Infrastructure Fellowship and the Climate Finance Action Network to enhance capacity building and enhance the pipeline of bankable projects.
- For example, Climate Finance Action Network has placed advisors in 8 Pacific Island countries. These highly trained, well-prepared and well-connected CFAN advisors will provide countries with the technical and financial expertise and opportunities they need to build climate resilience.

Coordinated Project Database

- Create a common database to help institutional investors access the inventory of projects the MDBs are looking at and can show their interests at the early stage, build a platform that will be able to download high level information about MDBs projects (including sector, country, total project cost, any sponsor and EPC/Contractor(s) and any information related to the project contract(s) and key contacts in charge of the project.

Contacts

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