SCALING FINANCE FOR THE SUSTAINABLE DEVELOPMENT GOALS

Foreign Direct Investment, Financial Intermediation and Public-Private Partnerships

United Nations
Global Compact

CONTENTS

FOREWORD

Re-orienting Capital Markets Towards Sustainable Development

The urgency of addressing the climate crisis and efforts to realize the Sustainable Development Goals (SDGs) have set financial innovation to move at a fast pace. This is welcome, as it reflects a collective search for solutions that should lead to the most effective approach.

While we are not yet at the consolidation and standardization phases of SDG finance, it is nonetheless valuable to review the current range of innovation and highlight a few pathways that have the potential to bridge the gap in financing the 2030 Agenda for Sustainable Development.

In our first two publications: SDG Bonds — Leveraging Capital Markets for the SDGs and Corporate Finance — A Roadmap to Mainstream SDG Investments, we focused on optimizing the conditions for SDG impact in mainstream investments (listed bonds and equity) and creating large and diversified portfolios of credible SDG investment opportunities for institutional investors.

In this latest publication, Scaling Finance for the Sustainable Development Goals, we explore financial innovation for SDG investments that do not fit the criteria typically required for direct financing by portfolio or institutional investors. This includes foreign direct investment, financial intermediation and public-private partnerships for SDG finance.

We hope to contribute practical solutions to the rapidly evolving field of sustainable finance and to provide critical insights in the global agenda to leverage private finance for the SDGs. The three publications represent a broad vision from the UN Global Compact on how capital markets can increasingly re-orient towards more sustainable development while still serving investors' primary mandate, which is to preserve and maximize their investments within acceptable levels of risk. The publications also provide the conceptual framework for a new and comprehensive Sustainable Finance Programme at the UN Global Compact, which aims to empower companies as a global voice in the redesign of finance for sustainable development. The Programme includes:

1. A CFO Taskforce for the SDGs
2. A set of principles for SDG-aligned corporate finance and investment
3. A programme of activities to guide CFOs in the application of the principles for SDG alignment

These publications aim to provide practical resources and insights in your journey towards the SDGs. We look forward to working with you in pursuit of the 2030 Agenda.

Lise Kingo
CEO and Executive Director
United Nations Global Compact

ABBREVIATIONS

CFO	Chief Financial Officer
DFID	UK Department for International Development
DFI	Development Finance Institution
ECA	Export Credit Agency
FDI	Foreign Direct Investment
FPI	Foreign Portfolio Investments
GHG	Greenhouse Gas
HLEG	High-Level Expert Group on Sustainable Finance
IBD	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
ICMA	International Capital Market Authority
IDA	International Development Association (World Bank Group)
IFC	International Financial Corporation
IIA	International Investment Agreement
IPA	Investment Promotion Agency
IRR	Internal Rate of Return
LC	Letter of Credit
LDCs	Least Developed Countries
LICs	Lower-income Countries
M&A	Mergers and Acquisitions
MDB	Multilateral Development Bank
MFI	Microfinance Institution
MIGA	Multilateral Investment Guarantee Agency
MNC	Multinational Corporation
NDC	Nationally Determined Contribution
ODA	Official Development Assistance
ODI	Overseas Development Institute
PES	Payment for Ecosystem Services
SDGs	Sustainable Development Goals
SME	Small- and Medium-sized Enterprise
SPV	Special Purpose Vehicle
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
VNRs	Voluntary National Reviews

INTRODUCTION

Scaling Finance for the Sustainable Development Goals

Scaling Finance for the Sustainable Development Goals explores the role that financial intermediation and public-private partnerships can play in bridging the gap between global capital markets and SDG investments that are too small or too risky to attract direct portfolio investments. We first explore specific types of financial intermediation that have the potential to scale SDG finance in key areas:

- Providing access to finance in countries with less developed financial markets or for SDG solutions that are too small or illiquid to attract portfolio investors
- Linking global capital markets to companies, projects and individuals that cannot directly access these markets
- Leveraging the intermediation process to maximize the impact of downstream investments — for example, by ensuring sustainable practices of subsidiary businesses or by focusing on certain geographies, populations, or activities

In Part I, we look at foreign direct investment (FDI) and how multinational companies that raise capital on global financial markets can provide a critical source of SDG finance in emerging markets and least developed countries (LDCs). In Part II, we look at more traditional forms of financial intermediation by banks and financial institutions, such as providing financial services to companies and individuals, or creating innovative financial structures that pool investments and use securitization to scale SDG finance. We then explore the role of public-private partnerships in SDG finance (Part III) to support activities that cannot be financed on a purely commercial basis and therefore require some form of public support to benefit from private investments.

In doing so, we take the perspective of companies and examine the capacity of blended business models as a scalable type of public-private partnership for SDG finance, wherein public resources support existing or new business models. We also look at the role of subsidized corporate finance and how blended finance can be used to support companies making direct investments in the SDGs or banks providing SDG-related financial services. We suggest that companies and banks can be effective vehicles for scaling the SDG impact of blended finance because of their sophisticated management and governance models, liquid investment products, and a track record of innovation and delivering financial returns.

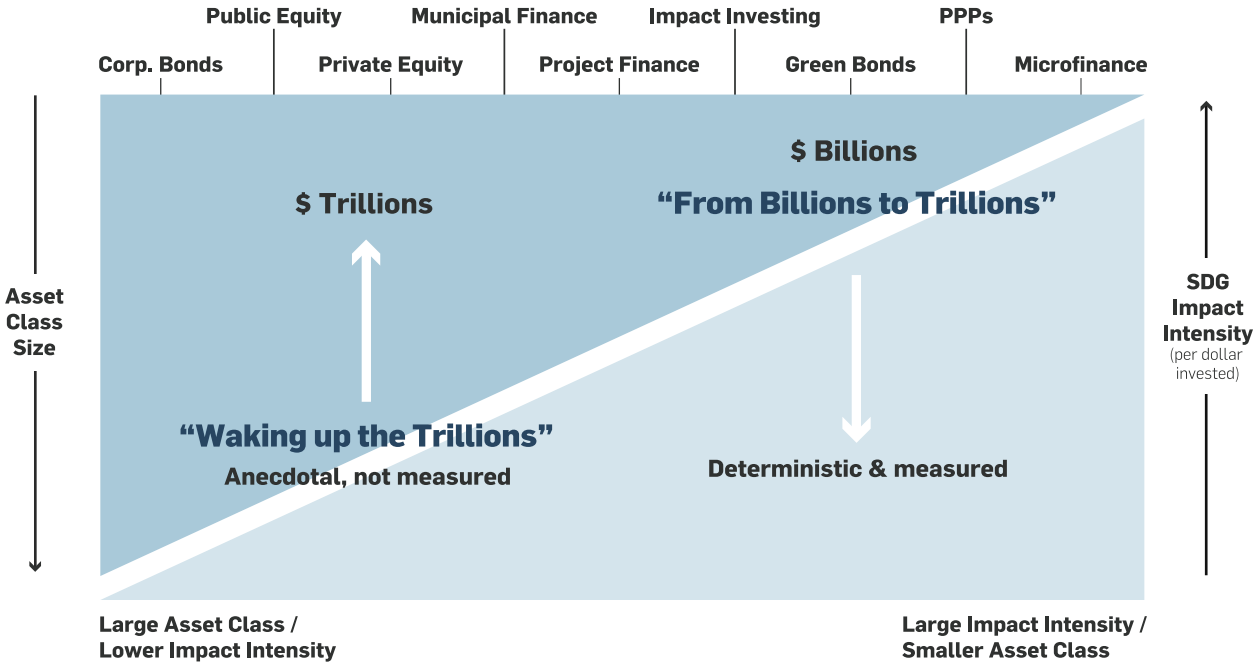
Lastly, we look at the importance of developing strong local capital markets. Strengthening emerging markets ensures a direct path to institutional investors and complements FDI and banking intermediation to localize the benefits of scaled SDG finance.

SCALING PRIVATE FINANCE FOR THE SUSTAINABLE DEVELOPMENT GOALS

At a basic level, scaling SDG finance is a quantitative goal to bring more capital to regions or activities that are key for the realization of the SDGs. It is often called for in response to the estimated US$ 2.5 billion annual SDG financing gap in emerging markets — to exponentially increase sources of public and private finance.

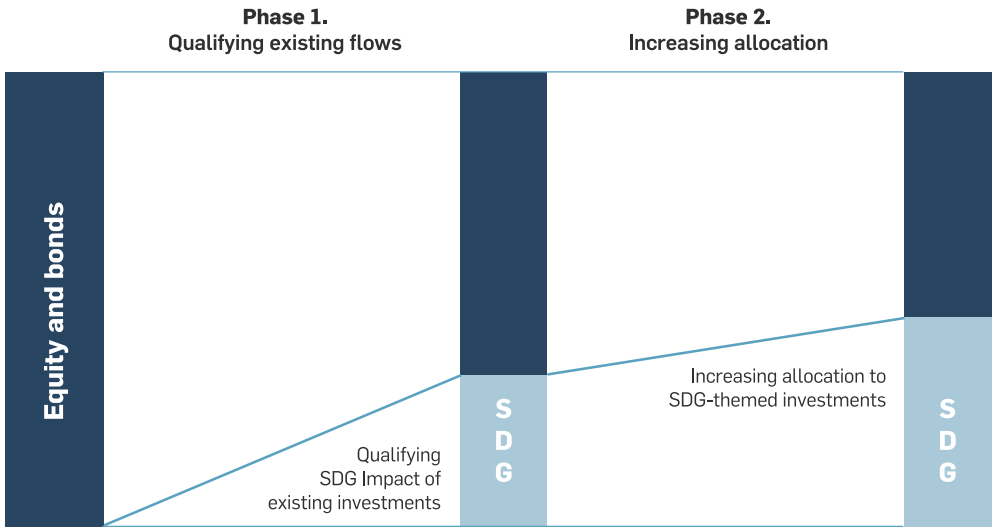
When it comes to leveraging private finance for the SDGs, however, a more nuanced view of scaling is needed to take into account existing flows of capital, the role of creating an enabling environment, and how to coordinate and maximize the combination of public and private finance. In Figure 1 below, we suggest two approaches to scaling SDG finance.

FIGURE 1: TWO DIMENSIONS OF SCALING SDG FINANCE



The first approach to scaling is to 'qualify' the SDG impact of large, traditional investment asset classes such as equity and bonds. It is well accepted that investments in equity and corporate bonds have an impact on the SDGs, but the impact is not well understood or measured partly because it is realized through internal investments or the services of underlying companies. This is also the case with foreign direct investments by large multinational companies and financial services provided by banks and other financial institutions. As described in Figure 2 below, one strategy for scaling SDG finance is for companies and banks to systematically manage, monitor and communicate their SDG impact. Such practices allow investors to better understand the SDG impact of existing equity and corporate bonds (Phase 1) and increase the flow of capital to those with positive SDG contributions (Phase 2).

FIGURE 2. QUALIFYING THE IMPACT OF LARGE ASSET CLASSES



A second — and more traditional — approach to scaling SDG finance is to increase the amount of capital available for investments that directly contribute to the SDGs but that are too small, too risky, or do not have sufficient financial returns for corporate or financial investors. Here the strategy for scaling is to leverage financial engineering and blended finance to create larger investments, thereby lowering the risk and/or increasing the return of the investments. Three main approaches to scaling these investments are discussed in this paper:

- Standardization and aggregation of smaller investments through securitization or syndication (addressed in Part II)
- Leveraging public finance for blended capital solutions that can support both corporate and financial investments (Part III)
- Creating the conditions for more sustainable investments through an enabling environment, including the development of local capital markets and stock exchanges (Part III)

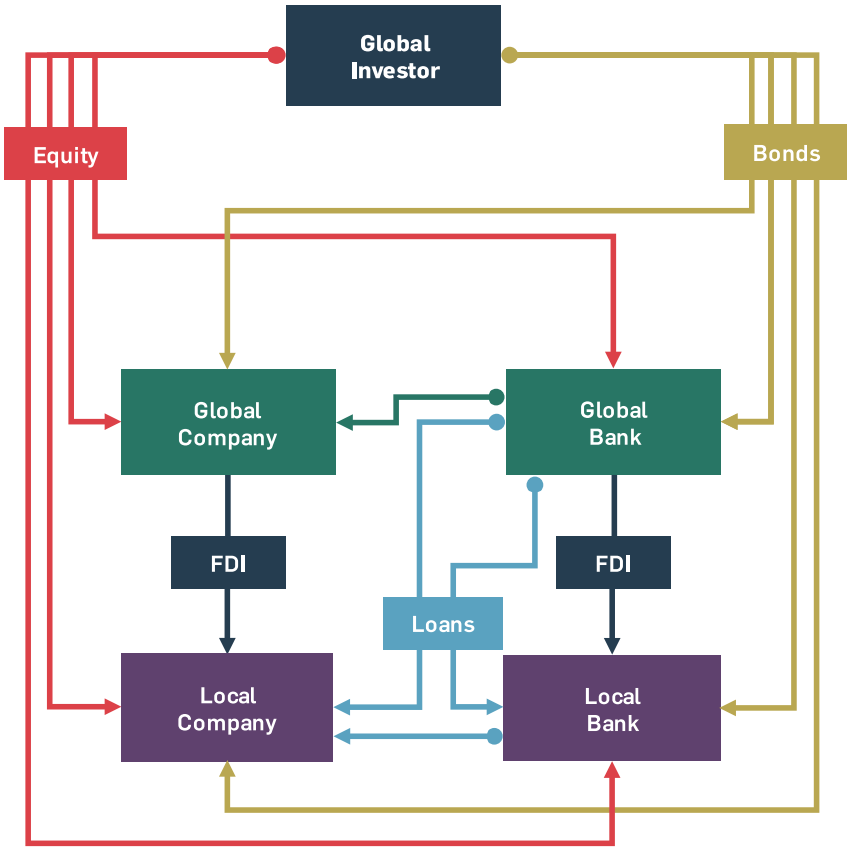
THE ROLE OF CORPORATE AND FINANCIAL INTERMEDIATION

Corporate and financial intermediation[1] can play a critical role in scaling SDG finance when the financial characteristics of SDG investments do not match the risk-return and size constraints of institutional investors. It can provide a bridge when SDG investments are too small, risky, or illiquid to attract institutional investors.

At the local level, financial intermediation can also bring about a local transfer of ownership of business and financial assets and maximize the impact of global investments on local economic and social development. In addition, it can trigger a multiplication effect of money creation that is typical of a well-functioning economy.

1. Financial intermediation occurs when an institutional unit acquires financial assets and, at the same time, takes on liabilities on its own behalf via financial operations on the market. The assets and liabilities of financial intermediaries have different characteristics, which assumes that in the financial intermediation process, the funds raised are transformed or grouped together according to their due date, volume and degree of risk. Source: INSEE, https://www.insee.fr/en/metadonnees/definition/c1873.

FIGURE 3: FINANCIAL INTERMEDIATION THROUGH FDI



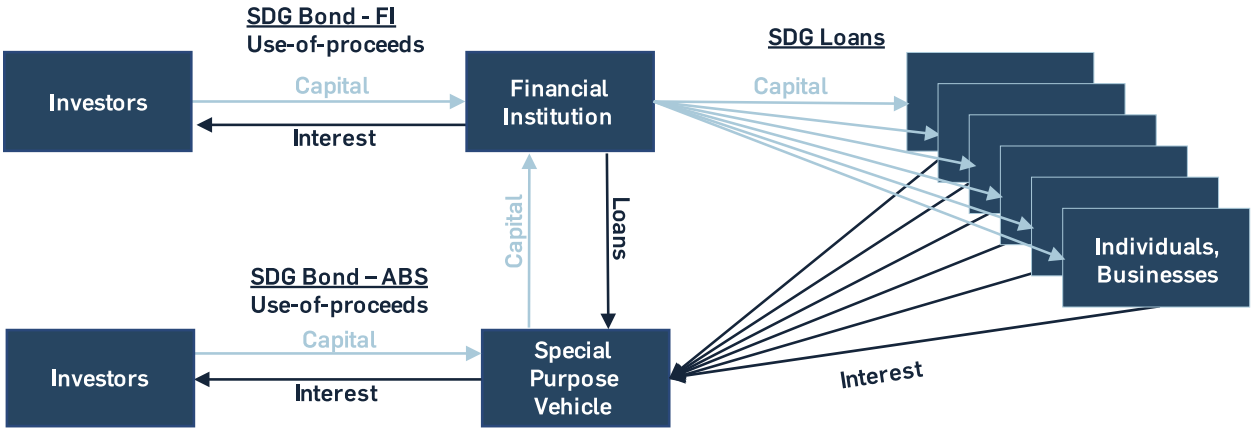
While many types of finance can be understood as financial intermediation, in this publication we focus on specific types of financial intermediation that can have a significant impact on the SDGs:

- Foreign direct investment
- Services of banks and financial institutions
- Financial engineering

The illustrations provide examples of financial intermediation and how they can work together to scale SDG finance. Figure 3 shows the interaction between portfolio investments, FDI and bank loans when global investors invest in the bonds and equity of large multinationals that themselves invest directly in local companies through FDI and bank loans.

Figure 4 illustrates the financial intermediation process in financial engineering. Here financial institutions raise capital in financial markets to provide SDG-themed loans or other financial services to individuals and businesses. These loans are then packaged together in special purpose vehicles (SPVs) and sold to capital markets as liquid securities (securitization). A similar process of financial intermediation occurs when financial institutions pool together financial assets in a fund (bonds, equity and other securities) to increase investment size and diversify risk.

FIGURE4. INTERMEDIATION THROUGH FINANCIAL ENGINEERING



Note: FI = Financial Institution; ABS = Asset-Backed Securities

PART I

Foreign Direct Investment

FDI can be a source of financial intermediation between global capital markets and smaller, less liquid investment opportunities in emerging markets and LDCs. Foreign companies (including banks) that make direct investments in emerging markets are often multinational companies with access to deep, global capital markets. They can raise capital through equity and bonds and use these funds to make direct investments in other countries through FDI. By extension, FDI can provide a source of finance for some of the most difficult sustainable development issues in emerging and frontier markets, where the interplay of basic economic development needs and lack of basic social infrastructure deters other types of foreign capital investment.

Financial intermediation through FDI involves a three-step process:

1. Portfolio investment in equity or bonds of a global company or bank
2. Investment by a global company or bank in equity of a local company or bank through acquisition or building a subsidiary
3. Local provision of products and services by local companies or banks

The role of FDI for sustainable development has been recognized in the 2030 Agenda for Sustainable Development and the Addis Ababa Action Agenda on Financing for Development, and it puts multinational companies in developed and developing markets at the forefront of achieving the SDGs.

In this section, we first provide an overview of FDI and its potential to finance economic and social development in emerging and frontier markets. In doing so, we draw an important link between institutional investors and the impact of FDI from their portfolio companies in countries and sectors that are key to the realization of the SDGs We then explore the conditions under which FDI can contribute to the SDGs, based on academic literature and UN development priorities. Lastly, we look at how corporate management and governance practices along with financial instruments can help actualize the potential benefits of FDI and communicate these benefits to investors.

THE ROLE OF FDI IN SUSTAINABLE DEVELOPMENT

2030 AGENDA FOR SUSTAINABLE DEVELOPMENT

10.b Encourage official development assistance and financial flows, including foreign direct investment, to States where the need is greatest, in particular least developed countries, African countries, small island developing States and landlocked developing countries, in accordance with their national plans and programmes. [underline added]

ADDIS ABABA ACTION AGENDA ON FINANCING FOR DEVELOPMENT

45. We recognize the important contribution that direct investment, including foreign direct investment, can make to sustainable development, particularly when projects are aligned with national and regional sustainable development strategies. [underline added]

UNDERSTANDING FOREIGN DIRECT INVESTMENT

FDI is a category of cross-border investment where an entity resident in one economy has control over or a significant degree of influence on the management of an enterprise resident in another economy. FDI is measured in stock and flows and includes equity capital, reinvestment of earnings and intercompany debt. Ownership of ten percent or more of the ordinary shares of voting stock is the criterion for determining the existence of a direct investment relationship.[2]

There are multiple types of foreign direct investments. FDI can be done through the construction of new facilities (greenfield) or via mergers and acquisitions (M&A) involving local companies (brownfield). Overall M&A represents half of all FDI; however, greenfield investments are more prevalent in emerging markets.[3]

FDI can also be categorized in reference to the value chain of the investing companies.[4]

- **Horizontal FDI** consists of establishing abroad an affiliate in a firm's primary industry to serve customers in the foreign market.
- **Vertical FDI** involves establishing a foreign affiliate that produces inputs to or provides intermediate services associated with a final product.
- **Complex FDI** combines features of both horizontal and vertical FDI.

Lastly, FDI can be differentiated by type of investment:

- **Real FDI** denotes investment by companies in the 'real' economy.
- **Financial FDI** is investment by banks and financial institutions setting up branches or subsidiaries to provide financial services abroad.

2. UNCTAD and World Bank.
3. Laura Alfaro and Jasmina Chauvin, Foreign Direct Investment, Finance, and Economic Development, Encyclopedia of International Economics and Global Trade, 2017.
4. Ibid.

CASE STUDY
ENEL'S ACQUISITION OF ELETROPAULO IN BRAZIL

Enel Brasil's acquisition of Eletropaulo (currently Enel Distribución São Paulo) is an example of how FDI, supported by capital market transactions, can provide a critical source of finance for SDG investments in emerging markets.

In June 2018, Enel Brasil (a subsidiary of Enel S.p.A) acquired Eletropaulo Metropolitana Electicidade de Sao Paulo S.A. (Eletropaulo) and became the largest distributor of electricity in Brazil with 17 million customers and 20% of the distribution market. The investment rationale focused on three main aspects, which ultimately reinforce Enel Group contribution to SDGs 7, 9, 11 and 13:

- consolidating Enel Americas footprint in Brazil, growing in low carbon service becoming a leading integrated payer (SDG 13);
- leveraging on Enel Group competences for networks digitization and quality of service providing infrastructure towards sustainable cities, while offering RAB and customer base growth opportunities (SDG 9 & 11);
- boosting Enel Americas growth in free market and new energy service space through innovation and energy efficiency solutions (SDG 9 & 11).

To finance the acquisition, ENEL used a combination of debt and equity financing in different markets. First, a syndicate of local and international banks provided Enel Brazil a loan in Brazilian Real (BRL) for the acquisition. Then, ENEL S.p.A., through its Dutch holding company (Enel Finance International N.V. or EFI), issued a bond on the US market and used part of the proceeds to re-finance Enel Brasil's debt from the acquisition via an intercompany loan.

In order to disburse directly the intercompany loan to Enel Brazil in Brazilian Real, EFI entered into a cross currency swap hedging itself against the EURO-BRL exchange rate and interest rate risk.

THE LINK BETWEEN PORTFOLIO INVESTMENTS AND FDI

Assessments of sources of private capital for development often contrast FDI with foreign portfolio investments (FPI), but such assessments fail to recognize the role of portfolio investors as owners of companies doing FDI. Yet, institutional investors are often the owners and creditors of global companies that make critical FDI in emerging markets (see Figure 5). In addition, FDI often involves significant financial resources, either for an acquisition or to build and operate a new subsidiary. Unless the parent company has excess cash or the home financial market is deep enough, FDI will, therefore, require significant loans or issuance of corporate bonds, with intermediation by global capital markets.[5]

To the extent that they manage and disclose the SDG impacts of FDI, global listed companies can provide a pathway between portfolio investors and SDG investments that are otherwise too small, risky, or illiquid. By extension, institutional investors have an opportunity to scale their SDG investments through FDI of their portfolio companies by:

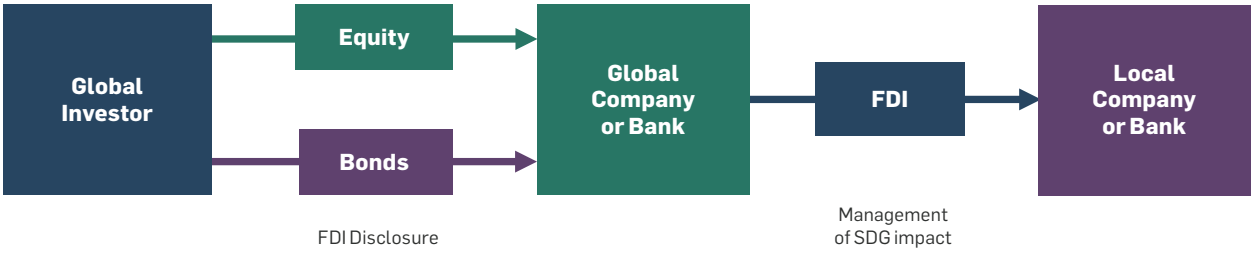
- Understanding the sustainable development benefits of their portfolio companies' FDI
- Increasing allocation to companies with the most positive contributions

Equity investors (and to some extent bond and loan financiers) can be highly influential in making sure multinational corporations (MNCs) participate in sustainable FDI, and they can apply responsible investment practices, including company engagement.

This suggests that the ultimate owners of MNCs — pension funds, foundations and insurance companies — can have a voice and leverage their equity voting rights to promote sustainable development standards among companies and banks conducting FDI, thereby making a major contribution to the financing and realization of the SDGs. Transparency around how pensions and insurance companies use their voting rights and other influence over investee companies to promote the SDGs through FDI would be a powerful incentive for companies to expand work in this area.

5. Poelhekke, Steven, Financial Globalization and Foreign Direct Investment (2016). De Nederlandsche Bank Working Paper No. 527.

FIGURE 5: LINKING PORTFOLIO INVESTMENTS AND FDI



CASE STUDY

WORLD'S FIRST SDG-LINKED GENERAL-PURPOSE CORPORATE BONDS

In 2019, ENEL S.p.A., through its Dutch holding company Enel Finance International N.V., issued two separate SDG-linked general-purpose corporate bonds to institutional investors based in the US, Europe and other international markets, raising over US$ 4 billion.

Proceeds from the bonds will be used to finance the company's overall sustainable strategy to transition toward renewable electricity generation capacity, energy efficiency and carbon neutrality, improving access to energy and creating the infrastructure for electric mobility.

This will include FDI in key markets in Latin America and Africa where the company will provide critical access to clean and affordable energy.
The bonds were issued at a discounted interest rate with respect to a comparable issue without sustainability characteristics, reflecting the commitments by ENEL to make timely progress in the implementation of its strategy, as evidenced by clear indicators that will be independently verified:

- Increase renewable generation capacity to 55% of consolidated installed capacity by December 31, 2021
- Reduce carbon dioxide emissions to below 125 g/kWh by 2030

The bonds also include a step-up mechanism where interest rates will increase by 25bps if the company fails to meet its targets.

FDI AS A SOURCE OF SDG FINANCE IN EMERGING MARKETS

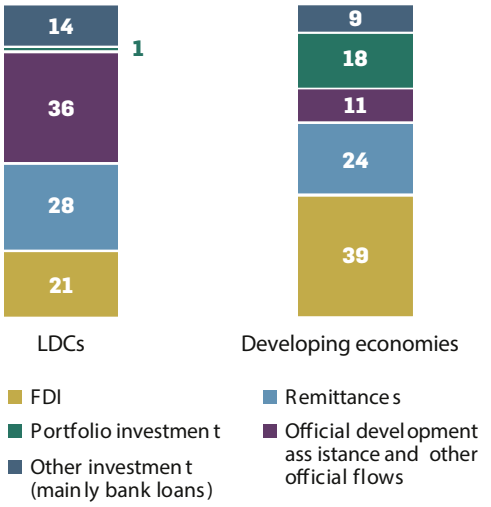
According to the United Nations Conference on Trade and Development (UNCTAD), FDI constituted the most significant external source of financing for developing economies between 2013 and 2017 (39%), followed by portfolio investments (18%) and bank loans (9%).[6]
In LDCs, the primary sources of external finance were Official Development Assistance (ODA) and remittances. Nonetheless, FDI remained a substantial source of external financing at 21%, and the contribution of bank loans reached 14%. For developing economies, FDI is also a more stable source of financing compared with portfolio investments and bank loans, which experience dramatic fluctuations over business cycles (seeFigure 6).

The importance of FDI for emerging markets is also evident when compared with capital market transactions. World Bank data indicates that FDI represented a large share of private capital for emerging markets, reaching 4.0% of GDP, compared with public bonds at 5.5%, private bonds at 1.0%, and equity portfolio investments at 0.2% (seeTable 4). The trend is even more pronounced in low-income countries, where the share of all capital market instruments drops and FDI becomes the primary source of private capital.

6. World Investment Report 2018, UNCTAD.

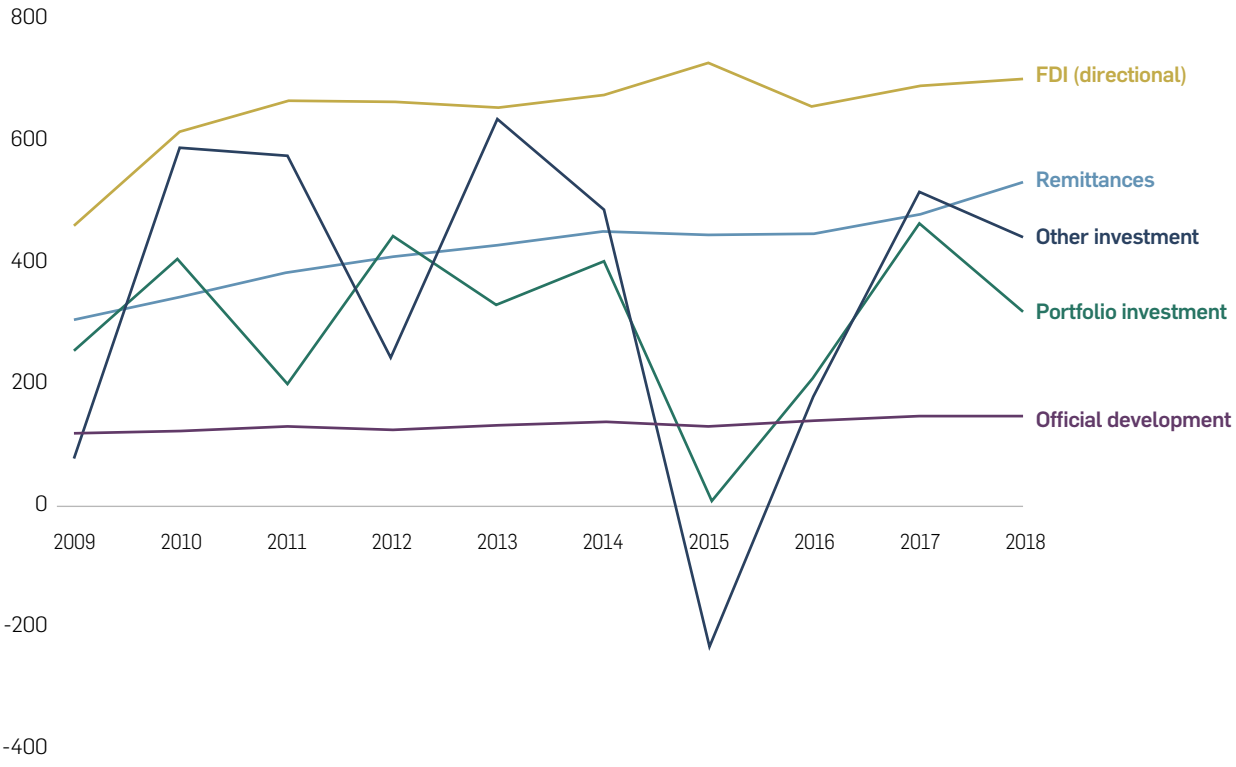
FIGURE 6: THE IMPORTANCE OF FOREIGN DIRECT INVESTMENTS

Sources of external finance, developing economies and LCDs, 2013–2017 (Per cent)



	Growth rates (%)		
	2017	2013–2017 average	Volatility index
Developing economies			
FDI	0	0	20
Remittances	95	27	
ODA and other official flows	-1	2	19
Portfolio investment	110	-80	88
Other investment (mainly bank loans)	70	-25	90
Least developed countries			
FDI	-17	6	23
REmittances	4	3	35
ODA and other official flows	-1	2	17
Portfolio investment	21	-13	237
Other investment (mainly bank loans)	-58	6	113

Developing Economies: Sources of External Finance, 2009-2018 (Billions of Dollars)



Source: UNCTAD.

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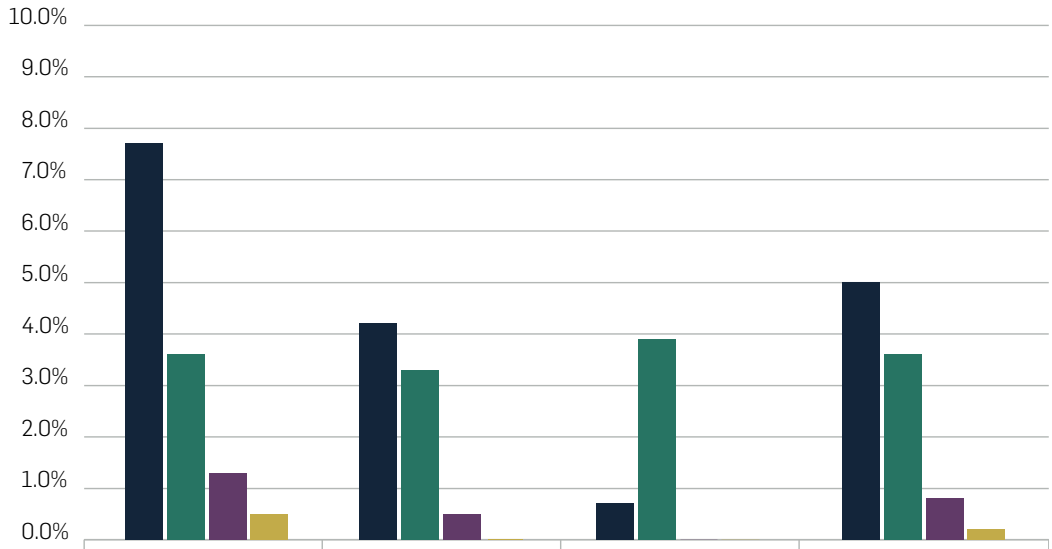
FIGURE 7: SOURCE OF CAPITAL IN EMERGING MARKETS (% OF GDP)



	Upper Middle Income	Lower Middle Income	Low Income	All Emerging Markets
Public Bonds	7.7%	4.2%	0.7%	5.0%
FDI	3.6%	3.3%	3.9%	3.6%
Private Bonds	1.3%	0.5%	0.0%	0.8%
Portfolio Equity Flow	0.5%	0.0%	0.0%	0.2%

Public Bonds. Public and publicly guaranteed debt from bonds that are either publicly issued or privately placed. Total outstanding.

Private Bonds. Private nonguaranteed long-term debt of a private debtor not guaranteed for repayment by a public entity. Total outstanding.

FDI (foreign direct investment) refers to direct investment equity flows from a resident in one economy owning 10% of ordinary shares of voting stock of an enterprise resident in another economy. It includes equity capital, reinvestment of earnings and other capital.

Portfolio equity flows include net inflows from equity securities other than those recorded as direct investment and including shares, stocks, depository receipts (American or global) and direct purchases of shares in local stock markets by foreign investors.

Income Levels. Countries' income level calculated based on 2017 GNI per capita, as follows: low income is US$ 995 or less; lower middle-income between US$ 996 and US$ 3,895 and upper middle-income between US$ 3,896 and US$ 12,055.

Source: UN Global Compact analysis; World Bank data for 2017.

MAXIMIZING THE IMPACT OF FDI

As discussed above, FDI is a critical source of financing for emerging and frontier markets. It is generally regarded as having a great potential to promote economic development by strengthening productivity, promoting growth and helping diversify the economy. FDI does not, however, automatically contribute to sustainable development. As with any investment, it must be made with consideration of its economic, social and environmental impacts — especially at the local level. According to the Indian economist Prabhat Patnaik, "[w]hat is needed ... is a nuanced approach to FDI flows, and not one that believes that the more the FDI flows, irrespective of what kind and to what destination, the better."[7]

A recent publication on FDI sustainability characteristics defines 'sustainable FDI' as

> *commercially viable investment that makes a maximum contribution to the economic, social and environmental development of host countries and takes place in the framework of fair governance mechanisms.*[8]

In this section, we first look at the inherent benefits of FDI, focusing on economic development benefits, control and additionality. We then look at how FDI can contribute to the long-term development of local markets, targeting local development gaps and sustainability issues while mitigating negative impacts.

INHERENT BENEFITS

The main impetus for FDI is strategic; the parent company often finds a synergistic relationship between the target investment and its existing business. FDI therefore contributes 'strategic' value beyond a pure financial investment. This is in contrast with portfolio investments, where the contribution is mostly financial.[9]

In the context of emerging and frontier markets and the SDGs, FDI can provide a range of **macro- and micro-economic benefits:**

- Creation of new economic sectors
- Access to new markets
- Job creation
- Technology transfer
- Enhanced productivity levels
- Improved management and governance
- Re-allocation of capital towards productive sectors

Importantly, FDI can raise the corporate governance standards of local companies and elevate their management of environmental and social impact.

A related benefit of FDI comes from the 'direct' nature of the investment and the relative control over the invested entity. Unlike portfolio investments, which are generally non-controlling and therefore more passive, FDI provides the investing company with the ability to influence the direction of the investee company, including its contribution to sustainable development.

FDI SUPPORTING THE AFRICAN INDUSTRIAL REVOLUTION

FDI is a critical aspect of Africa's recent industrial expansion beyond the traditional extractive sectors to sectors such as food processing and auto manufacturing, thereby substituting imports with local manufacturing to meet growing local demand. Recent examples of FDI in these sectors include Nibulon (Ukraine)'s US$ 2 billion project to upgrade Egypt's grain storage infrastructure and Hyundai's auto manufacturing plant in Ethiopia, with a planned capacity of 10,000 vehicles per year. Africa also benefits from FDI in export manufacturing as industries shift from China to lower-cost regions.

Industrial capacity is also building through FDI in sectors that can have long-lasting benefits on sustainable development of local economies, such as tourism, agriculture, technology and renewable energy. For example, Microsoft has been creating a talent pool in Africa and recently launched its Africa Development Center with initial sites in Nairobi, Kenya and Lagos, Nigeria. Other examples include Google's new artificial intelligence center in Ghana and, in South Africa, Huawei's new data centers and Mainstream Renewable Energy's new 110 MW wind farm.

7. Prabhat Patnaik, FDI As A Means Of Financing Development, March 1, 2014. G-24 Policy Brief No. 18.
8. Towards an Indicative List of FDI Sustainability Characteristics, Karl P. Sauvant and Howard Mann, 2017, published by the International Centre for Trade and Sustainable Development and the World Economic Forum. http://ccsi.columbia.edu/2017/10/24/towards-an-indicative-list-of-fdi-sustainability-characteristics/.
9. Private equity is an exception, as it typically involves a strategic investment.

Additionality is a third benefit of FDI given the scarcity of capital in emerging and frontier markets. Additionality — a key concept of impact investing — is the "extent to which a new input (action or item) adds to the existing inputs (instead of replacing any of them) and results in a greater aggregate."[10] In the context of financing, additionality means that the capital invested would not otherwise be available.

FDI by companies in the financial sector (Financial FDI) provides many of the same macro- and micro-economic benefits as FDI conducted by real-economy companies. There are, however, specific benefits that financial FDI brings, mainly linked to the role that affiliates of global banks can play in facilitating FDI in other industry sectors.[11]

Financial FDI provides critical financial intermediation for real-economy FDI (and by extension for foreign portfolio investments) by vetting and monitoring local investments and potentially increasing the size and quality of the pool of target firms. The presence of local affiliates of global banks also helps address information asymmetries that are inherent in international investments, through independent investment and credit research. This is particularly important in countries with lower standards of governance, transparency and investor protection. The role that affiliates of global banks play in improving conditions in local financial markets is addressed in Part III in The Link Between FDI and Capital Market Development.

10. Impact Management Project
11. See footnote 5.
12. See footnote 3.
13. See footnote 8.

CONSIDERATIONS FOR LONG-TERM DEVELOPMENT OF LOCAL MARKETS

The benefits of FDI depend on the host country's level of economic development and whether the investment is complementary to or competitive with local real and financial resources. Economic research shows that FDI can genuinely aid development financing when it brings in real resources and does not contribute to contraction in domestic output and employment.[12] Specifically, the following factors affect the development impact of FDI:

- **Changes in the allocation of local resources, including employment and finance.** FDI is most beneficial in economies that are short of real resources such as industrial capacity, foreign exchange reserves, or commodities. In economies with export surpluses, FDI can still be helpful because it can bring technology transfers and access to international markets. A possible downside of FDI, however, is that when global companies complement their FDI with local financing, it can restrict access to finance for local actors.
- **Development of local capital markets.** FDI is most attractive as a source of capital in markets where capital is scarce (additionality). However, the degree to which FDI can provide additional sources of capital also positively correlates with the development of local financial markets. Good local financial conditions allow for increased FDI because companies can secure complementary financing locally and hedge local currency risk. The existence of local capital markets can also mitigate the potential usurpation of local financial resources when foreign affiliates raise capital locally (see also The Link Between FDI and Capital Market Development in Part III).
- **Local resources and assets.** According to some economic analyses, FDI through M&A (brownfield) contributes less to finance for development, as it brings financial resources but not real resources. In addition, M&A has the effect of "de-nationalizing" economies by shifting control over productive assets from domestic nationals to foreigners.[13]

ALIGNMENT WITH HOST COUNTRY'S SUSTAINABLE DEVELOPMENT PLANS

As part of their implementation of the 2030 Agenda for Sustainable Development, countries develop a series of national, regional, and local strategies and programmes that are documented in their Voluntary National Reviews (VNRs) and Nationally Determined Contribution (NDCs) and translated in national development plans. These national plans can provide roadmaps for the private sector to invest in the SDGs, focusing on the unique needs and challenges in specific countries. They provide a baseline indication of where countries stand in their implementation of the SDGs and gaps that can be filled by private sector solutions and private capital. They also provide a sense of how Governments prioritize among the SDGs based on the unique situation in each country.

Aligning FDI with a country's SDG plans can increase the overall scale and intensity of impact by contributing to a broader SDG-enabling effort. For example, if a country has committed to climate mitigation through a meaningful deployment of a specific type of renewable energy capacity, impact is enhanced when foreign businesses invest in building similar or complementary energy capacity in that country.

Lastly, investing alongside a country's SDG plans can lead to better risk-adjusted financial returns since these activities may receive direct or indirect support from the Government in the form of incentives, subsidies, or favorable policies and regulatory regimes. In turn, this can lead to more stable and longer-term private-sector contribution to the SDGs.

These benefits are highlighted in academic research on the characteristics of sustainable FDI:

> *[M]any governments consider that some types of investment, especially when supported by national and international policies, can make a particular contribution to the development objectives of their economies. ... At a minimum, ... they consider that investment with certain characteristics is particularly desirable and, therefore, might benefit from various policy measures to encourage it.*[14]

Accordingly, the need to align FDI with local development priorities is often reflected in international investment agreements (IIAs), where recipient countries specify their expectations for the contribution of private international investments. It is also reflected in the policies of investment promotion agencies (IPAs) in developed and developing countries, which often prioritize projects and FDI that they consider as contributing most to their own development priorities.

AN EXAMPLE OF FDI CRITERIA FOR COUNTRY INVESTMENTS

FDI in the Democratic Republic of the Congo increased by 11 per cent in 2018, to US$ 1.5 billion. Continued investments in mineral exploration (especially for cobalt, of which the country holds 60 percent of the world's known reserves) underpinned flows to the country. International mining companies including Glencore (Switzerland) and Molybdenum (China) expanded their presence in the country in 2018. Extractive-industry investors will now operate under an amended mining code, with new provisions that increase royalties, remove the 10-year amnesty on new rules for existing miners, and impose a super-profits tax.

The alignment of FDI with national development plans is also a key consideration in the promotion of FDI in the 2030 Agenda for Sustainable Development and the Addis Ababa Action Agenda on Financing for Development. Paragraph 45 of the Addis Ababa Action Agenda states:

> *We recognize the important contribution that direct investment, including foreign direct investment, can make to sustainable development, particularly when projects are aligned with national and regional sustainable development strategies. ... We will prioritize projects with the greatest potential for promoting full and productive employment and decent work for all, sustainable patterns of production and consumption, structural transformation and sustainable industrialization, productive diversification and agriculture.*

14. See Footnote 8.

FOCUSING FDI ON PRIORITY SECTORS AND REGIONS

Scaling the impact of FDI also requires reallocation of capital towards countries and sectors most in need. Quoting again from the Addis Ababa Action Agenda on Financing for Development:

> *Private international capital flows, particularly foreign direct investment, along with a stable international financial system, are vital complements to national development efforts. Nonetheless, we note that there are investment gaps in key sectors for sustainable development. Foreign direct investment is concentrated in a few sectors in many developing countries and often bypasses countries most in need and international capital flows are often short-term oriented.*

According to the United Nations Development Program (UNDP), the sustainable development benefits of FDI are not uniform. Investments are increasingly being made in real estate versus manufacturing or research and development. FDI is also heavily concentrated in middle-income countries and in resource-rich low-income countries, leaving least developed countries with less than 2 percent of total world FDI flows.[15]

FIGURE 8: IFC PERFORMANCE STANDARDS

Source: IFC.

FOCUS ON ECONOMIC AND SOCIAL BENEFITS FOR EMERGING MARKETS

In their recent publication on FDI Sustainability Characteristics, Sauvant and Mann identify emerging FDI sustainability characteristics based on a variety of instruments linking sustainability to investments in emerging markets (e.g. international investment agreements, company codes, etc.).[16] The authors observe that economic and social benefits (versus environmental benefits) figure more prominently among these characteristics than with typical corporate sustainability issues, which they explain through a focus on emerging markets.

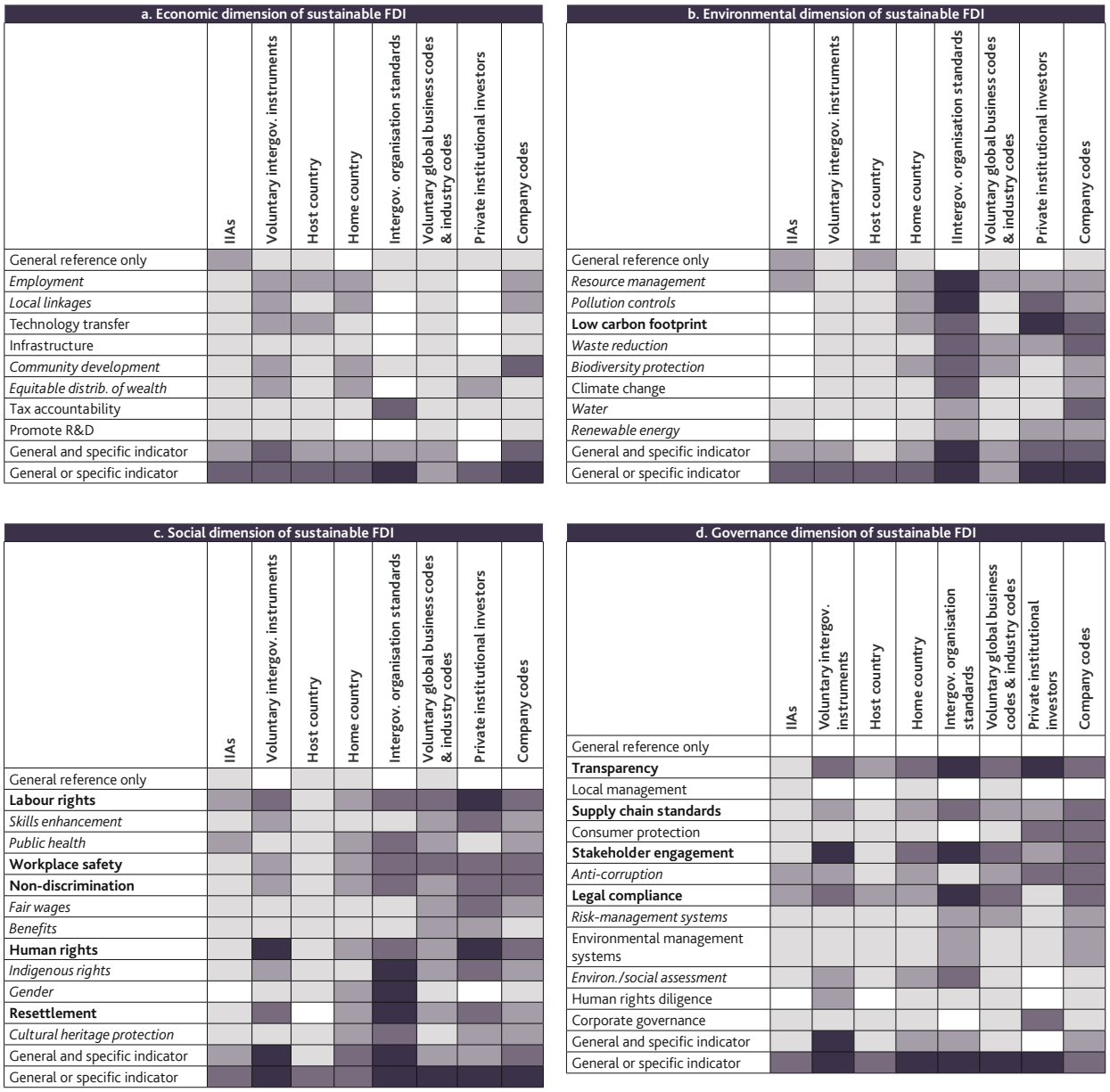
> *What is noticeable is that none of the FDI sustainability characteristics in the economic sustainability dimension make it into the group of common sustainability characteristics, though they figure more prominently among the emerging common FDI sustainability characteristics. This may reflect the fact that the sustainable development discussion was previously particularly driven by developed countries and their civil societies, which have a particular interest in environmental sustainability and governance, and, in the case of social sustainability, by trade unions. On the other hand, a great number of IIAs, most of which involve developing countries, make general references to the furtherance of economic development."*[17]

In addition, they found that emerging FDI sustainability characteristics in the social dimension focused more on the well-being of local societies, including issues such as indigenous rights, resettlement and cultural heritage. This is consistent with the Performance Standards of the International Financial Corporation (IFC), which define IFC clients' responsibilities for managing environmental and social risks. Four of the eight standards focus on the well-being of local populations: community, resettlement, indigenous people and cultural heritage (seeFigure 8).

According to the Economist Prabhat Patnaik, "FDI flows into the developing world must fulfill two criteria: they must be economically justifiable; and they must not go against certain overriding social considerations."[18]

15. FINANCING THE 2030 AGENDA: An Introductory Guidebook for UNDP Country Offices. UNDP 2018.
16. See Footnote 8.
17. Ibid.
18. See Footnote 7.

FIGURE 9: MATRIX OF SUSTAINABILITY CHARACTERISTICS OF FDI



Source: Towards an Indicative List of FDI Sustainability Characteristics, Karl P. Sauvant and Howard Mann, 2017.

Note: Bolded characteristics are common characteristics and italicized characteristics are emerging common characteristics, as defined in the text.

LEVERAGING CORPORATE INTERMEDIATION FOR IMPACT

The intermediation process of FDI is an opportunity to maximize the impact of downstream investments by integrating considerations of SDG impact into the strategy and governance mechanisms of the parent company and its subsidiary, including:

- The internal investment process of the parent company
- Governance of the parent and subsidiary
- Capital market transactions of the parent company
- Reporting by the parent and subsidiary

INTERNAL INVESTMENT CRITERIA

Parent companies can adopt internal investment criteria for FDI that are based on their overall sustainability strategy and risk management but adapted to operations in emerging markets and least developed countries. Over time, these criteria could become another 'hurdle' rate for FDI alongside the traditional internal rate of return (IRR), focusing on positive SDG impact and management of downside ESG risks.

Some companies have started to incorporate SDG considerations into internal investment decisions. For example, energy company Enel requires the incorporation of SDG/ESG considerations into corporate business plans before approving any specific investments.

CORPORATE GOVERNANCE

Parent companies can leverage their corporate governance structures and practices to maximize the sustainability benefits of FDI.[19] This includes the adoption of strategic and business development guidelines, codes of conduct or ethics, oversight by the board of directors, risk management, and internal controls and reporting. Parent companies can also transpose important governance standards and practices at the subsidiary level, including oversight of SDG impact.

CAPITAL MARKET TRANSACTIONS

Consideration of SDG impacts in the internal investment process and governance of FDI can be an important source of credibility when companies raise capital in support of SDG activities, whether through bonds, equity, or loans. For example, sustainable FDI can serve as the underlying investment behind SDG bonds, with mechanisms to measure, monitor and report SDG impacts.

To the extent that companies can commit to certain sustainable practices or even sustainable outcomes from their activities, contractual commitments can be included in bond or loan transactions to give investors assurance that their investments promote sustainable development.

The Enel SDG Bond Programme is designed to fund implementation of a company transition towards renewables, within an Enel Group strategy that is fully aligned with the SDGs. A significant portion of the bond proceeds will be used to fund investments in emerging markets, mostly in Latin America, following high governance standards in line with the Ten Principles of the UN Global Compact.

On-going investor communications should address a company's FDI footprint in emerging markets and LDCs and focus on elements that maximize benefits of FDI. Both positive contributions and management of downside impact should be considered, with emphasis on localization of benefits and sophistication of local financial markets. Companies should also track and regularly report on the SDG benefits of FDI, differentiating sustainability issues in their home countries from those prevalent in the foreign markets where the companies are directly investing.

19. This is one of the key benefits of subsidized corporate finance vs. blended finance in scaling SDG finance. See Part III.

PART II

Financial Intermediation

Private banks and financial institutions provide a critical link between the global capital markets and SDG investment opportunities. Their capital furnishes deeper access to finance in private markets, transferring risk and transforming the duration of financial liabilities.

Banks and insurance companies raise financing on global or local capital markets (equity, bond and repository markets) or from depositors. In turn, they use these funds to provide loans or other financial services in support of SDG-relevant activities such as developing and implementing new technologies and business models, bolstering underbanked markets (including emerging markets and LDCs), and providing consumer finance to expand access to essential products and services.

Financial engineering by banks and insurance companies can change the financial characteristics of investments to make them more attractive to institutional investors. In this intermediation process, funds raised are transformed or grouped together according to their due date, volume and degree of risk.

In both cases, financial intermediation has a multiplication effect wherein the original investment is leveraged into several more investments or financing, increasing the potential for SDG impact. If done at the local level, financial intermediation can also result in a local transfer of ownership of real and financial assets, driving further economic and social development.

In this section, we explore different types of financial intermediation and how they can help scale SDG finance. We also look at the process of intermediation as an instrument to maximize impacts on the SDGs.

THE ROLE OF BANKS AND FINANCIAL INSTITUTIONS

BANKING SERVICES

Financial intermediation by banks is critical because it creates a link between global capital and private financial solutions that are necessary for the realization of the SDGs, including the following:

- Mortgages, loans and other credit solutions to support financial inclusion
- Loans and other credit solutions to finance consumption of SDG-related products and solutions (such as energy efficiency and renewable energy)
- Leases to support circular economy models

Facilitating inclusive access to finance can provide banks with a compelling impact theory when raising capital on the global capital markets. Financial inclusion is featured as an enabler of sustainable development in eight of the seventeen SDGs, and there is growing evidence that it contributes to more stable financial systems and economies, increasing domestic resources through national savings and helping to increase Government revenue.[20]

According to the UK Department for International Development (DFID), "access to financial services can reduce poverty through the same channels that affect overall growth: by increasing investment and productivity resulting in greater income generation, and by facilitating risk management thus reducing vulnerability to shocks."[21]

On the environmental side, private loans and bank credit facilities are critical for both listed and non-listed companies transitioning to clean energy or other environmentally sound practices. In 2018, the green loans market was one of the fastest-growing segments in sustainable finance. The market grew from US$ 3.1 billion in 2017 to US$ 5.1 billion in 2018, mostly in real estate (32% of the market) and energy (24%).[22]

Figures 10 and 11 are excerpts of the use-of-proceeds of ANZ and HSBC's SDG bonds. They illustrate the wide range of SDG benefits that banks can support through the financial services they provide, including:

- Access to education and healthcare
- Clean water and clean energy
- Sustainable infrastructure (transportation, communication)
- Affordable housing and public transit
- Climate adaptation and disaster prevention

EXAMPLES OF FINANCIAL INTERMEDIATION FOR MICRO AND SME FINANCE

- **Credit Suisse** has been committed to microfinance since 2002, managing over **US$ 2 billion of assets that are used to fund microfinance institutions (MFIs).**
- **UBS' Loans for Growth Fund** provides **debt capital to specialized SMEs Financing Institutions** in frontier & emerging markets — fostering economic development, creating jobs and contributing to poverty alleviation.
- **TIAA-CREF** invested **US$ 32 million in two global private equity funds focusing on inclusive finance**. These funds in turn invest in financial institutions in developing countries that provide financial services and products to underserved consumers, micro-entrepreneurs and SMEs.

20. Source: UN Capital Development Fund (UNCDF).
21. The Importance of Financial Sector Development for Growth and Poverty Reduction. 2004. DFID.
22. Source: Climate Bond Initiative.

FIGURE 10: USE-OF-PROCEEDS OF ANZ SDG BOND

Eligibility Criteria: Activities that provide access to essential health-care services, promote mental health and wellbeing and achieve universal health coverage

Examples: Public hospitals, private hospitals that are non-for-profit or provide social benefit programs to disadvantaged communities, aged care services

Eligibility Criteria: Activities that provide access to safe and affordable drinking water, improve water quality and/or increase water use efficiency

Examples: Water treatment facilities, water supply and distribution, water recycling facilities

Eligibility Criteria: Activities that promote equal access for all men and women to affordable and quality education

Examples: Technical, vocational and tertiary education providers, construction of facilities such as tertiary campuses, universities, student housing or training infrastructure

Eligibility Criteria: Activities that increase the share of renewable energy in the global mix, and expand infrastructure and upgrade technology for supplying modern, reliable and sustainable energy services for all

Examples: Wind, solar, hydro power, biomass, or geothermal generation, as well as energy efficient technologies in new and refurbished buildings, energy storage, district heating or smart grids

Source: ANZ.

FIGURE 11: USE-OF-PROCEEDS OF HSBC SDG BOND

Eligibility Criteria: Develop quality, reliable, sustainable infrastructure, to support affordable and equitable access for all that will also benefit economic development and human well-being;

Upgrade and retrofit infrastructure to make them sustainable, with increased resource-use efficiency and greater adoption of clean and environmentally sound technologies and industrial processes

Examples: Rail transportation projects for public use; Development of roads in areas that lack connectivity, or in areas lacking infrastructure; Communication projects including internet coverage and mobile phone usage

Eligibility Criteria: Activities that expand or maintain the supply of affordable housing; Activities that expand or maintain access to sustainable transport systems

Examples: Rail transportation projects for public use; Development of roads in areas that lack connectivity, or in areas lacking infrastructure; Construction of Social Housing; Right to Buy schemes

Eligibility Criteria: Adaptation projects that demonstrably contribute to reducing vulnerability to climate change identified in the project area and do not increase carbon emissions

Examples: Natural disaster prevention infrastructure; Education programmes to increase awareness and knowledge on climate related issues

Source: HSBC.

TRADE FINANCE

Banks can play an important role as providers of trade finance to support international trade with emerging markets, linking local companies to the value chain and helping them become more competitive. According to research by the Asian Development Bank, trade finance can contribute to employment and productivity growth by helping create export opportunities for local companies "which would otherwise be considered too risky, to link into expanding global value chains."[23] Unfortunately, research also finds that while trade finance is "robust for the main routes of trade and for large trading companies [...] access to trade finance remains costly and scarce in countries which have the strongest potential for trade expansion."[24]

Trade finance can also be an instrument to promote more sustainable international trade. In a recent publication,[25] the Banking Environment Initiative (BEI) explored how documentary trade finance can be leveraged to enforce sustainable practices in international trade. This is particularly important in emerging markets, where a significant proportion of international trade is financed through documentary trade.

In a standard trade finance transaction, a bank issues a letter of credit to guarantee payments for shipments that meet certain conditions, based on documents presented to the bank. "By removing the risk faced by suppliers, i.e., that buyers will not pay for their goods, trade finance banks play a critical role in facilitating world trade."[26] (seeFigure 12).

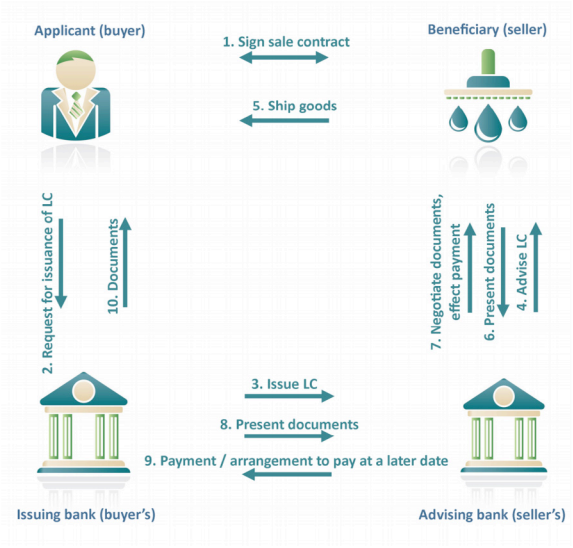
According to BEI, the concept of a Sustainable Shipment Letter of Credit (LC) is very simple: a sustainability standard can be included in a letter of credit's conditions and documentary evidence.

> *If the buyer requires of its supplier commodities produced to a particular, pre-existing and internationally recognised sustainability standard, it can instruct its bank (the issuing bank) to issue an LC in favour of the supplier including this condition. If such a request does not add materially to the complexity of the documentary trade process and if buyers, suppliers and banks can be incentivised to prioritise these Sustainable Shipments, then the trade finance industry can play a material role in increasing the visibility of sustainability standards in supply chains and rewarding their greater use, thereby helping to drive new market norms."*[27]

Trade finance is also a strategic area for export credit agencies (ECAs) and development finance institutions (DFIs) to promote trade and sustainable development in emerging and frontier markets. ECAs and DFIs can play a critical role in promoting sustainable trade finance by providing guarantees and other benefits for banks that promote sustainability standards in international trade.

For example, IFC's US$ 5 billion Global Trade Finance Program (GTFP) provides banks with risk mitigation solutions (price incentives or longer tenors) for new or challenging trade routes when defined climate change benefits can be demonstrated.

FIGURE 12: IFC'S GLOBAL TRADE FINANCE PROGRAM



Source: Banking Environment Initiative.

23. Auboin, M. and A. DiCaprio. 2017. Why Do Trade Finance Gaps Persist: And Does It Matter for Trade and Development. ADBI Working Paper 702. Tokyo: Asian Development Bank Institute.
24. Ibid.
25. The BEI's Sustainable Shipment LC: A financing innovation to incentivise sustainable commodity trade (CPSL, 2014).
26. Ibid.
27. Ibid.

INSURANCE AND GUARANTEES

Insurance plays a crucial role in scaling SDG finance for solutions and markets that are too risky for commercial finance alone. Insurance and guarantees are often used by DFIs as highly effective mechanisms to leverage scarce public funds to bring in private capital.

Traditionally, de-risking solutions for development finance have been provided as public-private partnerships, where a public institution (sovereign state or development bank) or a philanthropic organization uses concessionary capital to guarantee the risks of a project or an investment and attract private investors. Guarantees are also provided by ECAs to promote export of national technologies and solutions in markets that are too risky for the private sector alone.

The **African Energy Guarantee Facility** (AEGF), created by the European Investment Bank (EIB), Munich Re and the African Trade Insurance Agency (ATI), offers protection against political risks to facilitate private investment in the use of renewable energy. The AEGF is structured in different risk transfer tranches, which can be assumed by insurers and private financial institutions. The facility offers an insurance capacity of US$ 1.4 billion for political risks for a total of 25 African countries.

However, such insurance solutions need to be scaled exponentially to lower the risk of the enormous pool of private investments needed to realize the SDGs. The financial need extends well beyond the concessionary capital of development banks, foundations and export agencies.

One solution is presented by financial innovation in the insurance industry to develop new business models for private insurance products and guarantees that can reduce the risk of SDG investments. For example, advances in climate science, technology and data collection help actuaries better forecast climate-related risks and create innovative insurance products that can reduce the risk of SDG investments in climate adaptation, renewable energy, agriculture and consumer finance.

EXAMPLES OF PRIVATE INSURANCE AND GUARANTEES

Swiss Re is collaborating with The Nature Conservancy to incorporate nature-based coastal adaptation measures into open source risk models and maps, informed by assessment of the cost effectiveness of green (e.g. mangroves) and grey (e.g. seawalls) infrastructure solutions.

A Solar Revenue Put developed by kWh with backing by Swiss Re drives down investment risk and encourages the development of clean, low-cost solar energy. The Solar Revenue Put is structured as an insurance policy on solar production and revenues and provides credit enhancement for financial investors. The put provides comprehensive coverage that banks rely upon, enabling financial institutions to more easily finance solar projects on terms more favorable to the sponsor.

Performance guarantees for solar panels are an innovation of Munich Re, which provides a 25-year performance guarantee to manufacturers of photovoltaic modules, lowering the risk and increasing the financial attractiveness of investments in renewable energy.

Wind Energy Yield Cover is another Munich Re offering. It provides risk insurance for wind energy, covering risks associated with turbine performance and wind output.

HEDGING AND DERIVATIVES

Hedging can be used to manage currency risks in frontier markets. For example, cross-currency and interest swaps have been used for many years to de-risk investments in emerging markets, focusing on political and currency risks, including the risk of having debt and revenues in two different currencies. Hedging can also be used to protect against the risk of loans with variable rates (prevalent in emerging markets where there is a higher risk of inflation).

WORLD'S FIRST SDG-LINKED CROSS-CURRENCY SWAP

Enel S.p.A. and Société Générale entered into a cross-currency swap in connection with Enel's General-Purpose SDG-linked bond, issued in September 2019. The goal of the derivative transaction was to hedge against the exchange rate and interest rate risk created by the different denomination of the bond repayments (US dollars) and the source of repayments (Euros).

As part of the transaction, Enel received a discounted rate based on its commitment to sustainability performance. Société Générale provided the discount as part of its commitment to the Positive Impact Principles and based on Enel's positive contribution to one or the pillars of sustainable development (economic, environmental and social) and mitigation of any potential negative impacts to any of the pillars.

As part of the transaction, Enel obtained a price adjustment based on its commitment to sustainability performance in line with the Bond features. This SDG-linked cross-currency swap is an example of sustainability-linked derivatives and it is offered by Société Générale as part of its Sustainable & Positive Impact Finance commitment, to support positive contribution to one or more of the three pillars of sustainable development (economic, environmental and social) and mitigation of any potential negative impacts.

Similarly, derivative products can be used to transfer the risk associated with an SDG investment to a financial intermediary in exchange for a fixed, recurring payment. For example, synthetic green asset-backed securities allow the credit risk of green loans to be transferred from a lender to an investor, helping banks meet risk-weighted capital requirements and freeing up funds to originate new loans.

SECURITIZATION AND SYNDICATION

Securitization transforms financial assets or a pool of assets into securities, which can be traded on capital markets. For creditors — companies or banks providing credit — selling off existing financial assets frees up capital and increases cash flows to develop or finance more SDG-enabling projects. For borrowers, it expands the pool of capital available to global investors and leads to a more stable source of capital at a lower cost.

While the practice of securitization more generally has come under increased scrutiny following the financial crisis of 2008, it can provide important benefits to the financing of sustainable development. For example, loans for renewable energy — both residential and commercial — have been pooled into securities (bonds) that can be sold to large institutional investors, improving the cost and availability of funds for a transition to clean energy. Securitization can also pool together and finance loans to small- and medium-sized enterprises (SMEs) in emerging markets or SDG-themed assets that can be easily standardized (e.g. residential solar equipment).

Other examples include:

- Bonds backed by consumer loans or leases for electric cars (e.g. Toyota)
- Bonds backed by renewable energy projects (e.g. JRE Mega Solar Project Bond Trust 1)
- Green receivables bonds that raise capital for green projects by securitizing receivables (e.g. agribusiness receivables credits in Brazil)
- YieldCos: publicly listed companies holding multiple renewable energy assets

Securitization has also been used to scale micro-finance, insurance, and loans to SMEs in developing and frontier markets.

The **Women's Livelihood Bond (WLB)** is a US$ 8 million bond intended to help impact enterprises and microfinance institutions to grow their businesses and scale social impact. WLB is the world's first listed bond with dual focus on financial and social returns, empowering the lives of over 385,000 women in Southeast Asia. WLB is structured to create a 'basket' (Special Purpose Vehicle) of impact enterprises and raises funds from investors seeking financial and social returns.

Syndication is a form of financial intermediation that consists of combining a pool of smaller investments to diversify risk and increase investment size to attract institutional investors. In turn, access to larger pools of capital lowers the cost of financing the underlying investments.

In the context of SDG finance, syndication can be used to increase the quantity and lower the cost of financing for investments that are too small or too risky for commercial banks or institutional investors. It can also reduce the costs of fund management, administration and impact measurement, which can be prohibitive for single investments.

Examples of funds pooling together SDG investments include:

- Funds of green, social or sustainability bonds
- Funds of companies contributing to the SDGs (equity or bonds)
- Private equity funds focused on SDG solutions
- Funds of microloans for farmers (microfinance)

LEVERAGING FINANCIAL INTERMEDIATION FOR IMPACT

As with real-economy FDI, the intermediation process of banks and financial institutions presents an opportunity to maximize the impact of downstream investments. The bargaining power of financial intermediaries can provide leverage to ensure a focus on key geographies, populations, or activities for the SDGs, or to impose strong covenants for sustainable practices.

Because the secondary (or downstream) investment processes in financial intermediation are internal and typically not publicly disclosed, financial intermediaries must have strong governance mechanisms to generate credibility and ensure that the potential SDG benefits of financial intermediation are actualized. The form of a credibility mechanism will depend on the type of financial intermediation, the impact theory, and whether intermediation is done through active management or standardization. Figure 13 below shows examples of credibility mechanisms based on different types of financial intermediation, from more actively managed investments, where more delegation of judgement is warranted, to less actively managed investments, where standardization is critical.

FIGURE 13: MAXIMIZING IMPACT THROUGH FINANCIAL INTERMEDIATION — MECHANISMS TO ENSURE CREDIBILITY

TYPES OF FINANCIAL INTERMEDIATION	IMPACT THEORY	MECHANISMS TO ENSURE CREDIBLE IMPACT
Banks / Financial Institutions	SDG focus of financial services Management of E&S downside	Corporate commitment Criteria for investments (use-of-proceeds Performance-based products
Asset Management / Private equity	SDG focus of investments Management of E&S downside	Criteria for investments Active investment management (engagement, reporting)
Securitization of Financial Assets (e.g. EV loans)	Proven SDG contribution of underlying asset (e.g. taxonomy)	Standard underlying assets (e.g. renewable energy project) Standard underlying financial contract (e.g. loan or leases)
Pooling (funds) of Real Assets (e.g. YieldCos)	SDG contribution of underlying asset	Standard underlying assets (e.g. renewable energy project)

CORPORATE-LEVEL MECHANISMS

Financial institutions are separate legal entities (often corporations), and mechanisms to ensure credibility of impact are, therefore, similar to those recommended for FDI in Part I. The SDG impact of financial institutions is considered in various aspects of corporate strategy and governance, including:

- Internal investment process
- Governance
- Capital market transactions
- Reporting and investor communication

Consideration of SDG impacts in internal processes and governance can be an important source of credibility when banks and financial institutions raise capital for SDG activities. General-purpose corporate bonds can be linked to the company's overall SDG strategy, or use-of-proceeds bonds can be issued if SDG investments fall into established green or sustainability taxonomies.

PRODUCT-LEVEL MECHANISMS

When providing loans and other financial products, banks can use their leverage to get strong commitments from clients to maximize the SDG impact of their activities. This can take the form of **SDG-linked covenants** in loans, mortgages, letters of credit, and other financial products. For example, a number of financial institutions have issued corporate loans with interest rate that are tied to the borrower's key performance indicators related to the SDGs.

EXAMPLES OF PERFORMANCE-BASED LOAN PRICING

Iberdrola (Electricity, Spain): € 1.5 billion loan with favorable interest rates contingent on company performance on SDG 7 and indicators 7.1 on universal energy access and 7.2 on the share of electricity produced from renewables.

Colonial (Real Estate, Spain): € 75.7 million sustainable improvement loan to finance a LEED-certified building, with variable interest based on ESG and LEED performance.

Royal DSM (Healthcare, Netherlands): € 1 billion (US$ 1.2 billion) revolving credit facility with variable interest rate based on greenhouse gas (GHG) emissions, energy efficiency and electricity sourced from renewables.

Use-of-proceeds mechanisms can also be applied to bank loans to ensure that funds will be used for activities that positively contribute to the SDGs. Recently, International Capital Market Authority (ICMA) issued a set of principles for Green Loans based on the credibility mechanisms of the Green Bond Principles. These principles focus on defining and auditing the use of bond proceeds.

STANDARDIZATION

Standardization plays a critical role in scaling SDG finance. First, standardization of financial products and services can help to scale SDG finance by facilitating the replication of smaller investments, either by pooling them together with similar investments or by lowering the incremental transaction cost of issuing each product. This is particularly important for securitization and syndication, which are premised upon pooling together smaller investments whose underlying financial and sustainability characteristics are similar and well understood by investors.

Furthermore, standardization can help maximize the SDG contribution of financial products and services by ensuring a minimum level of impact. For example, sustainability standards for underlying investments can be used as criteria in the selection and management of assets in funds and other pools of assets. They can also be used in the methodology for constructing index funds — in considerations for the selection of the underlying assets and how the index is weighted. Sustainability standards increase the transparency of SDG investments and provide a credible and scalable pathway for sustainable finance.

Taxonomies represent an important source of standardization of financial products and services for the SDGs. They can provide an initial and illustrative set of assets and activities that qualify as sustainable investments for banks and financial institutions. They can also serve as an organizational tool — an industry classification system — for analyzing, comparing and bundling assets together into investments with similar SDG focus.

For example, the European Union is developing a taxonomy of economic activities that can make a substantial contribution to climate change mitigation or adaptation while avoiding significant harm to its other environmental objectives. Similarly, ICMA produces a taxonomy of eligible activities as part of its Green and Social Bond Principles. The organization has created a linkage document illustrating the relationship between eligible categories for Green and Social Bonds and the SDGs (seeFigure 14).

FIGURE 14: MAPPING GREEN AND SOCIAL BONDS ELIGIBLE PROJECTS TO THE SDGS

SDG	SBP PROJECT CATEGORIES	GBP PROJECT CATEGORIES	EXAMPLE INDICATORS
	Access to Essential Services (3.1, 3.2, 3.3, 3.4, 3.5, 3.7, 3.8, 3B, 3C) Affordable Basic Infrastructure (3.6)	Pollution Prevention and Control (3.9) Renewable Energy (3.9)	3.1 Number of people reached with improved health care 3.2 Cost reduction for standard treatments and medicines 3.3 Amount of waste water treated, reused or avoided before and after the project 3.4 Amount of raw/untreated sewage sludge that is treated and disposed of
	Access to Essential Services (4.1, 4.2, 4.3, 4.4, 4.5, 4.6, 4.7, 4A, 4C) Socioeconomic Advancement and Empowerment (4.4, 4.5)		4.1 Number of people receiving education services 4.2 Number of students attaining standard for education level 4.3 Education facilities for inclusive and effective learning environments
	Access to Essential Services (5.4) Socio Economic Advancement and Empowerment (5.1, 5.4, 5.5, 5B)		5.1 Number of equal paying jobs created for women another under-represented gender groups 5B Number of women using technology products
	Affordable Basic Infrastructure	Sustainable water and wastewater management (6.1, 6.2, 6.3, 6.4, 6.5, 6A, 6B) Terrestrial and aquatic biodiversity conservation (6.6)	6.1 Number of people provided was safe and affordable drinking water 6.2 Number of people provided with adequate an equitable sanitation 6.3 Volume of water saved 6.4 Volume of waste water treated for reuse 6.6 Area covered by sustainable land of water resources management practices

Source: The International Capital Market Association (ICMA).

LOWER CAPITAL REQUIREMENTS FOR SUSTAINABLE FINANCE

Maintaining a portfolio of sustainable loans can improve the financial position of banks by lowering the risk of default that could result from negative sustainability impacts. Reducing risk could, in turn, result in lowering the capital reserve requirements of banks, enabling them to increase the amount of capital for lending.

Lower capital requirements could result naturally from the management of sustainability risks in banks' portfolios. It could also result from regulatory incentives provided by central banks to encourage more lending or better pricing for sustainable businesses or practices.

Such incentives are being contemplated in the European Union under the concept of a 'green supporting factor' and the European Commission is "looking positively" at lowering capital requirements for banks and an "efficient way to direct investment into new technologies such as electric cars and mortgage loans for energy-efficient homes".[28]

Separately, the High-Level Expert Group on Sustainable Finance (HLEG), as part of its recommendations for Financing a Sustainable European Economy, suggested that lowering capital requirements for lending to the green sector should only be implemented if there is an actual risk-differential justifying such a discount.[29]

28. Brussels looks at easing bank capital rules to spur green investment, Financial Times, January 1, 2018.
29. Financing a Sustainable European Economy: Final Report 2018 by the High-Level Expert Group on Sustainable Finance. European Commission. 2018.

PART III

Public-Private Partnerships

In this section, we look at the role of public-private partnerships in supporting SDG-related activities that cannot be financed on a purely commercial basis (often the social aspects of the SDGs) and, therefore, require some form of public support to attract private investments. In doing so, we take the perspective of companies, looking at different ways they can benefit from public funds or commitments to support their SDG contributions. We focus on markets that present greater economic or political risks or that offer new solutions that are not fully tested and, consequently, have a high risk-return profile. We explore the value of public support at different links of the investment value chain, including:

- Consumer incentives and pay-for-performance schemes that can form the basis of new business models (blended business models)
- Capital, guarantees, or insurance that can help companies make their business model work in difficult situations (subsidized corporate finance)
- Quasi-private financing schemes that are demonstrated with public finance but can be replicated by commercial banks or insurance companies (blended finance)

We propose that blended business models and subsidized corporate finance should be prioritized over blended financial structures, for two reasons.

First, blended business models focus public funds on solutions that are almost commercial or that can eventually become commercial after an initial demonstration effect, improving the leverage ratio of private-to-public capital. Similarly, subsidized corporate finance can be an efficient use of public funds, as companies generally look for solutions that are commercially viable after a period of experimentation.[30]

Second, blended business models and subsidized corporate finance can leverage the corporate structure as a scalable and credible investment vehicle for the SDGs. As discussed in Parts I and II above, real-economy companies and banks can provide critical access to finance for more risky SDG investments and leverage their bargaining power as corporate and financial intermediaries to impose SDG considerations as part of their investments or financial services.

We also suggest strategic use of blended finance in areas where it can be most optimal, focusing on temporary needs in the early development stage of solutions or after a market failure. Lastly, we recommend maximizing private sources of blended finance.

Our goal is to outline an order of preference among methods for leveraging public funds for private finance, favoring solutions that generate the highest ratio of private-to-public capital and that maximize the impact of SDG finance. This approach is consistent with the World Bank's cascade approach to maximize financing for development by leveraging the private sector and optimizing the use of scarce public resources (seeFigure 15 below). According to the World Bank Group Development Committee,

> *The Cascade first seeks to mobilize commercial finance, enabled by upstream reforms where necessary to address market failures and other constraints to private sector investment at the country and sector level. Where risks remain high, the priority will be to apply guarantees and risk-sharing instruments. Only where market solutions are not possible through sector reform and risk mitigation would official and public resources be applied."*[31]

30. There is currently a debate in the development community on the best way to leverage public capital for private investment, and to improve the ratio of private-to-public capital in blended finance solutions.
31. Forward look: a vision for the world bank group in 2030 — progress and challenges. Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries, World Bank and IMF, March 24, 2017.

FIGURE 15: WORLD BANK'S CASCADE APPROACH

Source: World Bank.

BLENDED BUSINESS MODELS

We introduce the concept of blended business models in contrast with blended finance. Instead of using public funds or guarantees to make investments more attractive for investors (blended finance), blended business models direct public resources towards reducing the risk or boosting returns of enterprises that provide SDG solutions, thereby helping to create robust business models that can be financed on commercial terms.

The opportunity lies in identifying consumer preferences or incentives for the underlying products or services that companies provide (e.g. for ecosystem services, social benefits, or vaccines for rare diseases). These incentives can be integrated into a company's business model as locked-in demand and guarantees, improving the risk and return profile (akin to a public contract for a private company) and helping to attract more investment. This is the model behind social impact bonds, where private actors fund and execute social projects and are paid by Governments if and when they meet agreed-upon measures of success.

In this section, we explore several types of blended business models wherein consumers, the public, or public organizations make direct payments to the private sector in exchange for SDG benefits:

- Consumer preference and incentives
- Pay-for-performance models
- Payment for ecosystem services
- Private offsets and public commitment

CONSUMER PREFERENCES AND INCENTIVES

A new kind of business model, variously described as "circular economy," "sharing economy," or "inclusive economy," is seen as a scalable solution to increase efficiency and make business more inclusive and less resource-intensive, in line with many of the SDGs. Examples include:

- Renewable energy and energy efficiency
- Closed-loop manufacturing
- Extending the lifetime of products
- Product-as-a-service
- Leasing
- Sharing products and assets with low use rates

While these models and technologies can succeed in large part on their own merit due to their inherent efficiency or the benefits they provide, their success also carries social value and, therefore, engenders public support.

This is evident, for example, with renewable energy and electric vehicles, where the value proposition for the consumer is often based on perceived sustainable development benefits and Government incentives. Another example is how Governments' commitments to climate change mitigation factor prominently in projections for the growth of renewable energy. Public commitments and incentives such as the US investment tax credit for solar or Germany's Energiewende policies can influence business' decisions about what technologies to deploy and what products and services to offer.

Here the public contribution is somewhat indirect. It happens because business models leverage the social value that is created, gaining public support through consumer preferences or incentives for consumers. For example, consumer preferences for sustainable products can lead to more stable demand or Government incentives, subsidies, or guarantees, which can lower the cost or risk of doing business.

PAY-FOR-PERFORMANCE MODELS

These solutions involve conditional payments by Governments, development banks and foundations based upon the successful implementation of sustainability solutions by the private sector. They are mostly used in the social and economic development sectors and can be financed through innovative financial products, including social impact bonds and development impact bonds.

Social impact bonds are three-way financial arrangements where private actors finance and execute a social project and are paid by Governments upon meeting agreed-upon measures of success. They are typically used where early-stage intervention can direct outsized economic benefits to a public institution (e.g. a municipality, health authority, NGO, or development finance institution).

Similarly, development impact bonds are issued to private investors to fund development programmes and are repaid by donor countries or host-country Governments based on pre-agreed outcomes. The Center for Global Development and Social Finance suggests the use of development impact bonds for applications such as:

- **Education.** Provide loans to low-cost private schools, with the loans repaid by Governments or donors upon demonstration of improved educational outcomes.
- **HIV prevention.** Programme costs are repaid from a Government's savings on healthcare costs.
- **Energy efficiency.** Repayments derive from energy savings.

Development impact bonds can also be used to support contributions to climate change mitigation and emission reduction as well as resiliency improvement.

PAYMENT FOR ECOSYSTEM SERVICES

Payment for ecosystem services (PES) work with semi-externalities where environmentally damaging activities specifically impact commercial or public beneficiaries of a preserved natural ecosystem and these beneficiaries agree to pay for the preservation of said ecosystem. The most recognized examples of PES schemes include (i) payments by users of the Panama Canal to preserve the surrounding ecosystem and improve navigability, (ii) payments by the City of New York to improve upstream farming practices to reduce the cost of water treatment, and (iii) payments by the large food company Danone to preserve the quality of Evian's water source.

Another example of a PES scheme is the UN-sponsored REDD+ mechanism, where tradable carbon credits are issued upon measurement and verification of avoided deforestation.[32] These credits can then be monetized based on a collective interest in climate stability and mandatory and voluntary offsets by companies and Governments.

Revenue streams from payment for ecosystem services can be capitalized and can generate innovative private financing schemes. For example, while public finance accounts for a large proportion of investment in REDD+ projects, the private sector is becoming an increasingly important source of funding, contributing over US$ 400 million between 2009 and 2014.[33]

PRIVATE OFFSETS, PUBLIC COMMITMENT AND LONG-TERM CONTRACTS

Offsets consist of payments by companies or other entities to offset their GHG emissions or other impact on the environment. This practice is typically seen in regulated cap-and-trade markets for GHG emissions, but it also works on a voluntary basis when there is sufficient pressure on companies (from consumers, investors, employees, etc.) to offset an environmental footprint that they cannot mitigate (e.g. voluntary carbon credit markets).

Advance market commitments consist of capitalizing on multi-year financial commitments of countries (e.g. international aid or commitments to buy vaccines) to finance upfront investments that will deliver broad and long-term economic and social impact. For example, GAVI (the Vaccine Alliance) pools the demand from developing countries for new vaccines and provides long-term, predictable financing to attract new (private) vaccine manufacturers. Long-term contracts on preferential terms can provide companies with stable input and a reliable supply chain.

EXAMPLES OF INNOVATIVE FINANCING FOR ECOSYSTEM SERVICES

- **Credit Suisse's Nature Conservation Notes** to fund sustainable agroforestry and eco-system conservation, based on revenue from the sale of sustainably certified commodities and payments for ecosystem services.
- **European Investment Banks' Althelia Climate Fund** to finance forest protection and sustainable land use based on revenue streams from tradable carbon assets.
- **Cloud Forest Blue Energy Mechanism** to fund restoration and conservation of cloud forests in Latin America, based on revenue from improved productivity of hydroelectric plants.[34]
- **Rimba Raya, the largest REDD+ project in the world**, to support the conservation of a nearly 65,000-hectare natural reserve in Indonesia to avoid more than 130 million tons of CO2 emissions. The project was financed by Allianz, Microsoft and other private investors in exchange for verified avoided CO2 emissions (carbon credits) to meet carbon neutrality goals.[35]

EXAMPLE OF LONG-TERM CONTRACT — POWER PURCHASE AGREEMENTS

Power purchase agreements are long-term contracts that can provide energy companies with a stable revenue sources to invest in renewable energy.

For example, the Enel Group is planning for a 34% increase in total renewable capacity between 2019 and 2021 — a growth of about 9 GW of capacity in 3 years. This aggressive growth plan is made possible, in part, by long-term contracts (power-purchase agreements) with electric utilities and commercial and industrial customers, covering a majority (55%) of its energy production.

32. Reducing Emissions from Deforestation and Forest Degradation, as well as conservation, sustainable management of forests and enhancement of forest carbon stocks
33. Financing the Low-Carbon Future: A Private-Sector View on Mobilizing Climate Finance. The Climate Finance Leadership Initiative. 2019.
34. Source: Climate Policy Initiative.
35. Ibid.

BLENDED FINANCE

Blended finance is defined by the OECD as "the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries." In contrast with blended business models or subsidized corporate finance, blended finance brings together public and private financial resources as part of the capital structure to finance projects or activities that cannot be financed on a commercial basis.

Blended finance has become a very popular area of sustainable finance, and it is seen by many as a critical tool to scale finance for the SDGs. Yet, the growth of blended finance has tapered off in recent years (see Figure 16), as have projections on how much private capital it can attract to finance the SDGs.

Recent research from the Overseas Development Institute (ODI) provides a mixed review of blended finance, stating that:

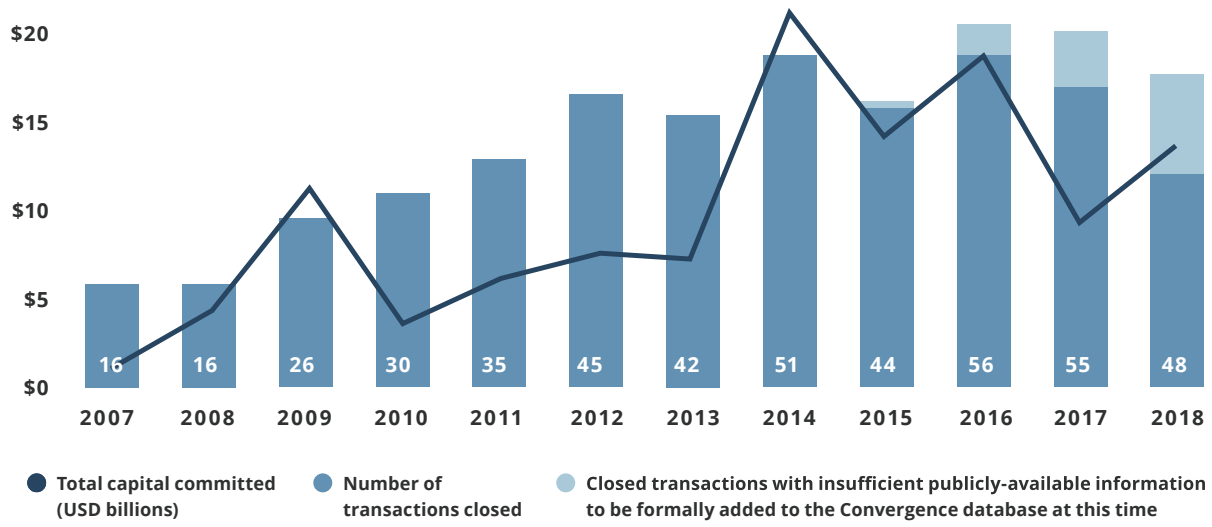
- Expectations that blended finance can bridge the SDG financing gap are unrealistic: 'billions-to-billions' is more plausible than 'billions to trillions.'
- The big push on blended finance risks undermining the poverty eradication agendas in the poorest countries.
- Policy makers need a better understanding of the poverty and development impact of blended finance, as well as its true costs, to ensure value for money and effective policymaking and allocation of aid.
- Multilateral development banks and development finance institutions need to collectively adopt a more distinct and tailored approach to blended finance in low-income countries.[36]

This has led to a debate over how to improve the ratio of private-to-public capital in blended finance solutions and, more generally, how best to leverage public funds to attract private investment. In the same report, ODI suggests the need for a better approach:

> *Donors need to think carefully about the allocation of ODA and the risks and trade-offs of investing ODA in blended finance. There may be other public policy interventions that are more transparent and effective in achieving development objectives than providing a direct subsidy to the private sector.*[37]

36. Overseas Development Institute, Blended Finance in the Poorest Countries — The Need for a Better Approach, Samantha Attridge and Lars Engen, April 2019.
37. Ibid.

FIGURE 16: GROWTH OF ANNUAL BLENDED FINANCE ACTIVITIES (2007–2018)



Source: Convergence.

CALIBRATING EXPECTATIONS FOR SCALING BLENDED FINANCE

Recent research suggests that ambitions for scaling blended finance — from billions to trillions — should be recalibrated in the context of lower leverage ratios in least developed countries and limited public funds for ODA and development finance.[38]

In its latest report The State of Blended Finance, Convergence, a global network for blended finance, notes that:

> *Indeed, blended finance transactions to date have represented a drop in the bucket compared to the promise of the potential resources available from global financial markets. ... we need to walk before we can run — and setting reasonable and right-sized expectations are key.*[39]

Figure 17 below shows that this situation is worst in least developed countries, where the need for financing is greatest, but where blended finance only brings US$ 0.37 of private finance for every dollar of public finance.

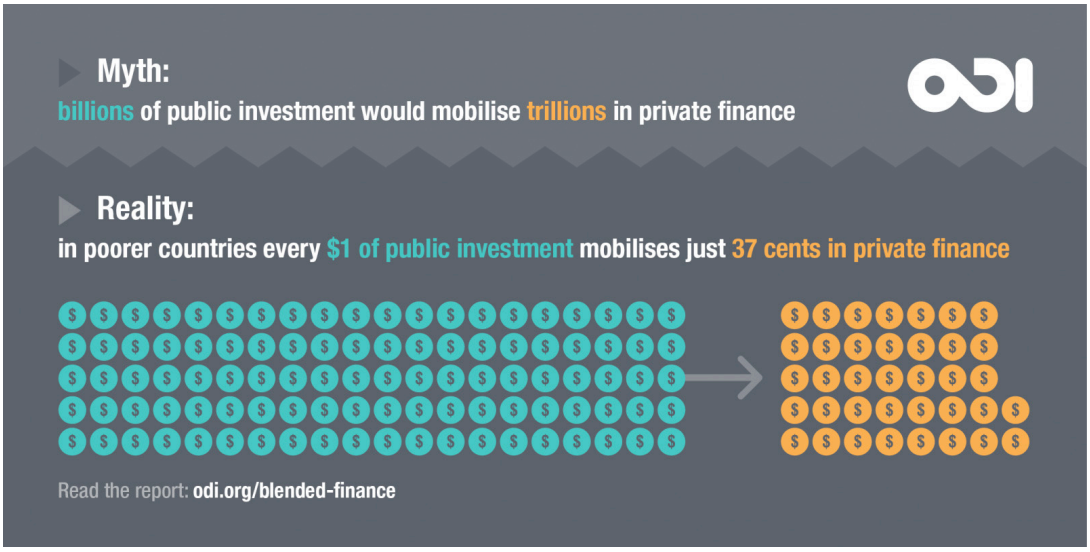
At this level of leverage, scaling blended finance solutions to trillions of U.S. dollars would require DFIs and other market participants to also originate trillions of U.S. dollars in investment opportunities, necessitating a step change in their capital and capacity from today's levels. Unless leverage ratios increase exponentially, scaling blended finance would require a step increase in sources of concessionary finance, while the scarcity of that capital is the very reason why blended finance was invented in the first place. Another difficulty is that scaling finance where it is needed most, including in LDCs, would require DFIs to take on more risk. According to ODI:

> *Low leverage ratios suggest ODF will have to play a major role in blended-finance investment. Our estimates suggest that the public sector (the MDBs and DFIs) has on average picked up 57% of the cost of blended-finance investments to date and as much as 73% of the cost in LICs...*
>
> *If blended finance is to be scaled up, ... MDBs and DFIs will need to make fundamental changes to their business models and take on riskier projects ... Conservative MDB and DFI financing models and the returns required on blended concessional finance are dampening risk appetite and the ability to engage in LICs.*[40]

As we contemplate scaling blended finance, we should also consider that there may be an optimal level of leverage between public and private capital beyond which governance

38. Ibid.
39. The State of Blended Finance. Convergence. 2019
40. See footnote 36.

FIGURE 17: LEVERAGE RATIO OF BLENDED FINANCE IN LEAST DEVELOPED COUNTRIES



Source: Overseas Development Institute.

issues for DFIs start to arise, including potential conflict with national agendas, as well as governance and legitimacy concerns. Traditionally, the work of DFIs has been funded by public sources, mostly Governments. As we increase the participation of private investors in the work of DFIs, there is a question of whether the DFIs would retain sufficient independence and legitimacy to deliver on their mission and mandate.

One solution could be to scale the blended finance market on the model of the US municipal bond market, where private investors fund public projects and administration. To some extent, DFIs are already doing that by issuing bonds based on their AAA credit ratings to support their core activities.

Potential conflict of interest and legitimacy issues can be addressed by ring-fencing private investment through use-of-proceeds mechanisms, as is now standard in green, social and sustainability bonds. Here the primary reason for use-of-proceeds clauses is not the protection of investors (although that is a secondary benefit), but rather protection of the DFI-issuers from potentially conflicting interests of private investors.

FOCUS ON TEMPORARY USE AND MECHANISMS THAT CAN BE REPLICATED COMMERCIALLY

Strategic use of blended finance should focus on solutions that can ultimately be mimicked by the private sector, so they can become self-sustaining and potentially end up un-blended over time (seeFigure 18). In this paradigm, candidates for blended finance would have a strong commercial element, and barriers to full commercial financing would be temporary. Given the strengths and limitations of blended finance, and the scarcity of public capital for development, we suggest focusing on temporary support for early-stage, high-impact SDG solutions or rectification of a systemic market failure.

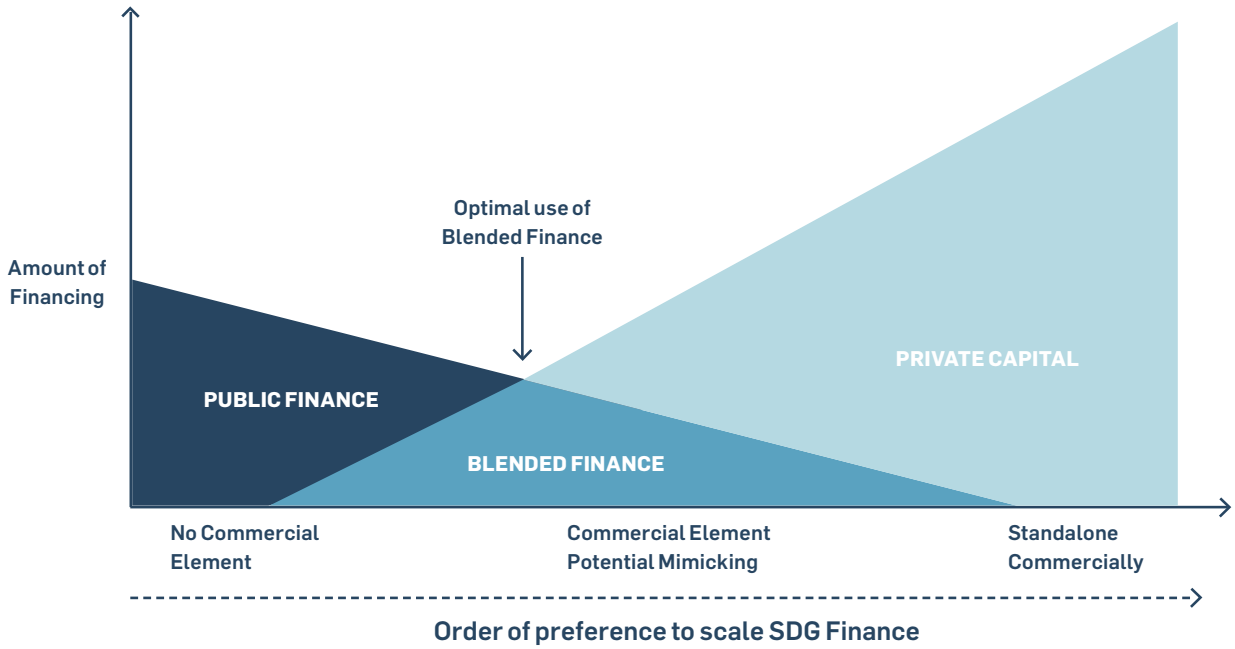
According to the Overseas Development Institute:

> *Using concessional finance to blend can help pioneer and create new markets, foster innovation and invest at the earliest stages of projects, when risk levels are at their highest and when private investors need a greater degree of risk mitigation.*[41]

Here there is parallel with venture capital, which funds critical life-stages of businesses. Like venture capital, blended finance could focus on investments with higher risk but also higher rewards if the solution it supports succeeds and scales to deliver meaningful impact.

41. Ibid.

FIGURE 18: STRATEGIC USE OF BLENDED FINANCE



PRIORITIZING USE OF PRIVATE CONCESSIONARY CAPITAL FOR BLENDED FINANCE

Consistent with the model of some development finance institutions,[42] one way to scale blended finance is to leverage private sources of concessionary capital, with scarce capital from public finance or ODA reserved for core development work. These private sources can include philanthropic foundations, impact investors and high-net-worth individuals, as these investors have a strong appetite for impact and an ability to absorb higher risk.

According to IFC, "[b]lending funds from private investors with concessional funds from donors and philanthropic sources has a strong potential to scale up investment in lower-income countries and thereby accelerate development."[43] Because there is a risk that the agenda of foundations, impact investors and wealthy individuals may not always align with country and international Government plans for sustainable development, the continued involvement of DFIs is critical, focusing less on providing concessionary capital for blending and more on providing expertise and capability to source attractive investment opportunities and commercial capital.

GOVERNANCE ISSUES

Blended finance mechanisms are often intermediated by public or non-profit organizations who either originate or select investments and source the concessional capital. These intermediaries have governance models and criteria for making investments that are neither standard nor transparent. Similarly, the investment vehicles used for blended finance have varied governance and accountability mechanisms. According to ODI's recent report on Blended Finance in the Poorest Countries:

> *Effective policy-making has been thwarted by the lack of a common official blended finance framework and poor data availability, hindering transparency and accountability, and undermining public trust in this approach. ... This is at odds with the blended-finance principles agreed by the international community.*[44]

EXAMPLES OF SUBSIDIZED CORPORATE FINANCE

US$ 700 million Guarantee for the Sankofa Gas Project by the World Bank Group, to help mobilize up to US$ 7.7 billion from private sponsors and finance a project that could potentially generate 1,000 MW of power in Ghana. See case study below.

Global Index Insurance Facility (GIIF). The World Bank Group and African Reinsurance Corporation (Africa Re) have entered into an agreement to carry out a risk-sharing facility, in the form of an experience account, to decrease premium levels for insured farmers and encourage local companies to create affordable insurance products.

IDB/GCF Energy Savings Insurance in El Salvador guarantees the financial savings of energy efficiency projects, helping small- and medium-sized businesses make investments in more efficient practices.

Bangladesh Investment Promotion and Financing Facility (IPFF) is a US$ 356 million World Bank credit line to Bangladesh Bank (the central bank) to on-lend to commercial banks for large infrastructure financing.

42. For example, see IFC, the private-sector arm of the World Bank, and IDB Invest, the private-sector development arm of the Inter-American Development Bank (IBD).
43. EM Compass, Blended Concessional Finance: Scaling Up Private Investment in Lower-Income Countries. November 2018. IFC.
44. Ibid.

SUBSIDIZED CORPORATE FINANCE

The concept of subsidized corporate finance is a partial answer to the challenges associated with traditional blended finance. It harnesses the benefits of corporate and financial intermediation by real-economy companies and banks to maximize the use of public funds as leverage for private capital, to maximize impact, and to ensure replicability and credibility of public-private partnerships.

WHAT IS SUBSIDIZED CORPORATE FINANCE?

Subsidized corporate finance refers to mechanisms where a public entity or development institution provides guarantees or other financial benefits to a company or bank to support business solutions for sustainable development. It involves the use of public finance (e.g. catalytic capital, insurance, guarantees) to support corporations operating in difficult but important markets for the SDGs, or proposing solutions where private finance is not available. This is complementary to but different from blended business models, where public funds or commitments are leveraged to create new business models.

In the development finance space, insurance and guarantees are highly effective mechanisms to leverage scarce public funds to incentivize the private sector. They can mobilize and leverage commercial financing by mitigating and/or protecting risks, notably commercial default or political risks.

The World Bank Group, through its Multilateral Investment Guarantee Agency (MIGA), has an entire practice dedicated to promoting cross-border investment in developing countries by providing guarantees (political risk insurance and credit enhancement) to investors and lenders. While MIGA works primarily with Governments, private companies often benefit from the guarantees and de-risking solutions it provides to improve emerging market investments. For example, the agency's risk insurance arm recently supported the world's largest solar power plant in Egypt by offering US$ 210 million in financial guarantees for the international companies contracted to build the solar fields.

Guarantees are also used by export credit agencies to promote export of national technologies and solutions in markets that are too risky for the private sector alone.

45. Ghana Sankofa Gas Project, World Bank Group Financial Solutions Brief, January 2018.

CASE STUDY
GHANA SANKOFA GAS PROJECT

The Sankofa Gas Project in Ghana is an example of how public-private partnerships can help finance critical SDG investments in emerging markets despite great market uncertainty, using a combination of the tools described in this paper — long-term off-take agreements, guarantees from DFIs and ECAs, FDI by multinational companies, and banking intermediation.

The Sankofa Gas Project is part of the Offshore Cape Three Points (OCTP) project that includes two major oil fields holding an estimated 131 million barrels and Ghana's first non-associated gas fields (Sankofa and Gye Nyame) with a potential production of up to 1 trillion cubic feet (Tcf) of non-associated gas.

The project was made possible by a long-term natural gas sale agreement with the downstream power sector in Ghana, overseen by the Ghana National Petroleum Company (GNPC). In addition, US$ 700 million in World Bank Guarantees (IDA and IBRD) helped mobilize US$ 7.7 billion in financing including FDI by a multinational company (ENI), credit facilities by international commercial banks (HSBC and Standard Chartered) and export credit agencies (UKEF), and political risk guarantees from MIGA.

According to the World Bank,[45] the project is expected to bring a combination of economic, social and environmental benefits for Ghana:

> *"The gas from the project will fuel up to 1,000 MW of domestic power generation, or about 40 percent of Ghana's currently-installed generation capacity. This will help improve the reliability of power services in Ghana, replacing the current use of expensive, polluting fuels (imported light crude oil) with cleaner and more affordable gas resources.*
>
> *Close to 90 percent of the net economic benefits of the project are expected to be captured directly or indirectly by Ghana through revenues for the government and GNPC (US$ 2.3 billion) and through fuel cost savings (US$ 1.2 billion). Additional indirect economic benefits of the Sankofa gas field include economic growth—as energy services improve due to increased stability of gas supply and reduced carbon emissions."*

CORPORATE STRUCTURE AS A CREDIBLE VEHICLE FOR BLENDED FINANCE

Subsidized corporate finance can leverage the corporate structure as a scalable and credible investment vehicle for the SDGs, drawing on the benefits of corporate and financial intermediation discussed in the first two parts of this paper:

- Sophisticated management and governance
- The ability to issue liquid investment products
- A track record of providing innovative solutions
- Proven delivery of financial returns
- Documented positive environmental and social impacts

In addition, profit motivations ensure that companies and private banks favor solutions that will become commercially viable after a period of experimentation. Support from the public sector is, therefore, temporary by design and focuses on mechanisms that can be replicated and scaled.[46]

Accordingly, over time, insurance and guarantees that support subsidized corporate investments can be replicated privately and scaled through commercial banks or financial institutions (seePart II, Insurance and Guarantees). For an example of a successful transition from public to private finance, see the excerpt "The successful transition from DFI funding to private capital in Chile" below.

Traditionally, de-risking solutions have been provided through public-private partnerships where a public institution (sovereign state or development bank) provides guarantees or concessionary capital to reduce the risks of a project and attract private investors. More recently, de-risking solutions have also been provided as blended capital, with contributions from either philanthropic foundations, through first-loss guarantees or concessionary capital, or via impact investors who are willing to accept lower risk-adjusted return in exchange for impact. In comparison with private financial institutions, however, states, development banks and foundations, and impact investors are limited in the amount of capital they can deploy to guarantee or otherwise de-risk a project, preventing the replication of their SDG investments at scale.

46. There is currently a debate in the development community on the best way to leverage public capital for private investment, and to improve the ratio of private-to-public capital in blended finance solutions. See Note 27.

Excerpt: The successful transition from DFI funding to private capital in Chile

Chile's power sector, which has been deregulated since the 1980s, is considered one of the most sophisticated power markets in Latin America; private investment is encouraged across the sector, including in generation, transmission, and distribution. However, the country's power sector transition to clean energy began only recently. In 2013, when less than 5% of Chile's electricity came from renewables, the government imposed a 20% renewable portfolio mandate on utilities for 2025.[1] By 2018, the share of renewables had already more than tripled to reach 18% of generation.[2]

DFIs played a critical role in nurturing the growth of Chile's renewable energy sector after its renewable mandate was introduced. The first project to break the $100 million mark was the $260 million 101MW Amanecer Solar PV project, in which the IFC and the U.S. Overseas Private Investment Corporation (OPIC) provided $212.5 million in debt.[3] Since 2013, DFIs have paved the way for commercial lenders, with OPIC, the World Bank, and the Inter-American Development Bank having cumulatively deployed more than $1 billion in project lending.[4] DFIs' presence in the market has gradually been phased out, supplanted by interest from commercial banks, which provided over $900 million of clean energy funding in 2017 alone.[5] International utilities like Enel and AES have also since entered the market, providing more of the finance by tapping their own balance sheets.

Lending from DFIs has played an important role in stimulating solar and wind production in Chile's electricity market by helping clean energy developers secure attractive financing. In the Chilean auction system, renewables compete with fossil fuel generators. In the first tender, solar and wind projects won contracts to deliver just 7% of the auctioned generation volume.[6] In the tenders held since 2018, however, renewables outcompeted fossil fuels to win 100% of the contracts on offer. In emerging markets where local financing is often limited or comes at a premium, concessional finance provided by DFIs can reduce the time needed for solar and wind to become more cost-competitive than fossil fuels by four to seven years on average.[7]

1. BNEF, Climatescope 2018: Chile country profile, 2018.
2. Martin Libra; PV Tech, accessed [31 July 2019], "Chile: Land of Opportunity for Renewable Energy," 31 October 2018.
3. Overseas Private Investment Corporation. "SunEdison, IFC and OPIC Close $212.5m Project Financing Arrangement for a 100 MW Solar Power Plant in Chile," [Press release], September 2013.
4. BNEF, Climatescope 2018: Chile country profile, 2018.
5. BNEF, Investment & Valuation — Financing Deals database.
6. BNEF, Clean Technology Fund (CTF), "Clean Technology Fund and Concessional Finance: Lessons Learned and Strategies Moving Forward," February 2019.
7. Ibid.

Source: Financing the Low-Carbon Future: A Private-Sector View on Mobilizing Climate Finance, Climate Finance Leadership Initiative, 2019, p. 56.

LINKING SUBSIDIZED CORPORATE FINANCE WITH FDI

Blending public and private finance reinforces the role of companies and banks as critical sources of financing for the SDGs in emerging markets, as described in Part I. The link between blended or subsidized finance and FDI is highlighted in the 2030 Agenda for Sustainable Development and the Addis Ababa Action Agenda on Financing for Development. Paragraph 45 of the Addis Ababa Action Agenda continues:

Internationally, we will support these efforts through financial and technical support and capacity-building and closer collaboration between home and host country agencies. We will consider the use of insurance, investment guarantees, including through the Multilateral Investment Guarantee Agency, and new financial instruments to incentivize foreign direct investment to developing countries, particularly least developed countries, landlocked developing countries, small island developing States and countries in conflict and post-conflict situations.

CASE STUDY
NGONYE 34 MW SOLAR PHOTOVOLTAIC (PV) PLANT IN ZAMBIA

This project is an example of how companies can use blended finance solution from development finance Institutions (DFIs) to subsidize foreign direct investments (FDI) for critical infrastructure in emerging markets.

In 2018, Enel Green Power started construction of the Ngonye 34 MW solar photovoltaic (PV) facility in Lusaka South Multi-Facility Economic Zone in southern Zambia. Once completed, the facility is expected to produce around 70 GWh of electricity per year, while avoiding the annual emission of over 25,600 tons of CO2 into the atmosphere.

The project, which is part of the World Bank Group's "Scaling Solar" programme, is designed to boost "the government's ambitious push to improve access to electricity throughout the country, while diversifying its generation mix, currently dominated by hydro, to hedge against severe drought and climate change effects."

The project leveraged a long-term power-purchase agreement and funding from diverse sources to tackle the financing gap for SDG investments in developing countries. Under the arrangement, the Ngonye PV plant, which is owned by a special purpose vehicle 80% held by Enel Green Power and 20% by Zambia's Industrial Development Corporation (IDC), will sell its energy to the country's state-owned utility ZESCO through a 25-year power purchase agreement.

The Enel Group and IDC signed a financing package of around US$ 34 million for the construction of the solar plant, including:

- Senior loans of up to US$ 10 million from the International Financing Corporation (IFC);
- Up to US$ 12 million from the IFC-Canada Climate Change Program; and
- Up to US$ 11.75 million from the European Investment Bank (EIB).

The financing was also made possible by allocating EUR 10 million from the proceeds of a Green Bond issued by Enel Finance International N.V.in 2018.

DEVELOPING LOCAL CAPITAL MARKETS

Scaling SDG finance in emerging markets and LDCs will involve the creation or improvement of local capital markets. As is often stated, the scale of the financing gap we face is only matched by the scale of global investment. The gap will only be closed with strong local capital markets and financial intermediation, such that both global and local investors can make direct portfolio investments in these key markets for the SDGs.

As discussed earlier, financial intermediation can trigger a local transfer of ownership of business and financial assets, heightening the impact of global investment on local economic and social development. It can also trigger a multiplication effect leading to local capital growth.

According to the UK development agency DFID:

> *[a] large body of evidence now exists which shows that financial sector development can make an important contribution to economic growth and poverty reduction. This is especially likely to be true in developing countries, whose financial sectors are likely to be particularly underdeveloped, and without it economic development may be constrained, even if other necessary conditions are met. By increasing the savings rate and the availability of savings for investment, facilitating and encouraging inflows of foreign capital, and optimising the allocation of capital between competing uses, financial sector development can boost long-run growth through its impact on capital accumulation and on the rate of technological progress.* [47]

While not a new priority for DFIs, building local markets and strengthening the enabling environment for private SDG investments is becoming more central. Indeed, IFC's new corporate strategy (IFC 3.0) focuses on creating markets and mobilizing private capital, with increased support to countries where private capital flows are inadequate to address major development gaps.[48] Similarly, one of the priorities in DFID's Economic Development Strategy is to support countries to "mobilise their own domestic resources by tackling corruption, improving tax systems, and enhancing the wider enabling environment for business."[49]

Building local capital markets has a number of other benefits, including limiting reliance on foreign debt and lower currency and interest rate risks as domestic finance is mostly done in local currencies. Also, as discussed in Part I, strong local financial markets are a resource for FDI.

Paragraph 45 of the Addis Ababa Action Agenda on Financing for Development addresses local market development:

> *Government policies can strengthen positive spillovers from foreign direct investment, such as know-how and technology, including through establishing linkages with domestic suppliers, as well as encouraging the integration of local enterprises, in particular micro, small and medium-sized enterprises in developing countries, into regional and global value chains. We will encourage investment promotion and other relevant agencies to focus on project preparation.*

47. The Importance of Financial Sector Development for Growth and Poverty Reduction. 2004. DFID.
48. See IFC's Strategic Alignment with the SDGs, https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Development+Impact/Development+Goals/SDGs
49. DFID's Economic Development Strategy 2017.

THE LINK BETWEEN FDI AND LOCAL CAPITAL MARKETS

As discussed in Part I, FDI as a source of capital in emerging markets positively correlates with the development of local financial markets. In turn, good local financial conditions allow for increased FDI because companies can secure complementary financing locally and hedge local currency risk. This is what some academics call the two-way causal relationship between FDI and local capital market development; they reinforce one another.[50]

Foreign investment also helps develop local stock markets as affiliates of multinational companies often list their shares on local stock markets. In addition, FDI inflow encourages market-friendly regulations, which promotes the development of the stock market. The existence of local capital markets can also mitigate the potential for usurpation of local financial resources when foreign affiliates raise capital locally.

Conversely, a relatively well-developed stock market helps attract foreign investors, as a sign of vitality and openness, and of a market-friendly environment. In addition, the strength and success of foreign portfolio investments can be a positive sign for multinationals considering FDI, as FDI is a longer-term and less liquid investment.

Financial FDI is also linked to local market development (seealso Part I on Financial FDI). Academic studies[51] have found that financial-sector FDI leads to improvements in and diversification of the local banking sector and better prudential regulation:

> *The institutional effects are clearer. Financial FDI from well-regulated and supervised source countries can support emerging market institutional development and governance, improve the mix of financial services and risk management tools of a host country, and potentially reduce the sharp crises associated with financial underdevelopment in emerging markets.*[52]

MOVING FORWARD TOGETHER

Realizing the dream of the SDGs of improving all lives and transforming our world for the better requires universal and transformative steps.[53] This includes modernizing the global economic and financial system to factor sustainable development and introducing financial innovation to increase the flow of capital towards the SDGs. However, financial innovation at the global level will only be beneficial in the long-term if it is translated at the country-level and intermediated through robust local capital markets, especially in emerging markets and least developed countries.

50. Causality and Externalities: Causality between FDI and Financial Market Development: Evidence from Emerging Markets. Issouf Soumare and Fulbert Tchana Tchana. The World Bank Economic Review. 2015.
51. See footnote 5.
52. Linda Goldberg. Financial-Sector FDI and Host Countries: New and Old Lessons (2004). NBER Working Paper No. 10441.
53. Transforming our world: the 2030 Agenda for Sustainable Development. Preamble. 2015.

THE TEN PRINCIPLES OF THE UNITED NATIONS GLOBAL COMPACT

HUMAN RIGHTS

1.
Businesses should support and respect the protection of internationally proclaimed human rights; and

2.
make sure that they are not complicit in human rights abuses.

LABOUR

3.
Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;

4.
the elimination of all forms of forced and compulsory labour

5.
the effective abolition of child labour; and

6.
the elimination of discrimination in respect of employment and occupation.

ENVIRONMENT

7.
Businesses should support a precautionary approach to environmental challenges;

8.
undertake initiatives to promote greater environmental responsibility; and

9.
encourage the development and diffusion of environmentally friendly technologies.

ANTI-CORRUPTION

10.
Businesses should work against corruption in all its forms, including extortion and bribery.

The Ten Principles of the United Nations Global Compact are derived from: the Universal Declaration of Human Rights, the International Labour Organization's Declaration on Fundamental Principles and Rights at Work, the Rio Declaration on Environment and Development, and the United Nations Convention Against Corruption.