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POLICY BRIEF
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Searching for Scale: Institutional Investors and Sustainable Development

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Highlights

- International private capital has retreated from developing countries.
- Innovative measures to attract private sector capital are crucial to overcoming the investment financing shortfall for sustainable development and climate finance.
- Syndicated medium-long-term development finance lending to institutional investors offers a scalable form of debt financing.
- Data transparency is necessary to ensure an accurate assessment of the risk of the investments.

The investment financing shortfall

Since the 2008 global financial crisis, international banks have largely withdrawn most of their long-term financing offers in emerging markets, resulting in a reduction of the available funding in these countries (compared to pre-2008 levels). This trend, coupled with an era of high inflation and interest rates, high geo-political risks and lower economic integration than in previous decades, has led to an annual financing gap for the Sustainable Development Goals (SDGs) and climate-related investments of 2.4 trillion in emerging markets (Songwe V, Stern N, Bhattacharya A, 2022). These markets often lack the well-established and deep local bond and equity markets necessary for funding long-term investments in climate resilience, green infrastructure and other development. In short, there is a major institutional gap in the global financial architecture that prevents the efficient allocation of capital around the world (UN Environment Programme, 2024).

Simultaneously, in recent years, pension funds and other institutional investors have increased their allocation of funds to sustainability and climate-related investments in developed markets. However, they are also starting to acknowledge that a transition to net zero by 2050

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will demand a significantly increase in climate-related investments in developing countries. To achieve this, larger portions of their capital must be invested in projects and initiatives that support the SDGs and climate targets in emerging markets. These institutional investors are hesitant to make large-scale allocations due to the perceived high risk of investing in most emerging markets, as well as a lack of mandate on where to fit the development finance asset class within their portfolio (Attridge, Samantha, et. Al., 2024).

Turning to the innovation financing space, a narrow path is emerging. From the supply side, new players have entered the corporate credit and bond markets, benefitting from the liquidity conditions, the search for yield and access to localized information. From the demand side, corporates with access to international capital markets are responsible for the bulk of investment opportunities.

The introduction of innovative measures to attract private sector capital is crucial to overcoming the investment financing shortfall for sustainable development.

Market conditions and institutional players

The deglobalisation of international banking following the great financial crisis has had a particularly significant impact on the developing economies, in addition to the observed withdrawals that have occurred from emerging market equity and bond funds. Big declines in the cross-border syndicated loan market have also posed a serious threat, as they propagate through the lender network, impacting the stability of the international financial system and further reducing credit flows to emerging economies.

Given the limited hard (as well as local) currency financing in developing countries, the introduction of innovative measures to attract private sector capital is crucial to overcoming the investment financing shortfall for sustainable development. Attracting institutional investors, such as insurance companies and pension funds (which are characterised by long-term investment horizons of 10-30 years), is particularly important in the case of large-scale projects in the Global South.

Syndicated medium- to long-term lending by institutional investors offers an alternative and scalable form of debt financing (as opposed to bilateral bank lending or corporate bond financing), providing benefits to borrowers and lenders alike by addressing several issues raised in lending and capital markets such as market matching problems, information asymmetry and moral hazard (Degl'Innocenti, Marta, et. al., 2022)

The silver lining of development finance assets

Multilateral development banks (MDBs) historically have focused on infrastructure, but in the 1980s diversified to corporate investment and productivity-enhancing frameworks for industrializing countries. In the meantime, advanced countries proactively promoted innovation-driven growth and the knowledge economy with dedicated financial instruments, in response to declining productivity. Several MDBs adopted this new cluster of instruments that required deeper knowledge of sectors and a more sophisticated risk-taking capacity.

The global financial crisis forced MDBs to move towards more systemic views, in close cooperation with local financial institutions and private sector investors with capital enhancement and first loss facilities. Also, financial innovation found a fertile ground in MDBs with the introduction of B-Loan structures, private equity partnerships and project financing. MDBs are currently refocusing their agenda to sustainable innovation financing related activities and the need for insights from policy-relevant research is expanding (Bartzokas, 2023).

In this context, the G20 Triple Agenda report highlighted the central role of MDBs and development finance institutions (DFIs) in providing this much-needed finance to these markets, as they are uniquely equipped to systemically tackle the SDG- and climate-related challenges on a large scale. At the same time, these development finance institutions have acknowledged their responsibility to prioritise mobilising capital from private and institutional investors (G20 Independent Experts Group, 2023).

There is significant potential to scale up the MDBs' business origination by proactively sharing their unique lender-of-record status. This refers to the A/B-loan product, a method used by MDBs and DFIs to mobilise capital. These institutions act as the main lender and administer the entire loan, retaining a significant portion of the loan on their own books (the A-Loan), while syndicating the remaining portion to private sector entities through a B-loan. This allows for the distribution of risk and mobilisation of private sector capital. The product could theoretically expand to hundreds of billions of US dollars as these assets are deconsolidated and no longer remain on the MDB balance sheet. By utilising this mechanism, MDBs could significantly enhance their originate-to-distribute objectives.

There have been multiple examples of successful scaling-up co-financing initiatives that are leveraging the partnership between the public and private markets to mobilise additional funding to emerging markets. One of these is ILX, an Amsterdam-based asset manager specialising in global development finance co-investment strategies. Underpinned by strong partnerships with global MDBs and DFIs, ILX's strategy centres around B-loan participations in SDG-aligned investments, particularly within the realm of climate finance. The pool of investors is composed of European pension funds, given that their fiduciary responsibility, longer tenure, and risk appetite align with those of MDBs and DFIs. This results in the financing of SDG-aligned projects in developing economies that contribute to meeting international agreements and climate goals, such as an aquaculture player in Turkey that increases sustainable fishing practices, or the first renewable utility-scale wind project in Azerbaijan.

Another notable example with a similar aim is the International Finance Corporation's (IFC) Managed Co-Lending Portfolio Program (MCPP), an initiative by the IFC to mobilise private sector financing and attract institutional investors to co-lend alongside IFC in emerging markets. Through this program, investors commit to a diversified set of projects rather than individual investments, benefiting from reduced risk through diversification and IFC's extensive experience in development projects. This increases access to long-term financing for essential infrastructure, energy, transportation, and other critical sectors, supporting sustainable development and economic growth in emerging markets. Additionally, actors such as the Private Sector Investment Lab (a collaborative initiative between the World Bank Group and CEOs of leading global private sector institutions) are working on mobilising private capital more effectively. Further initiatives such as these will contribute greatly to closing the SDG and climate funding gap.

The attractiveness and opportunities that the development finance asset class presents have been reinforced by the recent publication of the Global Emerging Markets Risk Database (GEMs) report on recovery statistics (GEMS Recovery Statistics, 2024). This report, coupled with MDB-specific disclosure on sovereign default and recovery rate statistics, will contribute to an accurate risk assessment, mitigate the current disparity between perceived risk and actual risk, and grow investors' confidence when investing in emerging markets.

The development finance asset class provides an investment opportunity that achieves both financial returns and positive impact. An effective collaboration between the public and private sectors is essential to meet the SDGs and climate objectives, and the role of MDBs and DFIs presents institutional investors with opportunities to fulfil their impact mandates.

Policy Recommendations

1. Facilitate the private sector's role in climate and development finance

    The private sector must increase its involvement by allocating part of its investments to SDG and climate-related projects. By providing smart intermediation solutions that will leverage and extend the syndication practice, markets gradually move to an improved second-best outcome of total financing available for developing countries.

2. Prioritize data transparency

    Data transparency is necessary to ensure an accurate assessment of the risk of the investments. The transfer of true risk requires transparency, standardisation and harmonisation.

3. Leverage the unique position of MDBs and DFIs as intermediaries

    MDBs and DFIs provide institutional investors with bankable impactful projects with market-equivalent risk-adjusted returns and safeguards in place. In order to become more effective intermediaries, they should seek to move towards a originate-to-distribute model.

4. Establish a financial innovation transfer channel from multilateral development banks (MDBs) to financial institutions in developing countries.

    Expected benefits are process related (efficiency and access to underserved markets) and product related (for example, with the aggregation of financial transactions supporting climate finance adaptation).

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