High-Level Expert Group

on scaling up sustainable finance in low- and middle-income countries

Mandated by the European Commission

Final Recommendations

Executive Summary

April 2024

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FOREWORD

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COMMISSIONER
for International Partnerships, European Commission

'Sustainable finance in low- and middle-income countries has to be scaled up given the current constraints on public finance and the limited availability of concessional finance. This has been a priority of my mandate under the Global Gateway investment strategy. This report sends a strong signal to our partners that the European Commission is committed to mobilise private capital at scale for sustainable investment for low- and middle-income countries.'

Olivér
VÁRHELYI

COMMISSIONER
for Neighbourhood and Enlargement, European Commission

'Mobilising sustainable investments in our partner countries has been a key priority during my mandate. Our ambitious Economic & Investment Plans in the Western Balkans, Eastern Partnership, and Southern Neighbourhood have been instrumental in this respect. These projects are expected to foster nearly EUR 50 billion of investments in vital sectors covering our partners' development needs: sustainable connectivity, human capital, competitiveness and inclusive growth, the twin green and digital transitions, and more. These recommendations will help our partners amid the current economic and geopolitical volatile landscape to develop further.'

Kristalina
GEORGIEVA

MANAGING DIRECTOR
International Monetary Fund

'Constraints on public finance coupled with high interest rates worldwide are making it ever more difficult to close the investment gap for low- and middle-income countries. This report is a valuable contribution to the ongoing international reflection on how to mobilise private capital for these countries, and resonates with the IMF's own ongoing work in this area. The IMF will continue to work closely with the European Commission in supporting our partners in developing their capital markets, attracting private investors, and overcoming financial obstacles to secure a bright, more prosperous future for all.'

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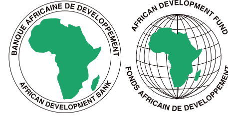

(NOT) JUST ANOTHER PAPER?

SUMMARY OF RECOMMENDATIONS OF THE HIGH-LEVEL EXPERT GROUP ON SCALING UP SUSTAINABLE FINANCE IN LOW- AND MIDDLE-INCOME COUNTRIES MANDATED BY THE EUROPEAN COMMISSION[1].

Nine years on from the global commitments to the Paris Agreement and the sustainable development goals (SDGs), and with just six years left to change trajectory, the situation has become alarming[2]. Not only are most of the targets off track, the poly-crises of recent years have undone much of the progress that had already been achieved. Many low- and middle-income countries (LMICs) require a full-scale injection of sustainable investments across the board to realise a just sustainable transition, from sustainable infrastructure to resilient agriculture, natural capital to health and education, climate adaptation to renewable energy.

The sustainability challenge is a global one, requiring global solutions that leave no one behind. The European Union (EU) has made significant commitments to sustainable development. Yet, the multiple crises (geopolitical, food and energy) coupled with critical raw material concerns are creating hurdles – to different degrees to all countries – in realising the transition. The result is a widening global gap in the finance needed for the achievement of the SDGs, estimated last year by the Organisation for Economic Cooperation and Development (OECD)[3] at USD 3.9 tn per annum.

Increasingly stretched public funds and concessional finance are clearly not sufficient to bridge this gap – but global private capital. Private investors increasingly seek sustainable investment opportunities to green their portfolios. The sustainability transition can hence represent a window of opportunity for LMICs. How can we best mobilise private capital for sustainable investment in LMICs given structural barriers to investment and in a context where private investors are increasingly deterred from investing in LMIC due to challenging macroeconomic conditions including high interest rates? According to J.P. Morgan, capital outflows from emerging debt markets recorded the worst-ever year in 2022, with almost USD 90 bn, followed by further outflows of USD 33 bn in 2023 and another USD 5 bn in the first two months of 2024[4].

1 This summary of the HLEG's final report follows on from the preliminary report published in June 2023.

2 United Nations, Secretary-General statement of 4 April 2022.

3 OECD, Global Outlook on Financing for Sustainable Development 2023.

4 Neuberger Berman, Re-Emerging Markets, 2024.

Unlocking investment from the private sector in a way that truly speaks to the growth ambitions of LMICs and enables a just, sustainable transition. This was the challenge set by the European Commission to the *High-Level Expert Group on scaling up sustainable finance in LMICs* (HLEG) in September 2022. This challenge has been keeping policymakers, NGOs, academics, financiers, investors and many others around the world occupied for years. Numerous task forces, workstreams, conferences and similar groups have pooled their participants' expertise and experience to come up with innovative solutions that will 'unlock the trillions'. The instruction from the European Commission to the HLEG was clear: not just another paper, but **proposals for concrete actions** tackling one question in particular: **'What should the European Commission do more of, less of, or simply differently'?**

#1

IS IT TIME FOR A NEW MODEL OF STRATEGIC ENGAGEMENT TO DELIVER GLOBAL GATEWAY?

Mobilising private finance in sustainable and resilient infrastructure in LMICs and ensuring sustainable supply chains can be mutually beneficial for EU partner countries and for the EU. On the one hand, advancing the development of sustainable and resilient infrastructure in LMICs can power inclusive and sustainable growth, helping to create new green industries and jobs, boosting economic resilience. For this to happen, LMICs need to invest around USD 1.5 trillion per year in sustainable infrastructure through 2030[5], which cannot be provided by public finance or domestic capital alone. On the other hand, in the EU, institutional investors' capital and increasing appetite for long-term sustainable investment can and should help. At the same time, the EU is looking for strategic partners in LMICs to diversify and secure its supply of affordable, renewable energy and critical raw materials, and partner countries can benefit from tapping into this growing demand. This twin ambition of helping LMICs develop sustainably, while creating opportunities for the EU and its businesses to invest responsibly and remain competitive, is at the heart of the Global Gateway strategy[6] – with which the European Commission pledged to mobilise up to EUR 300 bn for sustainable and high-quality projects[7].

As a first and natural step of a new transformative approach to scaling up sustainable finance, the HLEG strongly encourages:

The European Commission to develop a ***new strategic engagement model*** *with LMICs based on a* ***high-level political, economic, social, business and regulatory dialogue****, to provide a* ***coordinated EU offer****. This model should bring together key stakeholders on the partner country's side with the EU, its Member States, DFIs, the EIB, EU investors and EU businesses.*

The new proposed partnership model would turn the EU and partner countries' respective sustainable development challenges into a mutual opportunity for inclusive growth in key areas of the Global Gateway strategy. Simply put, this is about bringing together all the key players around the table so they can understand each other's priorities and identify a coherent set of actions to move together towards shared goals.

This approach would **draw on a coherent and broader EU offer** towards its partner countries, which should not just be limited to EU development tools (guarantees, budget support and technical assistance (TA)) but encompass trade, energy and industrial policy aspects. In practice, EU partner countries' governments would have the opportunity to clarify their sustainable roadmaps and related investment plans and link them with key EU priorities in a mutually beneficial spirit, allowing partner countries to benefit from EU's growing demand for sustainable products and critical raw materials. This would also help the private sector (including EU investors) see the direction of travel, figuring out which reforms and policies are necessary for local and global private investors. Thereafter, the EU

5 World Bank, Sustaianble Infrastructure Finance, 2024.

6 European Commission, Global Gateway.

7 It is important to mention that beyond sustainable infrastructure investment, which is a core issue, there is also a pressing need to mobilise capital for other sustainable development objectives.

would offer strong support for reforms, as often there are gaps in local regulation such as investor protection or sustainability regulations that hinder investment. It is also recommended that the EU shares its recent experience in building its own **sectoral transition pathways** with partner countries' governments, involving (where relevant) local private businesses.

#2

HOW CAN EU EXTERNAL FINANCIAL SUPPORT BE MADE MORE AGILE AND FIT-FOR-PURPOSE TO SCALE UP SUSTAINABLE PROJECT DEVELOPMENT?

In order to present itself as a **credible partner with whom to engage on a structured dialogue** and ensure that the new strategic engagement model is a success, the EU should assess and improve **its financial intervention capabilities**. It is important to **enhance the agility of EU instruments and select the right (combination of) tools** in order to ensure that the EU can propose to partner countries a coherent EU offer as a result of the High-Level Dialogue on sustainable investment, taking into account the various environments and different needs. Mobilising private capital is increasingly a central tenet of EU external action under the Global Gateway strategy. However, the European Fund for Sustainable Development Plus (EFSD+), the financing arm of Global Gateway, is not deployed in tandem with such a high-level policy dialogue.

While guarantees and blending operations are an effective instrument to support private capital mobilisation, no amount of de-risking for private investors can make up for lack of investor protection at country level. Guarantees and blending operations must be complemented by technical assistance aimed at filling regulatory gaps and supporting public institutions.

In the spirit of a mutually beneficial partnership and to ensure its financial support is more effective, impactful and relevant to the needs of the countries for their sustainable transition, the European Commission should closely ***link its financial offer to the High-Level Dialogue on sustainable finance and investments****. This requires the EU to enhance the* ***agility and capacity of its EU external financial support*** *while selecting the most effective (combination of) EU budgetary instruments in mobilising private capital, adapted to the context.*

As part of the new partnership model, the HLEG also encourages the EU to provide its support more coherently along the whole project lifecycle and investment chain while involving private investors in a timelier way. One of the main expected outputs of the High-Level Dialogue should be the identification of priority investment areas in which the partner country and the EU agree to collaborate. However, much more is needed to translate those investment priorities into pipelines of **bankable sustainable projects**. For example, in Sub-Saharan Africa (SSA) today, 80% of infrastructure projects fail at the earlier stages of development[8]. How can the EU further – and better – support LMICs in actually bringing to life sustainable infrastructure projects with high potential, including by supporting them in their earlier stages? Through **coordinated and effective support for project preparation**.

Today, there is a landscape of numerous fragmented project preparation facilities (PPFs). However, these PPFs do not always cover the very early stages of project preparation and have often limited private sector involvement, so there is clearly room to efficiently coordinate and pool efforts to both achieve scale and increase project take-off. The European Commission should step up its efforts to support sustainable project development through their lifecycle. With this in mind, the HLEG believes that...

8 McKinsey & Company, Solving Africa's infrastructure paradox, 2020.

*The European Commission should create a **single EU digital platform for sustainable projects** in LMICs, which would help coordinate and manage the development of sustainable projects **through their lifecycle**, from their onset to their closure, allowing timely access and involvement of key relevant actors and EU instruments to strengthen and scale up collective action. It would act as a **single entry point** for all stakeholders and provide clarity on sustainability aspects of the projects.*

This digital platform would complement the new engagement model by translating political priorities into concrete actions. The tool could bring added value by making accessible to all stakeholders key data on the sustainability aspects of the projects. It could also be used to share standardised processes and contracts that are developed to provide clarity and protection for investors and end-beneficiaries.

Finally, the HLEG encourages the European Commission to work with DFIs and Multilateral Development Banks (MDBs) to explore how local capital markets can be leveraged to mobilise more private capital as well as support countries to build the ecosystems of financial intermediaries required. **DFIs and MDBs are well positioned to help unlock much needed private capital at local, EU and international levels**, given their long-standing experience and in-depth understanding of risks and opportunities in investing in LMICs.

However, to date, DFIs and MDBs have overall mobilised limited private capital with insufficient de-risking mechanisms, and sometimes even crowded out private capital. This is due to various reasons, including their business models, incentives structure and mandate which traditionally centered around **direct loans and grants for development**. This is highlighted in the ongoing MDBs reform discussions, in which crowding-in private capital as well as ensuring additionality of operations are critical issues. Therefore...

*The European Commission should call for **MDBs** to adjust their **mandate, business models and incentive structures** to enhance at scale private sector mobilisation for SDGs, including climate actions.*

*Further, the European Commission should call on EU Member States to reassess and reform their national **DFIs' mandate, business models and incentive structures** with respect to private sector mobilisation objectives, working together under a Team Europe approach.*

#3

WHAT INNOVATIVE INSTRUMENTS ARE AVAILABLE TO INCREASE FISCAL SPACE FOR SUSTAINABLE INVESTMENTS?

Looking at public finances in LMICs, many countries are currently suffering from the effects of several consecutive and concurrent crises. Interest rate hikes, global inflation, high levels of indebtedness – they all have taken their toll and many LMICs do not have sufficient fiscal space to fulfil the critical public function of funding new or existing infrastructure. Hence, increasing fiscal space is the order of the day, with the International Monetary Fund (IMF) and World Bank seeking solutions for meaningful debt restructuring/debt relief and enhancing domestic revenue mobilisation.

In the context of its mandate, the HLEG looked in detail at commercial debt-for-nature swaps (DFNS)[9], concluding that in most of the cases, DFNS prove to be very complex, lengthy and costly requiring a disproportionately high amount of guarantee from donors as compared to the policy (environmental) impact achieved. Having said that, there is no one-size-fits-all solution, and each country might require a tailor-made approach addressing its unique debt issues and sustainable investment challenges.

The HLEG members have also analysed alternative approaches deserving attention and with the potential for the private sector to play a role, such as **asset recycling, especially through the use of securitisation and asset-backed securities (ABS)**.

Asset recycling aims to monetise the value of existing infrastructure assets, and reallocate the unlocked resources to new sustainable investments, without increasing public debt. There are different models such as via concession or lease and through securitisation.

Asset recycling has the potential to bring (local currency) private investment at scale, promoting local capital market development and prompting governments to thoroughly evaluate the value and potential of their existing – natural and manmade – assets. That by itself can be a beneficial exercise.

As always, there is a price for these benefits, and asset recycling mechanisms such as securitisations can be complex (and hence costly) to structure, and may require a robust monitoring system and oversight. Critical success factors include high quality underlying assets (which are not of strategic importance), relatively developed capital markets and institutional investor basis and appropriate regulatory and institutional environment[10].

Some public assets, such as state-owned power generation facilities, may require transition finance to decarbonise (including in hard-to-abate sectors) or adaptation finance to strengthen their resilience to climate change (e.g. for transport, water or energy infrastructure). Here **green securitisation** can provide an opportunity to mobilise support, including finance and technical assistance to transform those assets.

Some LMICs are already exploring securitisation to offload their assets to the private sector, thereby transferring risk away from themselves and freeing up their balance sheets[11]. This is also an effective means to **help make infrastructure a liquid asset class**, whereas traditionally the long investment timeframe and high upfront costs have kept infrastructure assets rather illiquid. With this in mind, the HLEG believes that…

*The European Commission together with MDBs, including the World Bank, the IMF and DFIs, should set up a bold initiative to **support sustainable asset recycling and securitisation** (asset-backed securities) in LMICs, where appropriate, to create the fiscal space needed for their sustainable and resilient infrastructure investments, and assist them in the effort to make sustainable infrastructure a liquid asset class.*

9 DFNS, in brief, are debt relief in exchange for the debtor's commitment to invest in nature / climate / SDG projects.

10 International Finance Corporation, African Development Bank, Making Finance Work for Africa Partnership, Gauging Appetite of African Institutional Investors for New Asset Classes, 2022.

11 Arun, A., Securitizing the Transition, The Polycrisis, 2023.

#4

WHAT INNOVATIVE INSTRUMENTS ARE AVAILABLE TO SUPPORT CLIMATE RESILIENCE AND DISASTER RISK COVERAGE?

Beyond enabling sustainable infrastructure investments, **preserving fiscal space is also closely linked to countries' ability to build resilience to climate change**. Analyses have demonstrated that climate change – both physical and transition risks – could for the most vulnerable countries risk further deteriorating their fiscal situation and reduce sovereign creditworthiness.

While a climate protection gap exists in advanced economies as well, such gap is of particular concern for LMICs. To illustrate the striking situation: the Vulnerable Twenty (V20) countries have lost already one fifth of their total wealth since 2000 and 98% of its 1.5 billion people do not have financial protection against climate-related events[12]. Notably, these risks affect disproportionately children and women.

If governments, businesses and households are not adequately protected against the financial costs of climate-related risks, the possible impacts on economic and financial stability can be extremely severe. This is why **loss and damage** and **climate justice** have become so high on the agenda of policymakers and in international climate negotiations, leading to the launch of the *Global Shield against Climate Risks* at COP27, which is intended to provide swift and pre-arranged financial support in times of climate disasters[13].

Among this widespread reflection, the HLEG looked at various examples of insurance and other risk financing currently being rolled out to see what could have the potential to maximise risk distribution and **attract private capital at scale**. Insurance, and insurance-based instruments like catastrophe bonds (CAT bonds) and risk pools, effectively share (or redistribute) risk globally, allowing the insured to access predictable and cost-effective finance when disasters strike, so building resilience.

Regional risk pools offer parametric insurance to their members, which are attractive as they can offer lower-cost coverage, technical assistance, as well as an explicit link to resilience and adaptation plans. As regards to CAT bonds, while they do not necessarily decrease the cost of insurance, they do provide access to a large base of private investors and thus have the **potential to achieve scale**. Another particular advantage is that the funds are available upfront from the issuance of a CAT bond, unlike in traditional insurance where the country would have to wait for the payout in the case of a trigger event.

Of course, insurance in no way replaces mitigation and adaptation: losses, even if spread out, are still losses and an insurance payout will itself not save a life or prevent assets being destroyed by a flood or typhoon. However, insurance can be instrumental to enable and accelerate wider adaptation investment through using insurance to de-risk adaptation finance and create incentives for resilience at the project-level. Higher resilience to climate risks also indirectly strengthens the overall investment climate of the country.

Hence, the HLEG encourages the European Commission and EU DFIs to work with MDBs and LMICs in the context of their national disaster risk management plans to facilitate **combined 'insurance and adaptation finance'** solutions. This would address a major gap in current global facilities, which support insurance but not adaptation. The EU can fill this gap and show leadership in advocating for a stronger focus on insurance as a way, not just to provide financial protection, but also to scale up adaptation finance. Notably, the European Commission and EU DFIs can provide **calibrated premium support** for the insurance (e.g. support that is conditional on making adaptation investments), as well as de-risking of the adaptation investments and suitable TA to support the beneficiary. In light of these elements, the HLEG concludes that...

12 V20, Climate Vulnerable Economies Loss Report, 2022.

13 German Ministry for Economic Cooperation and Development, V20 and G7 jointly launch Global Shield against Climate Risks at COP27, Joint press release of V20, G7 and the German Ministry for Economic Cooperation and Development, 2022.

*In order to address LMICs' financial vulnerability to climate change-induced disasters in a context where many are not insured and already have limited fiscal space, the European Commission should allocate dedicated resources to **disaster risk financing** for LMICs, and support the uptake of instruments such as CAT bonds and risk pooling. In doing so, the Commission should **explore approaches to combine insurance and adaptation/resilience financing** and integrate a resilience lens across MDBs' and DFIs' investments.*

#5

HOW TO CHANNEL FINANCE INTO OTHER CHALLENGING SUSTAINABILITY OBJECTIVES? PART 1 - SOCIAL FINANCE

In addition to sustainable infrastructure, LMICs have other key sustainability objectives for which it is challenging to channel (private) finance. Social SDGs currently receive the lowest levels of funding compared to other development goals[14]. In fact, it is estimated that many LMICs may not be able to cover even half of their social assistance costs through public finance alone by 2030[15]. Hence, **the HLEG looked into what it would mean, and what it would take, for private capital to be mobilised to address social challenges in LMICs**, from health, housing, and basic infrastructure to food security and socio-economic advancement.

One – rather straightforward – approach discussed in the HLEG involves assessing social impact and **mitigating social harm in all investments**, regardless of the investment's particular goal. Several measures are already used by regulators and practitioners to apply this approach: e.g. setting specific do no significant harm principles or minimum social safeguards in corporate governance and sustainability-related disclosure requirements, introducing exclusion lists in sustainability frameworks, and/or conducting risk assessments to assess a company's 'social risks'.

The second approach that the HLEG discussed, which was how to mobilise private social finance, through **actively funding activities with a substantial positive contribution to social objectives**, proved to be more complicated to assess. First, mobilising private funding for social services can lead to imperatives to generate enough revenue to satisfy the expectations of private investors, sometimes leading to **unintended consequences**, leading to further exclusion and inequality, such as when privatising universal education or healthcare. Second, while the SDGs set out our social goals at high level, there is no shared understanding of specific social objectives, risks and indicators, and how specific economic activities can contribute to each of them. Environmental objectives and criteria can be rooted in environmental science, but social objectives are often qualitative and context/country specific.

While there are ongoing regulatory developments such as the creation of 'social' taxonomies and other reporting frameworks, with greater development in LMICs than in advanced economies, the markets are moving, and financial instruments are growing in parallel (e.g. social bonds and gender bonds). In particular, social bonds have become more and more popular in recent years, **and greatly increased as a reaction to the Covid-19 pandemic**. The global issuance of social bonds to fund social initiatives increased to approximately USD 150 bn in 2020 (a growth of 720% compared to 2019)[16]. Moreover, the EU issued EUR 98.4 bn in social bonds under the SURE instrument to combat the economic and social consequences of Covid-19. However, so far **this is a concentrated market with a prevalence of supranational, sovereign and agencies as the main issuers**, potentially pointing to a limited role for private issuers due to the challenges noted above.

14 Environmental Finance, Sustainable Bonds Insight, 2023

15 Evans, M. et al., Financing social assistance in lower-income countries post-Covid-19, ODI Working Paper, 2023.

16 Asian Development Bank, Social Bonds—Recent Developments and Trends, Asia Bond Monitor March 2021.

Given the relative infancy of social private finance and the potential unintended consequences of privately funding the delivery of social services in certain sectors, the HLEG calls on the European Commission to avoid a general 'one-size-fits-all approach' but rather to ***assess the suitability of mobilising private social finance*** *through EU support,* ***on a case-by-case basis****. The HLEG also recommends providing* ***technical assistance*** *and funding* ***research*** *on measuring social impact and risk accurately. In parallel, the Commission should continue to explore the merits of supporting mature areas of social financing, such as mobilising private finance through sovereign, sub-sovereign or other public sector issuances of social and sustainability bonds.*

#6

HOW TO CHANNEL FINANCE INTO OTHER CHALLENGING SUSTAINABILITY OBJECTIVES? PART 2 – NATURE FINANCE

Another sustainability objective in LMICs, for which bringing private finance is challenging, although for different reasons, is the protection and restoration of natural capital. The HLEG specifically looked at the potential of carbon markets and biodiversity instruments as a means to bring more nature finance into LMICs, recognising that there is not a 'one-size-fits-all solution'. Indeed, LMICs have different needs and face different challenges; e.g. while carbon markets that focus on emissions reduction might be more relevant for large industrialised LMICs that need to prioritise transitioning away from high emissions, they are less so for smaller emitters that rather require support to preserve their biodiversity hotspots and carbon sinks.

As for carbon markets, several LMICs have already recognised their importance and have either implemented them or initiated preliminary steps. Currently, carbon markets in LMICs are growing in Asia and Latin America and tend to be on a voluntary basis. Only a very limited number of LMICs have adopted compliance carbon markets similar to the EU Emissions Trading System, which are regulated and require mandatory participation of specific economic sectors. Concerns about quality and greenwashing, as a result of a lack of strong regulation, transparency, high integrity, and accountability, have recently slowed the progress of voluntary carbon markets.

The HLEG notes that for many countries, carbon markets may not provide a solution to help channel sustainable finance flows to nature protection and preservation. The growing area of biodiversity finance can offer the needed alternative financing mechanisms for biodiversity-beneficial projects. In this respect, **biodiversity credits have the potential to encourage investments in natural capital, especially in biodiversity-rich LMICs. However, the biodiversity credit market is still in its early stages and faces certain challenges**, including the need to establish methodologies for internationally recognised biodiversity units, set up pricing mechanisms and adopt regulatory and integrity safeguards, including those related to additionality. However, even after overcoming these initial challenges, developing a functioning market will require further policy measures, such as setting mandatory disclosure targets and establishing compliance markets. It should also be noted that the additionality criterion tends to make some biodiversity projects, such as conservation and preservation activities, ineligible for biodiversity credits markets thereby requiring other support mechanisms.

In short, while carbon and biodiversity credits offer valuable opportunities for financing natural capital in LMICs, they also come with limitations, and might only be available as a medium-term solution. Therefore, the HLEG believes the European Commission should also explore alternative methods such as the '**landscape approach**' (or Integrated Landscape Management), under which land is managed holistically in a way that simultaneously considers not only social, and environmental objectives, but also economic drivers,

thereby providing **attractive business opportunities** to the private sector. There are already successful projects in LMICs (such as the Great Green Wall Initiative of the African Union, and the Gabon Special Economic Zone) that use a landscape approach, demonstrating its potential for driving sustainable development using a mix of public and private finance. In addition, **sovereign green bonds covering nature and biodiversity projects offer another innovative avenue for leveraging capital for conservation efforts**. For instance, the Seychelles issued the world's first blue bonds dedicated to marine conservation, directing funds towards marine protected areas and sustainable fisheries management. Nature as infrastructure and Nature-based Solutions (NbS) constitute another area where the support of nature finance could realise their full potential in protecting, conserving, and restoring nature. Therefore, against this background…

*The European Commission, together with DFIs and MDBs, should help LMICs tap into more private finance for restoring their **natural capital**, through scaling-up high-integrity **carbon and biodiversity credit markets**, and for preserving natural capital building on the **landscape approach** and other **innovative financial mechanisms**, including bonds related to the conservation of biodiversity.*

#7

HOW CAN THE EU HELP BOLSTER THE SIZE AND DEPTH OF LOCAL CAPITAL MARKETS?

The HLEG believes that more efforts are needed to build robust and liquid capital markets in LMICs, as they can serve to attract the needed private capital at scale from domestic and international sources, foster sustainable economic growth and assist LMICs in diversifying their sources of financing for a sustainable and fair transition. Today, the majority of local capital markets in LMICs lacks the requisite size and liquidity, as well as the requisite regulatory building blocks. Of the major stock exchanges, 15 collectively represented 70% of the total market capitalisation – none of which were located in Africa or Latin America. In the emerging markets, the largest exchanges are concentrated in China[17]. Further, only a small share of the sustainability-related instruments traded worldwide are listed on LMICs securities exchanges.

While acknowledging the work done in this area by regional development banks, MDBs including the World Bank, the IMF and EU Member State organisations, **only a few EU-driven actions**, including policy dialogue on structural reforms, **focus directly on fostering local capital market development in LMICs**. It is therefore urgent to step up the efforts in this area.

*The European Commission should step up its support to help partner countries put in place the **building blocks** and legal reforms, underpinning the development of **well-functioning local capital markets** (including insolvency laws, prudential rules, market transparency and market integrity safeguards, investor protection, market supervision). The European Commission should also set up a **dedicated exchange programme** gathering capital markets experts from both the EU and LMICs.*

Green, social, and sustainability (GSS) bonds[18] in LMICs have experienced growth in recent years (witnessing a nine-fold increase between 2014-2017 and 2020-2023). However, despite this expansion, they continue to account for only about 4%[19] of the global GSS bond market. Moreover, **this recent growth** hides significant variations across LMIC regions, **mirroring the different maturity of local capital markets**. Between 2020 and 2023, almost half of LMICs' issuances (excluding China) took place in Asia-Pacific, followed by the LAC region. **SSA is strongly lagging behind**, with less than 4% of LMIC issuances[20].

17 G7 Impact Taskforce, Mobilising institutional capital towards the SDGs and a Just Transition, 2021. Data as of June 2021.

18 GSS bonds are fixed-income debt instruments with a use-of-proceeds mechanism focusing on activities or assets with a sustainable purpose. The HLEG follows the same definition as in OECD, Green, Social and Sustainability Bonds in Developing Countries: The Case for Increased Donor Co-ordination, 2023.

19 Data provided by the Luxembourg Stock Exchange, 2024.

20 HLEG computations based on the CBI database.

The HLEG believes that GSS bonds, particularly green bonds, have a huge potential to redirect international and local capital towards sustainable investments in LMICs. **GSS bonds are more liquid** compared to direct investment into sustainable infrastructure projects and so **are preferred by many investors. For sovereign issuers**, issuing GSS bonds sends a strong signal about their commitment to meet the Paris Agreement, the Kunming-Montreal Global Biodiversity Framework (GBF) and the Nationally Determined Contributions (NDCs) as well as the SDGs.

GSS bond markets in LMICs however face **major challenges, on both the demand and the supply side**. For EU and international investors, demand challenges include the risk-return profile, the lack of information, including on ESG, and the related potential reputational risk of greenwashing. For LMIC issuers, the supply-side challenges include the lack of sustainable project pipelines and the expertise to issue GSS bonds, particularly for first-time issuers, and the associated higher issuance costs as compared to conventional issuances. To help LMICs tap into the potential of these instruments…

The European Commission should, in a Team Europe approach that pools resources together for higher impact and efficiency, launch a ***bold and transformative initiative*** *to support the development of GSS bond markets, and in particular green bond markets in LMICs, addressing the challenges at both sides of the investment chain, i.e. investors' and local issuers' sides.*

Being the world leader in green bond issuance, the EU is best placed to launch a bold and transformative initiative to coordinate efforts and pool resources to support the development of GSS bond markets, and in particular **green bond markets**, in its partner countries. Such an initiative would bring strong coherence between EU internal and external policies, putting in place a concrete building block of the Global Gateway. The initiative should rely on a de-risked public-private fund to attract EU and international investors at scale and include a TA programme contributing to reinforcing the partner country's local capital market ecosystem, including through capacity building to securities exchanges and bond issuers. The initiative should also explore avenues to offer coupon subsidisation for affordable debt servicing costs, where appropriate, and to cover the extra costs associated with the issuance of green bonds versus vanilla bonds (such as monitoring, reporting, third-party verification). Last but not least, the initiative should support the relevant frameworks for green bond issuance locally.

Beyond GSS bonds, within the broader sustainable bond universe, **sustainability-linked bonds** (SLBs) have recently gained some traction mostly in advanced economies. However, given uncertainties and concerns notably regarding the risk of greenwashing, the HLEG believes it is needed to **further scrutinise SLBs** before supporting their development at scale.

What else can the EU do? It could also promote the development of local currency sustainable financial products. This can also reduce countries' **exposure to exchange rate volatility**. This becomes even more pronounced in environments characterised by **inflationary pressures and rising interest rates**, particularly for governments grappling with high deficits and limited fiscal space. Furthermore, local currency financing helps diversify funding sources and strengthen resilience to external shocks.

To foster fully-fledged local capital markets in LMICs, the European Commission should support local currency-denominated sustainable financial instruments and, to that end, consider establishing a sizeable ***local currency sustainable finance facility*** *to be funded in local currency in a way that it reduces its FX exposure, relying on the presence and appetite of (notably local) institutional investors.*

#8

HOW TO ADDRESS THE QUESTION OF RISK-RETURN FOR EU INVESTORS VS. THE COST OF FINANCING FOR BENEFICIARIES?

In a context where the domestic institutional investors' base in LMICs is largely insufficient, the HLEG focused on what the EU can do to better mobilise EU institutional investors at a large scale. Currently only a very marginal portion of EU insurance companies and pension funds' assets are invested in LMICs, approximately 2%[21], most of which (around 85%) is concentrated in upper-middle income countries in Latin America and Caribbean (with top 3 countries being Mexico, Brazil, and Colombia), and Asia-Pacific (with top 3 countries being China, India, and Indonesia), leaving out lower-income countries such as in Sub-Saharan Africa.

Data shows that when investing in LMICs, institutional investors prefer to invest in fixed income products and invest through funds (indirectly). Funds offer a sizeable ticket– achieving the needed scale – as well as liquidity, diversification, and cost savings for research and due diligence.

Taking into account these preferences of institutional investors, DFIs/MDBs have started to launch innovative **financial structures through de-risked public-private funds, where DFIs/MDBs** absorb the first losses **through investing in junior equity to cover part of the risks private investors are not willing/able to take**.

What makes these structures stand out is their leverage on the **expertise of DFIs and asset management companies**; DFIs contribute with in-depth knowledge of LMIC markets, while asset management firms bring an institutional client network and the expertise to establish and manage the funds. Hence, the HLEG believes **de-risked public private funds have a huge potential to further mobilise EU institutional investors into LMICs, if the hurdles that prevent them from reaching scale, replicability and speed are addressed**.

In particular, European national supervisors have reclassified most of these de-risked public-private funds as non-STS[22] securitisations, making them fall into an asset class under the EU prudential framework that imposes substantial prudential costs (capital charges) notably for insurance companies and DFIs[23]. This greatly diminishes the funds' attractiveness and undermines the intended objectives they are meant to achieve. To illustrate, for an insurance company investing in the senior tranche (BBB-rated) of such de-risked fund can counterintuitively be twice as costly in terms of capital charges than investing directly in a LMIC regular equity fund, despite the higher inherent risk of equity[24].

Additionally, de-risked funds display an excessively prolonged time-to-market of at least 18-24 months, compared to just a few months for traditional funds; this stems from DFIs' and asset managers' processes, as well as the challenge of finding an appropriate balance between commercial interest and policy objectives. In this respect, standardisation could help, as it would offer **clear and consistent information**, particularly regarding risks, facilitating timely and well-informed decisions by both private and public investors.

21 HLEG computations using EIOPA's aggregated data provided on the basis of the 2022 reporting of all EEA solo insurance and reinsurance companies subject to Solvency II; and on the basis of the 2022 occupational pension funds reporting covering EU countries that comply with the EIOPA Decision. Combinations reported by less than three entities were deleted from EIOPA dataset for confidentiality reasons.

22 STS is defined in EU's Securitisation Regulation 2017/2402 and stands for 'Simple, Transparent and Standardised'.

23 Those under the scope of the EU's Capital Requirement Regulation 575/2013.

24 These differences in capital charges do not apply to insurance companies using internal models.

Another critical aspect is the sustainability challenge. Specifically, the **lack of ready-to-invest strong and credible pipelines of green/sustainable projects** in LMICs is a key issue for these funds targeting sustainable assets. For this reason, it is crucial that these efforts are supported by a robust technical assistance program aimed at overcoming this challenge.

*In order to mobilise at scale EU institutional investors, the European Commission should support innovative financial structures based on **de-risked public-private funds** by creating the conditions for those funds to flourish: in particular, providing clarity and confidence to investors and broader stakeholders about the key features of this type of structures in terms of risks, capital requirements and sustainability criteria. To do so, it is recommended to recognise de-risked public-private transition and/or sustainable funds in LMICs appropriately in the EU financial legislation through **a dedicated EU legal framework**. Such framework should also ensure that EU prudential treatments accurately reflect the associated risks, taking into account the de-risking mechanism of the structure and the quality of the underlying assets.*

Next, the HLEG also approached the risk-return equation from the perspective of the LMIC borrowers. Specifically, key hurdles for LMIC borrowers include their very high debt servicing costs. The HLEG asked itself two questions: ***First, is there a high perceived risk in Africa?***

When comparing bonds (with the same characteristics and ratings) issued by LMICs and advanced economies, it appears that LMIC issuers are charged on average 78 basis points (bps) more at issuance[25]. Zooming in geographies, SSA stands out as facing the highest financing costs even when compared to its peers. Proving the point, a recent IMF study[26] highlighted that SSA countries pay significantly higher coupons at issuance and higher refinancing costs in the secondary market compared to their peers from other regions. Is this gap justified? The IMF study tried to address the question and suggests that the difference is accounted for by structural factors such as the transparency of the country's budget process, the size of the informal sector, the level of financial development, and the quality of public institutions[27].

In contrast to this, SSA policymakers and investees stress the often-insufficient SSA in-country knowledge and expertise of EU investors. They emphasise the **importance of having a deep understanding of the political context and macroeconomic environment** of SSA countries.

In parallel, **credit ratings** provided by the Big Three Credit Rating Agencies (CRAs) can prove instrumental for SSA sovereigns and corporates to attract at scale EU and international investors, because the latter mostly rely on them.

This leads us to the **second question** of the HLEG: ***Is there a bias in the assessment of CRAs?*** Many SSA policymakers such as the **African Union** with its African Peer Review Mechanism (APRM) have been **repeatedly disputing the assessments made by the Big Three CRAs** claiming that they 'continue to make significant errors in their ratings'[28]. SSA policymakers stress the lack of expertise, limited physical presence on the ground, lack of methodological transparency, the leniency towards advanced economies and severity against LMICs, as well as a lack of competition in the CRA market. Indeed, the African Union has called for the establishment of a **Pan-African credit agency** to counter these issues.

The Big Three CRAs, on the other hand, claim the accuracy and fairness of their methodologies applied indistinctly to all countries. Aligned with this view, a recent Financial Times opinion piece[29] has examined observed default episodes that have occurred in the past and compared the pre-default ratings: 'the default data shows that default rates of African sovereigns are higher at each rating level than that of their global peers. Africa's ratings have been too high, not too low' – hence claiming the absence of a negative bias.

25 Panzica, R. and Fatica, S., The determinants of bond yields at issuance, Study by the European Commission's Joint Research Centre for the HLEG, 2023.

26 Gbohoui, W., Ouedraogo, R. and Some, Y.M., Sub-Saharan Africa's risk perception premium: in the search of missing factors, IMF Working Paper 23/130, 2023.

27 *Ibid.*

28 Africa Peer Review Mechanism, Africa Sovereign Credit Rating Review, 2023, Mid-Year Outlook, 2023.

29 Kraemer, M., African criticism of credit ratings is a red herring, Financial Times, January 19, 2024.

Without taking a position on the debate regarding the accuracy of credit rating assessments by the Big Three CRAs, the HLEG is of the opinion that the European Commission should accompany LMICs who wish to engage in the ***analysis*** *and* ***credit rating assessment****, helping them to provide the necessary information, including on local context, throughout the process.*

Finally, the creditworthiness itself, and hence the final credit ratings, of sovereigns notably in SSA can solely be improved by addressing the countries' macroeconomic fundamentals and related risks, including political risks and availability of data. To achieve these long-term objectives...

The European Commission should continue to provide ***budget support*** *for the needed* ***structural reforms*** *in LMICs, in order to tackle sub-investment grade credit ratings and improve LMICs' creditworthiness, addressing the countries' macroeconomic fundamentals and related risks and improving availability of data.*

The HLEG has also identified the need to explicitly address foreign exchange (FX) risk. The high **FX risk and related prohibitive hedging costs** are a significant burden that LMIC borrowers are often left to bear to attract EU investments, a problem which has become even more pressing in the current macroeconomic context of higher interest rates and inflation. EU institutional investors have a strong preference for hard currency-denominated investments also when investing in LMICs, while even in the sphere of development finance, about 80%-90% of DFI/MDBs loans are still provided in hard currency[30]. The cost of hedging, if any is offered on the market, is prohibitive mainly due to the **lack of liquidity associated with money markets in frontier countries**.

The HLEG does not believe in a silver-bullet solution. Instead of pursuing a 'quick fix,' the analysis and reflections from the HLEG emphasise the importance of tackling the underlying causes contributing to the systemic high FX risk in LMICs. This is a long-term journey, which requires collaboration and partnerships with local market authorities such as central banks.

Meanwhile, a crucial shift from current practices in development finance, wherein funding is provided in hard-denominated currency, is essential to move towards a more equitable distribution of FX risk between donors and beneficiaries. Effective solutions need to be found to reduce the high foreign exchange risk and its prohibitive cost of hedging. The HLEG believes that more efforts should be done in this area, by relying on a pool of stakeholder experts in the topic of FX risk in LMICs.

In order to address the root causes of systemic high FX risk in LMICs and the very prohibitive cost of hedging, the European Commission should support the necessary regulatory reforms to restore macro-financial stability and to deepen the local capital market, broaden domestic financial intermediaries and investors, enhance transparency and governance and strengthen legal frameworks in LMICs. In addition, in order to explore and develop adequate FX solutions the HLEG recommends the European Commission to ***rely on the input of public and private sector experts in the field of FX in LMICs through a dedicated Taskforce****.*

30 International Growth Centre, Mitigating foreign exchange risk in local currency lending in fragile states, 2023.

#9

WHAT IS NEEDED TO FOSTER CREDIBLE AND INTEROPERABLE SUSTAINABLE FINANCE FRAMEWORKS IN LMICS?

In order to **finance green activities**, there is a need for credible and interoperable sustainable finance frameworks. Indeed, as appetite for sustainable investment with impact has increased significantly in the past five years, so too have sustainable finance frameworks proliferated across the globe, including in LMICs. These frameworks can help facilitating informed investment decisions, avoid greenwashing, and scale up sustainable investments, also by clarifying sustainability criteria for project developers.

At the core of most (regulatory) sustainable finance frameworks are classification systems – or **taxonomies** – that determine what economic activities or investments can substantially contribute to sustainability goals. The objective of such classification systems or taxonomies is to provide transparency and clarity on which investments are aligned with the countries' ambition to meet the Paris Agreement objectives, the Kunming-Montreal GBF goals and/or the SDGs. However, with at least 37 taxonomies initiated globally[31], and multiple and diverse principles, standards, labels and disclosure requirements, there is increasing risk of fragmentation and unnecessary complexity. As such, **interoperability** is key to enhancing the uptake of sustainability by project developers, promoting cross-border capital flows towards sustainable investments and reduce costs (including ESG comparison costs).

To date, it can be very challenging for EU investors to assess whether relevant projects in LMICs can be reported as aligned with the EU Taxonomy, because the EU Taxonomy has been designed to reflect the **EU's economic, geographical and technological development**. To further complicate matters, there is often an important gap in **data availability** by public and private entities, especially SMEs, to enable EU investors to assess and demonstrate the EU Taxonomy alignment of their investments in LMICs. In order to ease this challenge and leverage on the local taxonomies developed by LMICs, comparisons between EU and LMICs' taxonomies can provide much needed clarity. **The European Commission is already contributing to these efforts: in recent years a number of LMICs have reached out to the European Commission's Directorate-General for International Partnerships to collaborate on comparative studies** assessing the similarities and differences between their national taxonomy and the EU taxonomy. A study comparing the EU and South African taxonomies was published in 2022[32] and several similar studies are currently being carried out in Latin America (Mexico and Colombia) and Asia-Pacific (Mongolia).

Sustainability-related **disclosure** often serves as another building block for a conducive sustainable finance ecosystem. It is considered **key to providing investors with the information necessary to make informed sustainable investment decisions**. There is a wide landscape of sustainability-related disclosure measures, including in a number of LMICs (e.g. Argentina, Brazil, India, Kenya, Malaysia, Philippines, etc.), as well as international or global efforts to develop and align sustainability related **disclosure standards** in order to further contribute to comparable sustainability data in the market. For example, the International Sustainability Standards Board (ISSB) of the International Financial Reporting Standards (IFRS) published a first set of standards and are aiming to develop a global baseline of sustainability disclosures for capital markets seeking to overcome the fragmentation of existing and emerging sustainability disclosure requirements[33]. As mandated by the EU's Corporate Sustainability Reporting Directive (CSRD), the European Financial Reporting Advisory Group (EFRAG) is building sustainability reporting standards at EU level (ESRS), with the first set published in 2023, and is committed to closely working with IFRS to ensure alignment. ISSB takes a financial materiality approach, while EFRAG is working with 'double materiality', meaning that disclosure is required if there is a material financial risk **to the company** or a material impact **of the company**.

31 Natixis, The New geography of taxonomies, 2021.

32 National Treasury, Republic of South Africa, A Comparison Between the EU Green Taxonomy and South Africa's Green Taxonomy, 2022.

33 The ISSB, the European Commission and EFRAG are also working to ensure as much alignment as possible between the respective standards.

Next, green and sustainable **labels and standards** for financial products are key tools to increase trust in the sustainable financial market and enable investors' access to sustainability-related financial products and instruments, such as for example for **green bonds**. Linked to the increasing interest in these instruments, several approaches have been developed to provide transparency and reliability about the sustainability of investment products. For instance, the International Capital Market Association (ICMA) published the Green Bond Principles (GBP) in 2014, setting out the first global principles to define 'green bonds'. In the EU, the voluntary European Green Bond Standard, was adopted in 2023[34]. Public actors, including in LMICs, followed suit by establishing national or regional green bond guidance in line with the GBPs (e.g. ASEAN, Mexico, Nigeria, etc.).

Last but not least, a closely related aspect to sustainable finance frameworks is ***greening finance***. The integration of sustainability considerations and climate-related risks in the financial sector could incentivise financing for sustainability goals and at the same time protect financial stability at large. According to a survey[35] conducted by the Basel Committee on Banking Supervision in 2020 among 27 supervisory authorities, about half of the surveyed jurisdictions observed that local banks were still in the early stages of developing their approaches to managing climate-related financial risks, indicating a significant need for improvement.

To help LMICs build a conducive environment and ecosystem to attract private capital, the European Commission should provide coordinated TA support through a dedicated and well-resourced ***Sustainable Finance Advisory Hub****, helping LMICs develop credible sustainable finance frameworks (taxonomies, disclosure requirements, standards) while promoting interoperability. Further, to enhance interoperability, the European Commission should step up its support to* ***comparing EU and national/regional taxonomies*** *in LMICs under the proposed Sustainable Finance Advisory Hub and should reflect on how to increase their transparency, visibility, recognition and use by the markets.*

The Hub should also support LMIC central banks, supervisors and financial institutions in integrating climate- and nature-related financial risks and sustainability considerations.

Beyond these measures, in the long term, the HLEG believes the Commission should explore further modalities to support greater interoperability, by enhancing the international use and implementability of the EU Sustainable finance frameworks (incl. the EU taxonomy) for the LMICs. Moreover, the Commission should continue working towards interoperability in international fora as well as with global standard setters.

34 Regulation (EU) 2023/2631.

35 Basel Committee on Banking Supervision, Climate-related financial risks: a survey on current initiatives, 2020.

#10

WHAT IS NEEDED TO SUPPORT SMES' ACCESS TO SUSTAINABLE FINANCE AND ENABLE ROBUST SUSTAINABILITY REPORTING IN LMICS?

Finally, the HLEG also looked at how to support SMEs in accessing sustainable finance in LMICs given their great potential for contributing to the transition to sustainability. SMEs play a crucial role in LMICs, contributing up to 40% of the GDP and accounting for as much as 90% of employment in certain cases. Yet, nearly half of the SMEs in LMICs have no access to formal credit[36]. Moreover, they face even more challenges when it comes to accessing sustainable finance, given the increasing demands related to sustainability reporting[37].

Furthermore, SMEs in LMICs that are increasingly integrated in global sustainable value chains need to **measure, report and improve their sustainability performance** to meet the demands of their clients (both in advanced economies or in LMICs)[38]. Not doing so might jeopardise their competitiveness. Supporting ESG reporting from SMEs has therefore never been as crucial as it is today to enable them to access sustainable finance.

These challenges can be addressed at two levels. First, SMEs can be supported through **non-monetary incentives** such as guidance, trainings and capacity-building to help them understand the requirements of their clients in terms of ESG. Clients at the head of global value chains, local partners and financiers, national development banks, commercial banks and large corporates have a key role in providing such guidance. Second, to alleviate the costs of compliance for SMEs, **monetary incentives** can be deployed such as grants and subsidies to help them report on their ESG performance and make their business more sustainable. Finally, to make the ESG reporting process as light as possible there is a need for **accessible data-reporting tools** for SMEs in LMICs.

In the EU, the European Commission has been focusing in particular on **ensuring that EU SMEs are not burdened disproportionately** by the ESRS and receive sufficient flexibility to prepare for them. However, stakeholders have raised concerns regarding the potential indirect adverse effects of the ESRS for SMEs also beyond the EU[39]. Indeed, **most companies (not just SMEs) in LMICs** already face challenges such as a lack of mandatory standards, high reporting costs and a shortage of experts in the field. It is crucial to make sure that LMIC companies do not fall further behind in their sustainability reporting, losing access to investors from advanced economies or jurisdictions with higher sustainability reporting expectations.

At the date of the report, EFRAG has started preparing **voluntary** reporting standards for non-listed SMEs (VSME). The VSME has the potential to standardise sustainability data requests for SMEs in the EU, but **it might also serve as a guide for SMEs in LMICs**, and to that end, the European Commission and EFRAG are encouraged to liaise with experts from LMICs.

*The European Commission should develop a **dedicated program** to support **SMEs in LMICs accessing sustainable finance**, including those operating within global sustainable value chains, with the right financial and non-financial incentives.*

36 The World Bank, Small and Medium Enterprises (SMEs) Finance, 2019.

37 OECD, Sustainable finance for SMEs: Challenges and opportunities, in: Financing SMEs and Entrepreneurs 2024: An OECD Scoreboard, 2024.

38 OECD, Financing SMEs for sustainability: Drivers, Constraints and Policies, OECD SME and Entrepreneurship Papers, No. 35, 2022.

39 European Commission, Feedback on European sustainability reporting standards, 2023.