



Task Force 6  
Accelerating SDGs: Exploring New  
Pathways to the 2030 Agenda



# FINANCIAL INNOVATION AND MULTILATERAL DEVELOPMENT BANKS

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# Abstract




**T**he ongoing policy debate on the global investment gap for sustainability is focusing on the mobilisation of available capital for the scaling up of investment. This Policy Brief considers to what extent international financial institutions can play a catalytic role in the effectiveness of this exercise with innovative products and proactive capacity building in the Global South. It is proposed that a financial innovation transfer channel from multilateral development banks (MDBs) to financial institutions in developing countries (estimated


balance sheet US\$ 600 billion and US\$ 9,600 billion, respectively) be opened up in five areas—i.e., loan syndications, lending facilities, private equity participation, infrastructure project de-risking, and balance sheet optimisation. The climate change agenda is an opportunity for a streamlined approach on the diffusion of financial innovation. Expected benefits are procedures-related (efficiency and access to underserved markets) and product-related (for example, with the aggregation of financial transactions supporting climate finance adaptation).



# **The Challenge**



# **1**




**W**orld leaders have committed to the 17 Sustainable Development Goals (SDGs) by 2030. An extra annual spending is required between now and 2030: some US\$500 billion in low-income countries and US\$2.1 trillion in emerging market economies. The problem of investment gaps is at the core of this challenge. Time is running short, and a series of recent crises is putting additional constraints on the mobilisation of local resources in developing countries. Policymakers are confronted with the risk of ‘perfect storms’ from geopolitical risks and tighter financial conditions, to the largest wave of urbanisation in human history, demographic shifts, and uncertain effects of a new technological age.

Furthermore, there are pandemic-amplified problems of poverty reversals, human capital depletion, food security, and climate change. Most of these will continue, and some, such as climate change, are likely to produce a long-lasting erosion of global public goods. The erosion of global public goods calls for a sustainability agenda aiming at innovation-driven solutions for the timely provision of global public goods.

Until recently, the policy wisdom for a transition trajectory in line with the Paris Agreement commitments drew upon two assumptions: (a) the impressive record of technological development in renewables; and (b) the availability of attractive profit opportunities in a market environment of low interest rates. For the Global South, the focus was on cost-sharing negotiations with developed countries for the rebalancing of the energy mix towards a more sustainable path. The slow progress was explained with either the opportunity cost of abandoning existing pollution-intensive production capacity, or by the poor performance in upstreaming good-quality transition investments.

Economists have long puzzled over why so little capital from advanced countries, with saturated capital markets and limited investment opportunities, is flowing to developing countries despite high growth potential and abundant investment opportunities. The problems with project implementation and resources mobilisation should not be underestimated. Market and coordination failures are prevalent in areas such as skills availability, infrastructure provision, and funding. The imbalance between supply and demand



of resources for the provision of global public goods is most pronounced in developing countries, where significant external financing is required.

At present, the world economy is going through a series of overlapping crises and sustainable investment projects are being affected. Before the COVID-19 pandemic, underinvestment created capacity problems in the availability of energy supply and distribution. During the pandemic, the volatility of demand undermined the flow of revenues and the market value of green projects. After the pandemic, the war in Ukraine, disruptions in gas and oil markets, and elevated geopolitical risks have triggered a new phase of regional market fragmentation in pollution-intensive sectors. In parallel, the deterioration of funding conditions is altering market conditions and performance prospects for long-term investments in climate finance.

Additional inflow of capital from commercial investors remains a challenge. Multilateral development banks (MDB) and other development finance institutions (DFI) provide annual financial commitments of around US\$130 billion to US\$140 billion

every year to low- and middle-income countries—less than 5 percent of the actual SDGs and climate investment requirements in those countries. The median sovereign risk rating of low- and middle-income countries is ‘B’. Almost all investors either cannot take or are reluctant to take ‘B’ risk— they seek ‘BB’ and ‘BBB’ risk. To mobilise private investment at scale requires industrial ‘de-risking’ mobilisation solutions to create those ‘BB’ and ‘BBB’ ratings. Against this backdrop, the biggest challenge for global financial markets today is how to channel the vast pools of savings that are now invested in fixed-income assets—as much as US\$17 trillion—to investments in developing countries.

MDBs historically had focused on infrastructure. They diversified in the 1980s to corporate investment and productivity-enhancing frameworks for industrialising countries. In the meantime, advanced countries proactively promoted innovation-driven growth, and the knowledge economy with dedicated financial instruments, in response to declining productivity. Several MDBs adopted this new cluster of instruments that required deeper knowledge of sectors and a more

sophisticated risk-taking capacity. The global financial crisis forced MDBs to move swiftly towards more systemic views in close cooperation with local financial institutions and private sector investors with capital enhancement and first-loss facilities.<sup>a</sup> Also, financial innovation found a fertile ground in MDBs with the introduction of B-Loan structures, private equity partnerships, and project financing. MDBs are currently refocusing their agenda to sustainable innovation financing, and the demand for insights from policy relevant research is expanding.

Turning to the innovation financing space, a narrow path is emerging.<sup>b</sup> From the supply side, new players have entered credit and risk capital markets, benefitting from liquidity conditions, the search for yield, and access to localised information. From the demand side, corporations with access to international capital markets are responsible for the bulk of investable projects. Ultimately, the drag from many parts of governance structures and framework conditions in these areas is weaker than the thrust of technology, and there is a compelling requirement for policy to speed up and accelerate their development.

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- a Three lessons learned from previous crises are directly relevant to the role of MDBs as accelerators of sustainable development related investment. First, policy driven investment recovery depends heavily on legacy issues (Non-Performing Loans, credibility, fiscal space). Second, data driven response delivers superior results in countries with limited policy capacity. And third, policy networks addressing coordination failures work well during adjustment processes
- b Financial innovation and innovation financing are special cases of innovation as they take place in financial institutions, primarily in the non-banking sector. Finance plays a fundamental role in technological change and innovation. The availability of financial capital and the organisation of financial markets strongly influence the way new technologies are deployed and new techno-economic paradigms emerge.




# **The G20's Role**

# **2**







**T**wo influential reports solicited by the G20 have underlined the importance of development finance institutions as catalysts in this exercise. These reports—*G20 Eminent Persons Group, 2018*, and *Boosting MDBs’ investing capacity, 2022*—offer a valuable synthesis of inputs from policy practitioners and development finance experts, and they have received strong support among G20 members. They also triggered a debate about

the business model of MDBs that is expected to produce concrete guidance to the management of these institutions later in 2023.


The proposal of this brief is to build on this momentum with a bottom-up initiative for the diffusion of financial innovations through partnerships with DFIs in the Global South and through the aggregation of bankable assets for interested investors.



# **Recommendations to the G20**

# **3**






**T**he ongoing policy debate on the global investment gap for sustainability is focusing on the extensive margin, i.e., better mobilisation of available capital for the scaling up of investment. This Policy Brief considers the intensive margin: to what extent development finance institutions can play a catalytic role in the effectiveness of this exercise with innovative products and proactive capacity building in close collaboration with DFIs in the Global South.

An international financial innovation transfer initiative in five areas is proposed: loan syndications, lending facilities, private equity participation, infrastructure project de-risking, and balance sheet optimisation. The role of MDBs in international loan syndications is well documented on tenure, risk taking, and market creation. The transfer of expertise for developing countries will deal with structural problems of scale, with aggregation techniques, and the much-required diversification to earmarked issuance supporting green transition. The use of short-term capital enhancement for increasing lending volumes as an anticyclical policy instrument is widely used by

MDBs. Drawing on this experience, they offer similar structures for targeted credit expansion in areas like energy efficiency and gender-friendly business development. Valuable experience on the design and monitoring of this experience is directly relevant to similar initiatives by DFIs in developing countries. The lack of risk capital is a long-standing problem in developing countries. The most innovative category of development finance has been structured finance, of which equity and mezzanine financing are integral parts. While structured finance has been an important fixture of private investment, it was not until the early 2000s that they were adapted for use in developing countries. In this case, the role of MDBs extends from diffusion of best practise to active collaboration with local development finance institutions.

The economic characteristics of infrastructure make it special. First, infrastructure exhibits externalities that benefit the economy, but may not necessarily benefit private investors. Second, infrastructure can be a natural monopoly and subject to regulation that comes with political risk. Third, the cash flow profile is back-loaded, risks are front-loaded, and the investment is



illiquid. Given limited public financing in most developing countries, the introduction of innovative measures to attract private sector capital will be crucial in overcoming the infrastructure financing shortfall, and the scope for a financial technology transfer channel from MDBs to local financial institutions is evident.


The universe of development banks in the Global South is vast and diverse. For the relative importance of development finance institutions in the Global South, and the opportunity cost of underutilised financial innovations, see Appendix 6. If indeed, a substantial scaling up of balance sheets is a policy priority, market-based funding products, and robust treasury management are necessary preconditions for access to capital and smart portfolio management. The scale of this undertaking and the set of required skills provide strong support to partnerships with MDBs, backed by strong commitment and policy ownership of such an undertaking.

In short, operational experience and recent research confirm that the successful diffusion of financial

innovation is synchronised with exogenous trends in commercial markets, in line with the academic literature on demand-pull diffusion, with MDBs assuming market creation roles at critical junctures. The implementation of supply-side financial innovations in response to crises and structural obstacles appears to be more challenging due to coordination failures and market fragmentation.

Turning to implementation, this proposal coincides with the debate on the reform agenda of MDBs. As part of these deliberations, shareholders will invite the leadership of these institutions to conduct a mapping exercise of internal codified knowledge in the five proposed thematic areas. With the integration of technical assistance packages, partnerships with DFIs in the Global South will establish a channel of knowledge flow for financial product structuring with credibility signalling and strong operational value added.

The climate change agenda is an opportunity for a streamlined approach on financial innovation with MDBs



focusing on dynamic capabilities and a systemic approach for the diffusion of financial innovations.<sup>c</sup> But achieving this vision requires a determined effort to understand the new reality

with new policy tools and to resolve the challenges arising from financial constraints in the provision of global public goods.<sup>d</sup>

Attribution: Anthony Bartzokas, “Financial Innovation and Multilateral Development Banks,” *T20 Policy Brief*, July 2023.

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- c The literature on the role of MDBs in loan financing, syndications and corporate bonds is extensive. The participation of MDBs in project finance increases at high levels of political risk and project finance more likely than loans. After a syndicated loan with MDBs participation, the amount, the average number of lending banks per loan and the average loan maturity increase. MDBs’ loans are not subject to moratoria, rescheduling or restrictions on convertibility or transferability of hard currency.
  - d The consensus among market participants is that MDBs financial transactions have above-average credit quality, better operational characteristics, and a market creation function.

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