

# High-Level Expert Group

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

*Mandated by the European Commission*



**Final**  
**Recommendations**  
April 2024





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CREDITS

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# FOREWORD



**Jutta  
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*for International Partnerships,  
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*‘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  
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*‘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  
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MANAGING DIRECTOR

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*‘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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## INTRODUCTION

**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<sup>1</sup>.** 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) at USD 3.9 trillion per annum.

**Increasingly stretched public funds and concessional finance are clearly not sufficient to bridge this gap - but global private capital is.** EU and international investors increasingly seek sustainable investment opportunities to green their portfolios. However, it is more challenging than ever to redirect their private capital towards LMICs for their sustainable transition, in a particularly challenging macroeconomic environment. With high interest rates globally, international investors have been repatriating capital out of LMICs. Indeed, emerging debt funds markets recorded the worst ever year in 2022, with almost USD 90 billion capital outflows, followed by further outflows of USD 33 billion in 2023 and another USD 5 billion in the first two months of 2024<sup>2</sup>.

In this particular context, in September 2022 **the European Commission has mandated the High-Level Expert Group on scaling up sustainable finance in LMICs (HLEG)** to provide recommendations on transformative and innovative actions the EU should take to scale up sustainable finance in LMICs, in the context of preparing an upcoming European Commission strategy, as announced in July 2021<sup>3</sup>.

**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 HLEG. This challenge has been keeping policymakers, non-governmental organisations (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.

HLEG members are senior, high-level experts from the financial services and banking industries, public sector, business, civil society, and academia. The HLEG composition aims at ensuring a geographical and gender balance, as well as a balanced representation of relevant know-how and areas of interest.

The Group has officially convened on twelve occasions prior to the publication of this Report. These meetings have taken place in Brussels, in both plenary and sub-group formats.

The HLEG's work revolved around three main questions:

1. Which innovative financing solutions have a high potential in further mobilising private capital in EU partner countries and how can sustainability-related financial instruments and products be further promoted?
2. How can the supply of sustainable finance find a matching level of demand for funding in EU partner countries? How to enhance linkages between local sustainable investment opportunities with domestic and international investors? How to foster business incubation?
3. How to support EU partner countries in building a conducive environment for sustainable finance, to attract domestic and international investors seeking sustainable investment opportunities?

1 United Nations, [Secretary-General statement of 4 April 2022](#).

2 Neuberger Berman, [Re-Emerging Markets](#), March 2024.

3 In July 2021 the European Commission adopted its Strategy for Financing the Transition to a Sustainable Economy.

# #1

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

Mobilising investment in sustainable and resilient infrastructure in LMICs and ensuring sustainable supply chains **can be mutually beneficial** for the EU and its partner countries, and as such is a cross-cutting theme for the HLEG's work.

**On the one hand**, advancing the development of sustainable and resilient infrastructure in LMICs can power inclusive and sustainable growth, helping to create new skilled jobs, new green industries and high value-added businesses for countries rich in natural resources, including critical minerals and renewable energy production potential. LMICs need to invest in sustainable infrastructure upwards of USD 1.5 trillion per year through 2030<sup>4</sup>, and these investment needs of LMICs will only increase moving forward.

**On the other hand, investing in sustainable infrastructure in LMICs is also an opportunity for the EU.** European investors are increasingly looking for sustainable investment opportunities. As people and governments become increasingly aware of the need to transition to a just and sustainable economy, pressure is increasing on the financial sector to green its assets and invest in sustainable projects. At the same time, the EU is looking for strategic partners in LMICs to diversify and secure its supply of affordable, renewable energy and of 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<sup>5</sup> – with which the European Commission pledged to mobilise EUR 300 billion for sustainable and high-quality projects<sup>6</sup>.

**As a first and natural step of a new mutually beneficial approach to scale up sustainable finance, the HLEG strongly encourages the EU to approach partner countries with an EU integrated strategic engagement model based on a political, economic and regulatory High-Level Dialogue<sup>7</sup>. This dialogue should bring together the whole range of key EU actors from Member State governments, the European Investment Bank (EIB) and Development Finance Institutions (DFIs), donors, EU investors, EU financial and non-financial companies, with relevant key stakeholders on the partner country's side.**

The High-Level Dialogue would bring together all relevant stakeholders to discuss how to best support sustainable investment in the recipient country. It would allow to align priorities and increase the efficiency of measures to support sustainable and transition investment. By consulting the private sector when designing their investment plans, governments can onboard private investors at an early stage, and integrate valuable feedback from investors that will make projects much more likely to reach bankability. By coordinating between DFIs and private investors, and ensuring transparency, it would be much easier to ensure that DFIs and investors work **together** rather than **competing** with one another for investment opportunities. 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.

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. The dialogue would allow partner countries to benefit from EU's growing demand for sustainable products and critical raw materials. It would also help partner countries in identifying which reforms and policies are necessary for local and global private investors, and implement them, with EU support where needed.

4 World Bank, [Sustainable Infrastructure Finance overview](#).

5 European Commission, [Global Gateway](#).

6 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.

7 This is already happening to an extent in the EU's recent new agenda for relations with Latin America and Caribbean, and – among others- strategic partnerships with Namibia and Kazakhstan on sustainable raw materials and renewable hydrogen.

This approach would reinforce the **coherence and breadth of the EU's offer** towards its partner countries, which should **not just be limited to EU development tools** (such as grants, guarantees, budget support and technical assistance (TA)) **but encompass trade, energy and industrial policy aspects**, while reflecting the key cross-sectorial priorities of the EU.

In particular, EU partner countries' governments could benefit from EU support and experience to clarify their sustainable roadmaps, related investment plans (e.g. integrated national financing frameworks) and so the private sector sees the direction of travel. In this respect, the EU could also **share its experience with building sectoral transition pathways** that it has gained through the EU initiative for Transition Pathways for European industrial ecosystems<sup>8</sup>. Despite the commitment of many countries to the Nationally Determined Contributions (NDCs), there is a general lack of **sectoral transition** pathways in most countries, including LMICs. **Sectoral transition pathways are crucial in transition finance**, as they provide an outline of the necessary actions and goals for transformation within sectors, and thereby provide investors with a plan that helps identify investment opportunities. Such pathways should define concrete and credible targets, actions, and monitoring systems.

The EU is encouraged to draw inspiration and lessons from existing multi-stakeholder platforms like the Just Energy Transition Plans (JETPs), currently being deployed in South Africa, Indonesia, India and Vietnam, and the Climate Finance Leadership Initiative (CFLI), currently operating in India and Colombia. The HLEG has studied these initiatives, among others, and concludes that – despite the varying degrees of investment materialisation observed so far – strong cooperation between the private sector, local financiers and local authorities has strong potential to generate robust pipelines of projects.

#### Climate Finance Leadership Initiatives (CFLIs) and Just Energy Transition Partnerships (JETPs)

The CFLI is an example of country multistakeholder platforms, already active in India and Colombia. It brings together leading domestic and international financial institutions and corporates at the CEO level and the finance practitioner level ('Members') as well as government partners and Multilateral Development Banks (MDBs) to accelerate local climate finance solutions. This is a private-led initiative under the umbrella of Bloomberg Philanthropies and endorsed by the Glasgow Financial Alliance for Net Zero (GFANZ).

The JETPs are multilateral cooperation agreements made to address transformational efforts of currently coal-dependent countries. This new partnership model was created to help LMICs transition away from fossil energy and toward renewable energy, while addressing social issues associated with such transition, and could be scaled up in other LMICs. The donor pool includes European countries, MDBs, national development banks and development finance agencies.

The High-Level Dialogue should also build on the lessons learnt from the EU's recent new agenda for relations with Latin America and Caribbean (LAC), and – among others – **strategic partnerships with Namibia and Kazakhstan** on sustainable raw materials and renewable hydrogen. In the case of the bilateral exchange with Namibia on green hydrogen, for example, the discussions involved Namibia, the EU, Member States, DFIs and Multilateral Development Banks (MDBs, including the EIB), and private players, both local and EU-based. The Memorandum of Understanding (MoU)<sup>9</sup> includes an operational roadmap, financial commitments from EU stakeholders (including a EUR 500 million loan from EIB to the Namibian government to support the development of long-term sustainable projects development), and technical assistance to facilitate the development of green hydrogen projects. The bilateral engagement is expected to significantly boost the development of the Namibian green hydrogen sector and contribute to the emergence of a high-technology sector in the country.

The European Commission has already enhanced its interaction with the private sector over the last years, for example with Global Gateway Business Advisory Group (BAG)<sup>10</sup> launched by the European Commission in September 2023. The group provides a forum to discuss and gather feedback on the strategic orientations of Global Gateway. It collects input from private sector representatives on their priorities, activities, challenges and opportunities in sectors and regions covered by Global Gateway.

8 European Commission, [Transition Pathways for European Industrial Ecosystems](#).

9 European Commission, [Press Release on Global Gateway: EU and Namibia agree on next steps of strategic partnership on sustainable raw materials and green hydrogen](#), 24 October 2023.

10 European Commission, [Global Gateway Business Advisory Group](#).

The HLEG recognises that LMIC investment needs go beyond infrastructure, as there is also a pressing need to mobilise capital in other economic and strategic areas including resilient agriculture, natural capital, health and education, social objectives and climate adaptation. Nevertheless, infrastructure investment should be prioritised as it acts as a catalyst for other sectors. Large scale infrastructure can have a transformational impact at a national level, and networks of small-scale infrastructure can improve social and innovation uptake while reducing environmental footprints. Moreover, ensuring that infrastructure is sustainable and resilient is critical for a number of environmental and economic reasons, including efficient resource use, avoidance of pollution and land degradation, and resilience to natural risks. The HLEG highlights the strong priority that the Global Gateway places on infrastructure, while acknowledging that investment is needed in other sectors as well.

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#### **Recommendation 1**

*With the twin ambition of helping partner countries in their sustainable development pathway, while creating strategic sustainable opportunities for the EU, the EU should develop a **new strategic engagement model** with LMICs based on a **high-level political, economic, social, business and regulatory dialogue**, bringing together the EU, DFIs, the EIB, EU investors and EU businesses. This would enhance the coherence and breadth of its offer by including, in addition to development instruments, also trade and industry policy aspects aligned with its key priorities. The High-Level Dialogue should also cover the regulatory reforms needed to unlock private investment based on the gaps that have been identified. The EU with the help of DFIs could share with partner countries its experience with **building sectoral transition pathways**, involving where relevant in working with their local private businesses.*

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## #2

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

One of the main expected outputs of the High-Level Dialogue under the new strategic engagement model is **the identification of priority investment areas in which the partner country and the EU agree to collaborate**.

In order to present itself as a **credible partner with whom to engage on a structured dialogue** and ensure that the new model is a success, the EU should assess and improve **its financial intervention capabilities**. It is important to **enhance the complementarity and agility of EU instruments and select the right (combination of) tools** in order to ensure that the EU can propose a **coherent EU offer as a result of the High-Level Dialogue on sustainable investment**, taking into account the specificities and needs of each partner country.

**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 currently 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. Hence, it is important that **guarantees** and **blending operations** continue to be complemented by appropriate instruments, such as **technical assistance, grants** and **budgetary support**. Among the range of instruments at its disposal, the EU should **select the most adapted** ones in order to crowd in private capital taking into account the context, needs, objectives and level of local capital market maturity. For example, in countries with relatively developed capital markets, the EU could consider how to better leverage innovative financial instruments, vehicles and funds to mobilise private capital (see section 7), while in more vulnerable countries, or in countries with less developed capital markets, the EU should focus first on the building blocks of a conducive environment for private investment using grants and technical assistance.

According to the EU public consultation on the EU's External Financing Instruments for the 2014-2020 and 2021-2027 multiannual financial frameworks, most respondents (approx. 55%) agreed that the EU enhanced its partnerships with partner countries but only a minority (approx. 35%) agreed that the EU improved its capacity to attract and support investment in partner countries, including from the private sector<sup>11</sup>. To enhance the flow of viable projects, there is a pressing need to introduce innovative financial instruments and vehicles (funds) to channel a substantially greater amount of finance into these markets.

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### Recommendation 2.1

*In the spirit of a mutually beneficial partnership approach 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 scale up and closely **link its financial offer to the High-Level Dialogue on sustainable finance and investment**. 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.*

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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 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**. **A large number of projects die in their infancy** – according to a McKinsey study<sup>12</sup>, 80% of infrastructure projects in Sub-Saharan Africa (SSA) fail at the earlier stages of development.

11 Public consultation on the External Financing Instruments for the 2014–2020 and 2021–2027 Multiannual Financial Frameworks, Factual summary report on the public consultation.

12 McKinsey & Company, [Unlocking private-sector financing in emerging-markets infrastructure](#), 2019.

How can the EU further and better support LMICs in actually developing and implementing sustainable projects with high potential? Through **coordinated and effective support for project preparation**.

Bringing infrastructure from concept to reality is far from an easy process. Sustainable infrastructure projects require support across **multiple stages** to get from an idea to a procurement-ready project. This is the concept of 'project preparation': the steps and measures taken by developers to ensure that the projects reach completion. A well-prepared project lays the foundation for a bankable and implementable project. Preparation activities are expensive and can typically account for 5% to 12% of a project's final cost<sup>13</sup>. Discussions within the HLEG identified several key reasons for this:

- a. **The lack of adequate expertise for project preparation**<sup>14</sup>. Project preparation is by nature a multi-disciplinary process, requiring an array of deep and diverse skills including mastery of technical, economic, social, environmental and financial aspects;
- b. **Not enough funding available for project preparation**, especially as private players are often reluctant to fund the expensive and risky process of project preparation;
- c. **Insufficient involvement of the private sector in project preparation**: without proper incentives and support, private players are reluctant to undertake the risky phase of project preparation. Governments and DFIs/MDBs should do more to involve private players in early-stage project preparation;
- d. **The absence of credible, open and transparent procurement rules**<sup>15</sup>, including on Public-Private Partnerships (PPPs);
- e. **Lack of sufficient demand/economic incentives for investment** in some sectors (e.g. energy and transport); and
- f. **Lack of clear Key Performance Indicators (KPIs) to measure project success**.

Today, there is a landscape of numerous fragmented project preparation facilities (PPFs), specialised entities or programmes that aim to bolster pipelines by providing financial resources, technical expertise, and advisory services to governments, project developers and other stakeholders<sup>16</sup>. Ideally, PPFs help mitigate early-stage risks and enhance the quality and bankability of projects, attracting suitable investment. PPFs have been instrumental in creating pipelines of bankable projects worldwide and are a crucial component of global efforts to transition to a sustainable economy worldwide.

However, the current way in which PPFs operate has several limitations, and there is therefore room to enhance their operations and increase their impact. First, PPFs provide support separately for each phase of the development cycle<sup>17</sup>, leading to redundant support in some phases, and incomplete funding for other phases. While some level of coordination on the ground does take place, it is far from institutionalised and systematic. There is a clear need to **efficiently coordinate and pool efforts** to both achieve scale and increase project take-off. Second, there is a lack of harmonisation and standardisation of documents and information. The project preparation cycle entails a range of processes and documents (including legal documents, feasibility studies, assessments, etc.). The lack of **standard documentation** makes cooperation of PPFs and other stakeholders much more difficult. Third, PPFs often fail to onboard private players from the earliest stages of project development. **Involving private investors and developers from the beginning** greatly facilitates the transfer of projects to the private sector when the project becomes investment ready.

The European Commission should step up its efforts to support sustainable project development through their lifecycle. With this in mind, the HLEG believes that...

13 Global Infrastructure Hub and CRISIL infrastructure advisory, *Leading Practices in Governmental Processes Facilitating Infrastructure Project Preparation*, January 2019.

14 Global Infrastructure Hub, [Financing Project Preparation](#).

15 World Bank Group, [Benchmarking Public Procurement 2017, Assessing Public Procurement Regulatory Systems in 180 Economies](#), 2016.

16 The funds provided by PPFs are usually used to finance a range of activities. This includes conducting feasibility studies, preparing technical designs, undertaking environmental and social impact assessments, facilitating stakeholder consultations, developing financial models, and supporting capacity building efforts.

17 ODI, [Private Infrastructure Financing in Developing Countries](#), 2018.

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### Recommendation 2.2

*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.*

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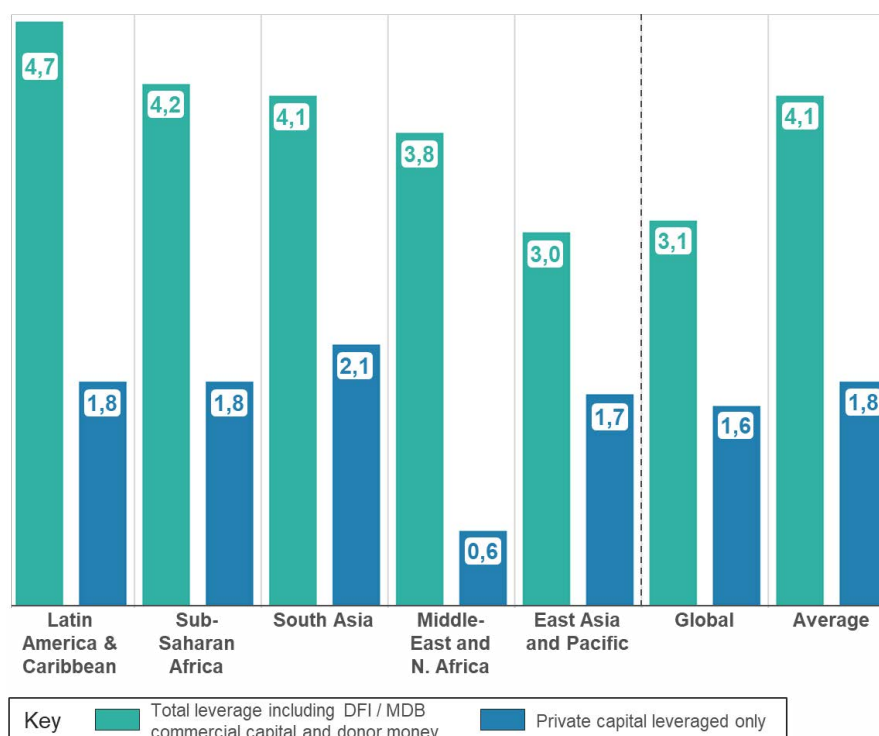
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This digital platform would complement the new engagement model by translating political priorities into concrete actions. In practice, this one-stop-shop platform could be used as the **operational and financial arm of the new partnership model**, dedicated to developing sustainable projects from their onset to their closure. There would be major incentives for both developers and investors in relying on the platform: it would provide relevant information on sustainability aspects of the projects and allow timely involvement of relevant stakeholders and EU instruments (grants, TA, blended finance and guarantees, etc.). The platform would also be used to share standardised processes and contracts to provide clarity for investors and end-beneficiaries, and it would act as the single-entry point for all stakeholders. In this way, it would mobilise interest for and create more visibility of available support instruments, in the end leading to higher demand for these support instruments. It would also be used to coordinate support on key regulatory reforms necessary for private investment (both sectoral legislation and cross-sector regulation to support investment).

Finally, more needs to be done by DFIs and MDBs to mobilise private capital for investments in LMICs and to support countries in building the ecosystem of financial intermediaries needed for strong local capital markets.

**DFIs and MDBs are well positioned to help unlock much needed private capital at local, EU and international level, given their long-standing experience and in-depth understanding of risks and opportunities in LMICs.** However, to date, DFIs and MDBs have overall mobilised limited private capital with insufficient de-risking mechanisms, and sometimes unintentionally crowded out private capital. Available data from Convergence (see figure 1 below) suggests that on average, blended finance funds have leveraged 4 dollars of commercial capital for every dollar of concessional capital but this includes capital deployed by private, public (e.g. MDBs and DFIs) and philanthropic investors at market rates – represented by the green figure. The blue figure shows the leverage ratio of commercial capital coming exclusively from private sector investors – which is much lower, on average only 1.8 dollars for every concessional dollar<sup>18</sup>. This data strongly suggests that there is room for DFIs and MDBs to expand their role as private capital catalysers.

18 Apampa A., [How much does a dollar of concessional capital mobilize?](#), Convergence, 2023.

**Figure 1 – Average leverage ratios and private sector mobilisation ratios by region (2018)**

Sources: *Convergence*<sup>19</sup>

The low level of mobilisation of private capital from DFIs and MDBs is not due to a lack of feasibility, as suitable mechanisms that allow DFIs and MDBs to mobilise private capital already exist, notably through blended finance. The question is why there are so few of these initiatives, and why the level of private capital mobilisation from DFIs and MDBs remains so low.

In addition, there is limited information available on the actual DFIs/MDBs investments, including on the risk taken and the extent to which it goes beyond what private investors are willing to take. The assessment of financial and development additionality per transaction is mostly qualitative, with limited quantitative data underlining this analysis.

A first reason of why DFIs and MDBs are mobilising less private capital than they could has to do **with their incentives, structures and mandates, which traditionally revolved around direct loans and grants for development**. Direct financing through loans has been at the core of development finance, hence of their business models, incentive structure and mandate. **Another reason for low levels of private sector mobilisation concerns MDBs/DFIs' risk appetite**. They are willing and able to take on a varying degree of risk exposure, but institutions with a high credit rating tend to follow a conservative risk framework to maintain their rating and thus secure funding at a low cost of capital. **However, this prevents them from funding riskier projects that have no alternative access to finance** – exactly where MDBs/DFIs are needed the most. At the same time, this conservative behaviour incentivises them to keep high-quality assets on their balance sheet, rather than offloading them to the private sector. These points are highlighted in the ongoing MDBs reform discussions, in which crowding-in private capital as well as ensuring additionality of operations are critical issues.

Against this background, and with limited public resources and Official Development Assistance (ODA), there is a need to review the mandate of DFIs and MDBs. First, more should be done to **differentiate their interventions between investment opportunities that could allow for private investment and those that are in greater need of concessional finance**. In this context, DFIs and MDBs need to increase transparency on their transactions, including the level of risk taken and respective assessment of concessionality. MDBs and DFIs possess vast amount

19 Convergence, [Leverage of Concessional Capital](#), 2018.



of credit, market and economic data on developing economies in their Global Emerging Markets (GEMs) Risk database that is not available elsewhere (see box). However, the data is currently only available to the 24 GEMs consortium members, including some EU DFIs, the EIB and the International Finance Corporation (IFC). Public data such as default rates, project-level information, recovery on defaults, project ratings, etc. is only available to the public at an aggregate (not project) level. Second, MDBs/DFIs should re-focus their efforts on private capital mobilisation, with need for larger and more catalytic blended finance structures operating under an ‘originate-to-share’ approach. These structures should aim to involve private capital rather than maximise high-quality debt assets for the DFIs/MDBs. The new engagement model could provide the opportunity to create such structures, but in parallel, it is important to review DFIs/MDBs’ mandates and structures.

A recent report by the Independent Expert Group<sup>20</sup> studied the question of private capital mobilisation by MDBs and found that this issue requires a comprehensive strategy involving public-private collaboration, new financial products, and changes in MDB operating models.

**Finally**, to further maximise impact and leverage the private sector at scale, EU DFIs also have a role to play: they need to operate in a coordinated approach and, as much as possible, pool resources together under joint initiatives in a Team Europe spirit. This will optimise the use of capital for MDBs and DFIs and may allow higher risk taking, as well as a more efficient use of the existing capital.

#### The Global Emerging Markets Risk Database Consortium (GEMs)

GEMs is one of the world’s largest credit risk databases for the emerging markets operations of its member institutions, that are (MDBs) and DFIs. It pools data on credit defaults on the loans extended by consortium members, the migrations of their clients’ credit rating and the recoveries on defaulted projects. GEMs was established in 2009 as a joint initiative between the EIB and the (IFC – World Bank Group). Since then, the GEMs consortium has grown to include 24 members comprised MDBs and DFIs. The Consortium members contribute anonymised data on their projects’ credit events notably in EMDEs. In return, members gain access to aggregate GEMs statistics on observed default rates, rating migration matrixes and recovery rates by geography, sector, time-period and various other dimensions.

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### Recommendation 2.3

*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.*

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## #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** in food, energy and other commodities' prices, **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.**

To curb domestic inflation, advanced economies' central banks implemented monetary tightening policies. This had major spillover effects in LMICs, as higher interest rates in advanced economies led to (i) capital outflows from LMICs, and (ii) significantly higher borrowing costs for LMICs. **Consequently, several countries are in a dire financial situation.** Indebtedness has skyrocketed worldwide, limiting governments' capacity to fund climate and infrastructure investment. In 2023, **39 countries were either in debt distress or at a high risk of debt distress**<sup>21</sup>, compared to only 17 countries ten years ago<sup>22</sup>.

In short, **increasing fiscal space** to support sustainable investments is high on the list of priorities, with the International Monetary Fund (IMF) and the World Bank (WB) already working on enhancing domestic revenues mobilisation and, where needed, solutions for meaningful debt restructuring and debt relief.

In this context, the HLEG has looked at which innovative financial instruments or mechanisms can best achieve this: the group analysed instruments such as **debt-for-nature swaps (DFNS)** and **asset recycling** (especially via **securitisation/Asset-Backed Securities (ABS)**).

**DFNS** were studied by the HLEG, driven by their promise to address two pressing global challenges simultaneously, namely tackling debt and the need for nature investments. **A DFNS is a refinancing operation where a country buys back part of its outstanding debt and replaces it by a new debt instrument, generating financial relief through this operation.** The financial relief/fiscal space is realised by buying back the old government bonds when they are traded below their initial value (at discount) and/or through interest rate of the new debt at better conditions as compared to the old debt. The process typically relies on a guarantee provided by a well-rated public entity often covering the **entire new debt** issued. In exchange, the country commits to invest (a part of) its financial gain in nature/climate-related projects.

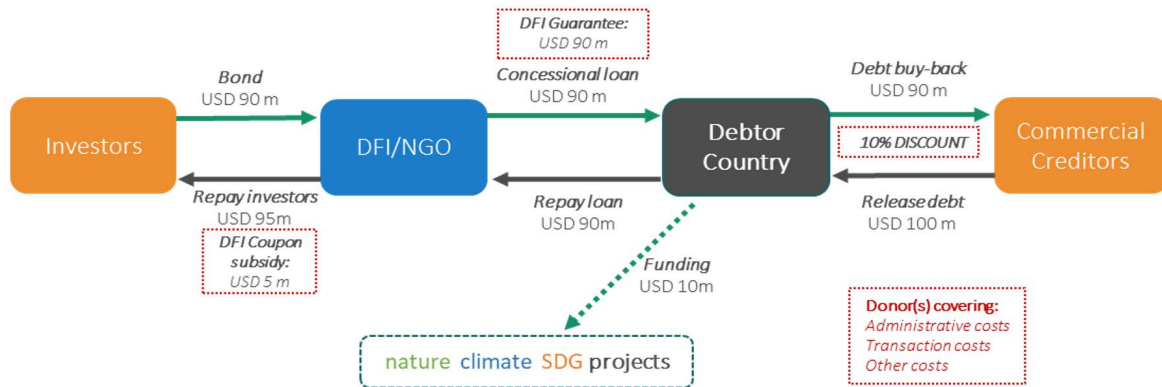
Primarily, there are two types of DFNS<sup>23</sup>:

- a. **Bilateral DFNS** involve only one creditor that agrees to forego a part of its claim on a debtor country, often as part of a development assistance initiative, in exchange of a commitment from the debtor country to fund agreed-upon sustainable projects/programmes. These have been the most prominent form of debt swaps to date. However, they are often of small size (and therefore limited impact) and one-off transactions.
- b. **Market-based DFNS** are more sophisticated instruments involving multiple private creditors and can be of larger scale. Given the number of potential stakeholders involved, they may result in a very costly, complex and lengthy process (the OECD estimates that preparatory activities can take between two to four years). Their chance of success heavily depends on specific market conditions and, in the case of **debt traded at discount**, all private creditors' acceptance of losing part of their credit, as well as having potential negative repercussions on their own credit rating.

21 Nine countries in debt distress, 30 countries at a high risk of debt distress.

22 Two countries in debt distress, 15 countries at a high risk of debt distress.

23 For a detailed review historical Debt-for-Nature Swaps in African Countries and historical data on debt-for-nature swaps worldwide, and Appendix B, Debt-for-Nature-Swaps: Feasibility and Policy Significance in Africa's Natural Resources Sector, African Development Bank, October 2022.

**Figure 2: Illustrative example of a market-based DFNS traded at discount**

The **first successful multilateral DFNS** was concluded in Bolivia in 1987 and was followed by several DFNS, throughout the 1990s. In the 2000s, DFNS transactions started to decline, likely due to different variables such as the higher prices of commercial debt in secondary markets<sup>24</sup>, the advent of other sources of debt relief (e.g. the Heavily Indebted Poor Countries (HIPC) launched in 1996 by the IMF and expanded later by the WB into the Multilateral Debt Relief Initiative (MDRI)) and probably the increased criticisms regarding the concrete impact of DFNS, in terms both of debt relief and of climate and environmental impact<sup>25</sup>. Nevertheless, since **COP20** in 2012, there has been renewed interest in DFNS, mostly by NGOs.

The Members of the HLEG have studied the most important and recent DFNS transactions (for more details refer to Annex):

- The **Belize** DFNS in 2021, for example, involved the United States Development Finance Corporation (DFC) providing a **political risk insurance/guarantee of USD 610 million** to cover both principal and interest for a **'blue loan' of USD 364 million**. Despite the substantial amount freed up through this transaction, exceeding USD 200 million<sup>26</sup>, only **USD 24 million** was directed to a conservation trust. Additionally, Belize committed to dedicate **USD 4.2 million annually** towards conservation finance until 2041 as part of the agreement, more than tripling Belize's existing budget allocated to nature conservation<sup>27</sup>.
- In May 2023, **Ecuador** embarked into the largest DFNS transaction ever with the support of DFC (**USD 656 million of political risk insurance**) and the Inter-American Development Bank (IDB) (with **USD 85 million guarantee**) and 11 private insurers providing **more than 50% reinsurance**. The operation is expected to contribute approximately **USD 17 million per year until 2041** in conservation and sustainable activities in the Galapagos<sup>28</sup>.
- In August 2023, **Gabon** closed the first DFNS in continental Africa. The USD 500 million deal was arranged by Bank of America, structured by The Nature Conservancy, and benefitted from **USD 500 million political risk insurance** from the US DFC. The operation allowed Gabon to lower the interest rate on its debt and extend its maturity. This refinancing operation is expected to unlock **USD 5 million each year over 15 years** for conservation action and establish an endowment expected to reach around **USD 88 million by 2038**, dedicated to funding future conservation projects in Gabon<sup>29</sup>.
- Following a DFNS transaction in 2022<sup>30</sup>, **Barbados** is currently in the process of embarking in a new DFNS and seeking to raise approximately USD 295 million through the sale of sustainability-linked debt. This

24 D. Essers, D. Cassimon, M. Prowse, [Debt-for-climate swaps: Killing two birds with one stone?](#), Global Environmental Change, 2021.

25 IMF [Debt-For-Climate Swaps: Analysis, Design, and Implementation](#), 2022.

26 Lazard, [Debt-for-SDGs swaps in indebted countries: The right instrument to meet the funding gap?](#), report for the European Commission, 2021.

27 As shown by the G20 Debt Service Suspension Initiative (DSSI) in which only one private creditor has accepted to actively participate. The World Bank, [Debt Service Suspension Initiative](#), 2022.

28 Reuters, [Ecuador seals record debt-for-nature swap with Galapagos bond](#), 2023.

29 U.S. Embassy in Gabon, [DFC Political Risk Insurance to Support a Blue Bond Providing \\$500 Million for Ocean Conservation in Gabon](#), 2023.

30 For more details on the 2022 Barbados DfNS transaction refer to Annexes.

issuance would be backed by a **USD 300 million guarantee** split between the EIB (on behalf of the EU) and IDB. The freed-up proceeds from the debt swap would be directed towards financing the upgrade of the South Coast Sewage Treatment Plant, with an estimated cost of approximately **EUR 100 million**<sup>31</sup>.

However, while these instruments might appear as being mutually beneficial to governments and nature, previous experiences have revealed some drawbacks that have raised debates and controversy. Overall, the Members of the HLEG recognise that, in most of the cases, **DFNS prove to be very complex, lengthy, and costly refinancing operations**. They require a **disproportionately high amount of guarantee when compared to the fiscal space created on the one hand and to the amount that goes into sustainable projects on the other hand**. At the same time, **DFNS could entail serious reputational risk (risk of greenwashing)**.

First, DFNS carried out so far have been **too small to provide meaningful debt relief** to the respective debtors. In 2020, SSA's external debt amounted to USD 702.4 billion. According to a report of the African Development Bank (AfDB) published in October 2022<sup>32</sup>, debt treated through debt swaps amounted to less than USD 320 million in the entire continent<sup>33</sup>.

Second, especially for market-based DFNS, there is a **risk of negative impact on the country's perceived creditworthiness**. The fiscal space gained through a DFNS becomes larger when the discount/interest rate reduction is higher, but at the same time, the risk of negative creditworthiness perception increases. This would potentially have negative consequences on the country's future access to public and private finance.

Third, data shows that the **amount of overall funds allocated for nature conservation, climate, or environment activities via DFNS has been limited in scale and, in some case disproportionately small compared to the overall treated debt**. More broadly **the labelling of the bond issued (to buy back the old debt) as 'sustainable' or 'green' is raising major associations with greenwashing**<sup>34</sup> as most of the proceeds are used for debt repayment purposes, and only a fraction of the freed-up capital is used towards nature/climate/environmental activities. In this context, there has been **a notable rise in the use of sustainability-linked bonds (SLB)** associated with DFNS. Besides DFNS, there are similar operations in the social domain, particularly in the health sector<sup>35</sup>.

However, issuers have noted the **benefits** – beyond financial – in terms of establishing clear governance and government support, transparency, monitoring and evaluation of conservation activities. Under certain specific conditions, DFNS may to some extent encourage the government to commit towards environmental objectives. In line with this rationale, international organisations such as the **IMF**<sup>36</sup> and the **WB**<sup>37</sup> view DFNS as potentially useful in specific contexts but not as a scalable solution.

In conclusion, the members of the HLEG recognise that, although there are some advantages to DFNS, other approaches may be more effective in freeing-up fiscal space and bringing sustainable development benefits. 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.

## Asset Recycling

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 for asset recycling, such as through concession, lease or securitisation.

Asset recycling has the potential for bringing (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.

31 European Commission, [EU to support Barbados in upgrading climate resilient infrastructure for clean water under Global Gateway](#), 2023.

32 Data precede the 2023 DFNS in Gabon.

33 African Development Bank, *Debt-for-Nature-Swaps: Feasibility and Policy Significance in Africa's Natural Resources Sector*, 2022.

34 Bloomberg News, [Barclays Sees Real Greenwashing Risk in ESG Debt-Swap Market](#), 2023.

35 Bloomberg News, [Giant Fund Explores Traded Debt Swaps for Health Investments](#), 2024.

36 M. Chamon et al., [Debt-for-Climate Swaps: Analysis, Design, and Implementation](#), IMF Working Papers, 2022.

37 World Bank Group, [Mobilizing Private Finance for Nature](#), 2020.



Asset recycling can only take place when there are **suitable assets** that have a stable or predictable cash flows without being a key public revenue stream. These assets should also not be of a strategic or security importance for the government. A second challenge is the need for a suitable **regulatory, institutional, and political context** (i.e., rule of law considerations).

### Asset recycling via concession or lease

Asset recycling allows existing public infrastructure to be monetised through sale or lease/concession to private or institutional parties. It follows a **two-step process**: first to monetise value from revenue-generating public assets (through leasing/concession), and second to use the proceeds to invest in existing and/or new infrastructure assets. Eligible public assets can be toll roads, bridges, airports, transit systems, power generation and grids, warehouses, etc.

Asset recycling can entail a broad spectrum of options to involve the public and private sectors. The monetisation step could range from outright asset sale to long-term concession. Usually, **the public sector continues to 'own' the asset** (except in the case of full privatisation). For example, under a common asset recycling scheme, a lease confers the right to use an existing state-owned infrastructure asset for a pre-agreed period in exchange for the lessee (private sector entity) making an upfront payment.

Asset recycling offers several **benefits for public and private entities, albeit requires strong engagement with communities and appropriate governance**. It can be particularly valuable in countries with **high levels of public debt**, as it can allow for the funding of new/existing infrastructure at no cost to taxpayers, and no additional government debt. As such, governments and taxpayers benefit from the unlocking of capital from existing state-owned revenue-generating infrastructure, and the private sector gain access to previously inaccessible stable long-term revenue-generating assets in LMICs.

### Asset recycling via securitisation and Asset-Backed Securities

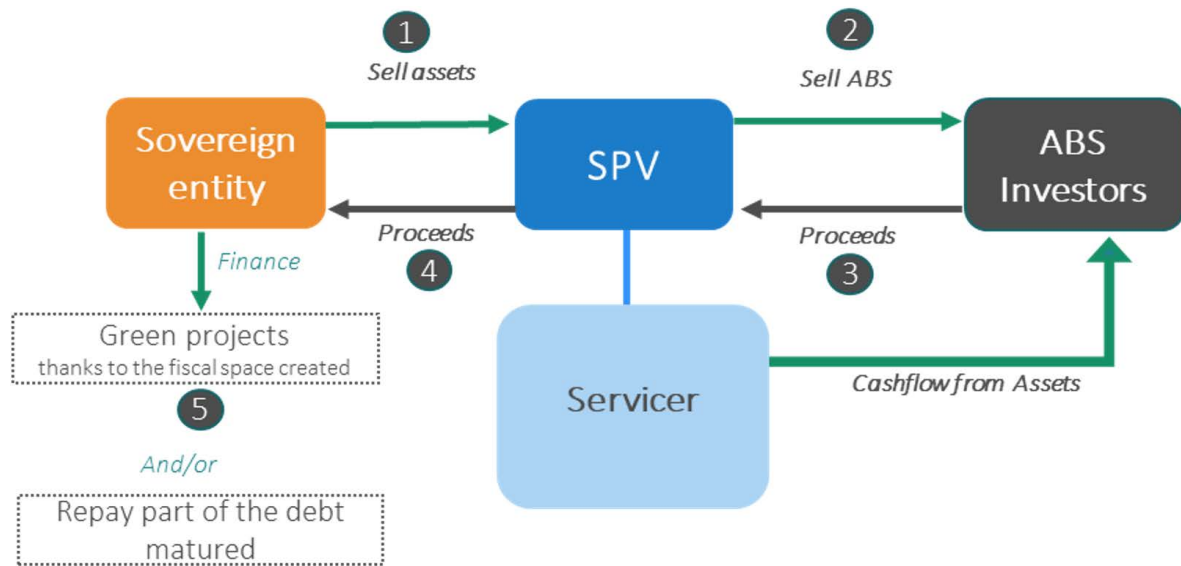
Some LMICs are exploring securitisation as it offers numerous benefits. It allows public entities to **offload their assets to the private sector through ad-hoc created special purpose vehicle (SPV)**, thereby **freeing up their balance sheets**<sup>38</sup>. The SPV raises funds from investors through the issuance of notes (ABS) that are issued in different tranches. The debt underlying an ABS is typically illiquid and cannot be sold separately. However, once pooled and securitised, it becomes more liquid and tradeable, **making infrastructure a more liquid asset class**, thereby tapping into a larger investor base.

In **green use-of-proceeds securitisation transactions**, funds raised through the securitisation are allocated to green projects and infrastructures, typically adhering to a framework for sustainable finance<sup>39</sup>.

38 A. Arun, [Securitizing the Transition](#), The Polycrisis series, 2023.

39 European Banking Authority, [EBA Report on developing a framework for sustainable securitisation](#), 2022.

**Figure 3: Illustrative example of a green use-of-proceeds securitisation in an asset recycling scheme**



Asset managers across African markets emphasise there are several features that are essential for successful securitisation: high **quality underlying assets**, **appropriate regulatory infrastructure**, **transparency** backed by strong regulation (including for related **risk**) and **valuation clarity** are all essential features for the uptake of securitisation and ABS in the region<sup>40</sup>. Additionally, relatively **developed capital markets** and **experienced institutional investors** are also essential for securitisation to be successful. Securitisations can also be quite **complex**, and hence **costly to structure**, and may require a **robust monitoring system** and **oversight**.

Among LMICs, there are examples of securitisation (not necessarily green or sustainable) which **could be replicated in the future for green or sustainable objectives**:

- a. Corporación Vial del **Uruguay** (CVU) is a solution to recycle toll road assets through the issuance of project bonds in local capital markets to finance new transport infrastructure in Uruguay. During 2017 and 2019, it placed ABS in the local capital markets for the equivalent of USD 450 million<sup>41</sup>.
- b. In **Côte d'Ivoire**, the Emerging Africa Infrastructure Fund (EAIF), a company affiliated with the Private Infrastructure Development Group (PIDG), is committing up to XOF 30 billion (USD 48 million) to launch the first-ever social asset-backed security in West Africa. The bond, valued at XOF 60 billion (USD 96 million), will be issued by the SPV Fonds Commun de Titrisation de Créances Electricité Pour Tous (FCTC EPT) in the local currency. This initiative is geared towards advancing universal access to electricity in Côte d'Ivoire<sup>42</sup>.
- c. **India** has created Infrastructure Investment Trusts (**InvITs**), pooled investment vehicles that buy, operate, and manage operational infrastructure assets, thus helping developers release their invested equity and deploy capital in new projects. InvITs are expected to generate Rs 1.5 trillion (around EUR 16.5 billion) in 2024.

Furthermore, key international actors such as the IMF, the WB and the OECD have promoted the transformative potential of asset recycling and the use of securitisation and ABS to finance infrastructure projects.

40 IFC, [Gauging Appetite of African Institutional Investors for New Asset Classes](#), 2022.

41 World Bank, [Institutional Investors and Sustainable Infrastructure: A Global Review of case studies to finance the infrastructure gap, 2023](#).

42 Emerging Africa Infrastructure Fund, [EAIF commits up to 30 billion to launch West Africa's first social asset-backed security, targeting 100% electrification in Côte D'Ivoire](#).

### Infrastructure Investment Trusts in India

**Type of initiative:** Securitisation and Asset Recycling to facilitate investment in infrastructure in India.

**Key Stakeholders:**

**Regulator:** Securities and Boards Exchange of India (SEBI).

**Sponsor/Developer:** Generally, an infrastructure development company. An InvIT can have a maximum of 3 sponsors.

**Investors:** InvITs can be privately placed or publicly placed on the stock exchange and bought by individuals and institutional investors.

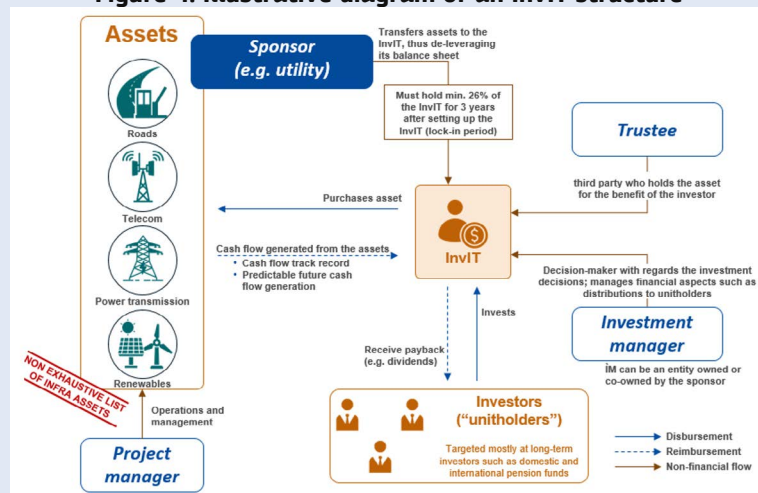
**Mobilised Amount:** 20 InvITs registered as of March 2023, with total market capitalisation of approx. 11 billion EUR in 2023<sup>43</sup>. Through InvITs developers are expected to **reduce debt to the extent of about 65-70%**, according to India Ratings<sup>44</sup>.

**InvITs, or Infrastructure Investment Trusts**, are investment instruments that work like mutual funds. They are **governed by SEBI**<sup>45</sup>.

InvITs are pooled investment vehicles that **buy, operate and manage operational infrastructure assets**, thus helping **developers release their invested equity and deploy capital in new projects**. The assets can either be **owned directly** by the InvIT, or **through an SPV**. In this second case, the InvIT must hold at least 50% of the SPV, the rest can be sold as securities on the market.

InvITs are a **hybrid between equity and debt investment**. The **investors in the InvIT** (called unitholders) receive payments from the cash flows generated by the asset in which the InvIT has invested. Units from public InvITs can be **tradable on the stock exchange**, which makes them highly liquid instruments. According to SEBI regulations, InvITs must invest a minimum of **80% of their assets in projects that are already completed**, in order to shield investors from risks arising from the development phase of the infrastructure. Additionally, InvITs must **disburse 90% of their earnings**

Figure 4: Illustrative diagram of an InvIT structure



The goal of the InvIT scheme was to allow **developers to free-up capital** by monetising completed or existing assets (**asset recycling**) thus **lowering their debt burden** significantly via an asset sale. Developers can use the proceeds to reinvest in other infrastructure projects and raising **capital without incurring additional debt**. InvITs allow for **individuals and small investors** to pool their resources as unitholders and have **access to infrastructure investments**, thus increasing the investor base for infrastructure investment.

**Strong regulatory framework** and **tight governance** are considered key success factors of the InvITs in India.

43 S. Sanghai, [Why REITs, InvITs occupy significant mindscape in capital markets](#), Economic Times, 2024.

44 ET Now, [InvITs to help sponsors reduce debt by 65-70%: Chintan Lakhani, India Ratings](#), Economic Times, 2017.

45 Securities and Exchange Board of India, [Infrastructure Investment Trusts regulations](#), 2014.

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### Recommendation 3

The European Commission should – together with MDBs, in to support sustainable asset recycling and green use-of-p. to create the fiscal space needed for their sustainable and the effort to make sustainable infrastructure a liquid asset class. The initiative should offer a flexible range of financial and non-financial instruments leveraging on:

a. Their expertise and financial resources for providing technical assistance to cover structuring and other costs, as well as capacity building to help governments conduct a thorough assessment of all their assets and identify the best ways to preserve, maintain and optimise their use, while simultaneously creating a conducive ecosystem for sustainable asset recycling/securitisation at national or regional level and maximising societal and environmental outcomes, including a just transition and adaptation;

b. EU financial instruments (e.g. guarantees) to mitigate the risk linked to local securitisation platforms and initiatives aimed at mobilising private investors towards sustainable and resilient infrastructure investments in LMIC. To allow a broad range of investors to invest into this kind of vehicles, an easy-to-invest approach with transparent structuring is key.

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Initiative to accelerate sustainable infrastructure investments in LMIC through asset recycling and securitisation while preserving fiscal space

Support at National / Regional Level

Enhancing Robust Regulatory Securitisation Ecosystems

Promoting Interoperable, Standardised (green) Securitisation Frameworks

Supporting Local Capital Market Development

Support at Project Level

Mapping Suitable Assets and Projects for Securitisation

Providing Technical Assistance via Grants & Capacity Building

Providing Concessional Finance and Risk Mitigation Instruments

## #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. Many LMICs are already highly vulnerable to climate-related shocks and these risks will become more acute over the coming decades with climate change. Analyses have demonstrated that climate change – both physical and transition risks – could reduce sovereign creditworthiness for the most vulnerable countries, risking further deterioration of their fiscal situation.

While a **climate protection gap exists** in advanced economies as well, such gap is of particular concern for LMICs as it risks aggravating their financial stability, fiscal vulnerabilities and investment constraints. According to Vulnerable Group of 20 (V20) research, 98% of the 1.5 billion people in V20 countries do not have financial protection against such events, while V20 countries have lost USD 525 billion to climate impacts since 2000 – one fifth of their total wealth<sup>46</sup>. Notably, a staggering one billion children live in 33 countries classified in the United Nations International Children's Emergency Fund's (UNICEF) Children's Climate Risk Index as 'extremely high-risk', meaning they face a combination of exposure to multiple climate and environmental shocks with a high vulnerability due to inadequate essential services, such as water and sanitation, healthcare and education<sup>47</sup>. Women are also disproportionately affected by climate-related risks: according to the United Nation's (UN) Food and Agriculture Organisation (FAO) households headed by women in rural areas lost about 8% more of their income to heat stress than male-headed households<sup>48</sup>. This is even more alarming when combined with the fact that catastrophes are becoming more frequent and severe: **according to Swiss Re estimates, 2022 global catastrophe losses were USD 115 billion, compared to a 10-year average of annual USD 81 billion losses**<sup>49</sup>.

In the face of such risks, LMICs – particularly in SSA – have **inadequate climate insurance coverage**: currently, the overall share of natural catastrophe losses in Africa and Asian LMICs that are insured are 5% and 16% respectively<sup>50</sup>. This leaves most of LMICs financially vulnerable to climate change-induced disasters in a context where many already have limited fiscal space and large investment gaps for their SDG financing needs.

The **limited climate insurance coverage** stems from a number of factors such as lack of awareness and limited access to insurance, as well as the lack of resources to pay for insurance. Governments, households and businesses are all inadequately insured against natural disasters, which is a major cause for concern as the impacts of climate change on economic and financial stability can be severe. Insurance against such risks is crucial, as it would provide **a cushion and prevent a financial shock** to the insured party when damages occur.

As a consequence, **loss and damage** and **climate justice** have become critical policy questions in international climate negotiations; COP27 saw the launch of the Global Shield against Climate Risks, which is intended to provide swift and pre-arranged financial support in times of climate disasters<sup>51</sup>.

46 V20, [Climate Vulnerable Economies Loss Report](#), 2022.

47 UNICEF, [Children's Climate Risk Index](#), 2022.

48 UN FAO, [The Unjust Climate](#), 2024.

49 Swiss Re Institute, [Hurricane Ian to add pressure in an already hardening re/insurance market](#), Economic Insights, 2022.

50 GFIA, [Global protection gaps and recommendations for bridging them](#), 2023.

51 Germany pledged EUR 170 million and other countries' commitments reached EUR 40 million so far. Federal Ministry for Economic Cooperation and Development, [V20 and G7 Jointly Launch Global Shield against Climate Risks at COP27](#), 2022.



### The Global Shield against Climate Risks

In response to the clear call by vulnerable countries within and outside the UNFCCC for an adequate response to the climate crisis, the Group of Seven (G7), in partnership with the V20 committed to jointly work towards a Global Shield against Climate Risks. This collaboration aims at scaling up action in the field of climate risk insurance and preparedness to address the urgent needs of poor and vulnerable countries facing increasing risks of losses and damages from climate change.

Beyond the G7 and the V20, supporters of this Initiative include the EU, Kreditanstalt für Wiederaufbau (KfW), the United Nations Development Programme (UNDP), the Asian Development Bank, the Centre for Disaster Protection, the WB, the Insurance Development Forum, the United Kingdom and the German Federal Ministry for Economic Cooperation and Development.

There are currently three financing vehicles of the Global Shield, which are a) the Global Shield Financing Facility hosted by the WB; b) the Global Shield Solutions Platform hosted by the Frankfurt School of Finance & Management; and c) the Climate Vulnerable Forum (CVF)-V20 Joint Multi Donor Fund hosted by United Nations Office for Project Services (UNOPS).

In order to minimise climate-related risks and the potential burden of natural disasters on LMICs, the HLEG believes that the goal of EU and other donors in supporting partner countries regarding climate insurance should be **twofold**:

- increasing **affordable and accessible coverage** at all levels with distribution of risks across public and private actors and;
- improving the **insurability** of risks through adaptation measures and the associated public good, data infrastructure.

### Insurance and risk financing at sovereign level

The HLEG looked at various examples of insurance and other risk financing currently being rolled out at a country or regional level. Insurance, and insurance-based instruments like catastrophe bonds (CAT bonds) and risk pools, effectively share (or redistribute) risk globally, allowing the insured party to access predictable and cost-effective finance when disasters strike, thereby building resilience to climate change.

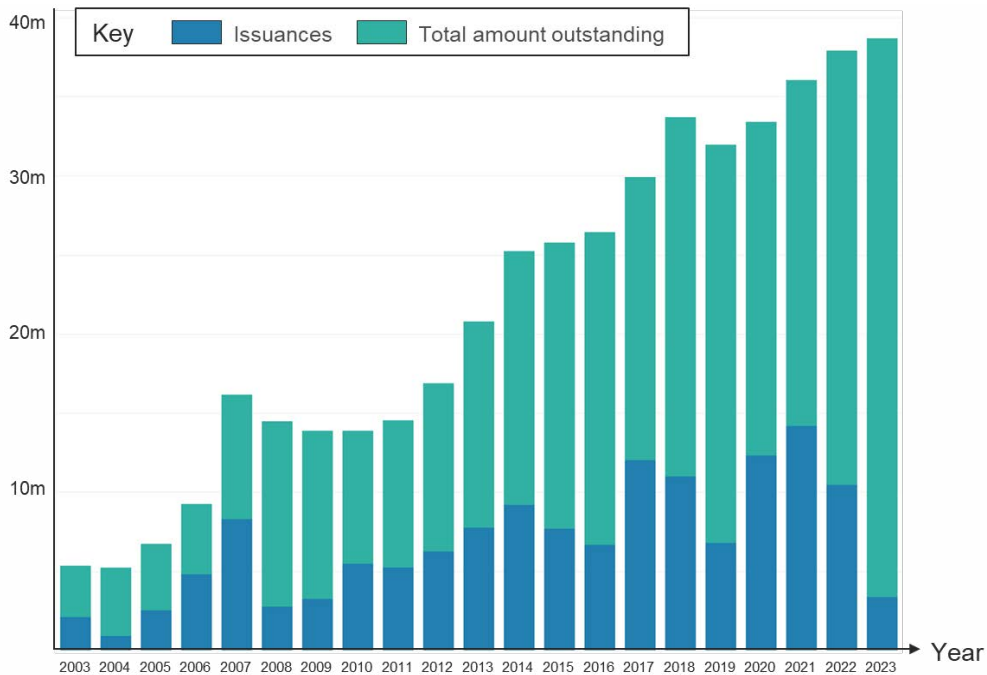
Indeed, at the 'sovereign level', **potential avenues to increase sovereigns' disaster risk coverage can be through ad hoc bilateral mechanisms<sup>52</sup>, market mechanisms such as CAT bonds, or multi-national risk pooling schemes**. It is to be noted that within the UN Agenda 2030 framework, insurance, including insurance-like mechanisms such as CAT bonds and risk pools, are explicitly recognised as a key vehicle to enable risk sharing and transfer solutions that can build greater resilience at both local, national and global levels.

**Regional risk pools** are attractive as they can offer coverage at lower cost through pooling risk across countries, have strong regional ownership and they also offer wider benefits such as platforms for technical assistance and access to risk data, as well as linking explicitly to resilience and adaptation plans. For LMICs, there are also several regional risk pools offering parametric insurance to member countries, including the Caribbean Catastrophe Risk Insurance Facility (CCRIF), the Pacific Catastrophe Risk Insurance Company (PCRIC), the Southeast Asia Disaster Risk Insurance Facility (SEADRIF), and the African Risk Capacity (ARC). The EU already supports several of these through grants and other donors via loans.

52 One example of such mechanisms is UNICEF's Today and Tomorrow initiative being piloted in Solomon Islands, Haiti, Bangladesh, Madagascar, and Mozambique. Another is the contingent credit facility (CCF) and principal payment option (PPO) offered by IDB.

**CAT bonds** are a type of insurance-linked security<sup>53</sup> (ILS) typically allowing insurance companies to transfer the risk of disasters covered by their policies to investors in the capital market. In a CAT bond, the insured entity (e.g. a country) pays a fee to the CAT Bond issuer (e.g. an IFI or an ad-hoc created SPV). The funding raised from the capital market by the issuer of the CAT bond is invested in high quality liquid assets and is paid out to the insured entity if and only if catastrophic events, such as an earthquake or hurricane, occur. The bond investors receive only the remaining principal after this payout is deducted.

**Figure 5 – ILS issuances and outstanding (millions of USD, 2003–2023)**



Source: Artemis, *Catastrophe Bond & ILS Market Report, 2023*

CAT bonds provide financial protection but do not necessarily decrease the cost of insurance or improve insurability per se, and indeed they have a certain overhead cost of issuance. However, they do provide access to a base of private investors and thus the **potential to achieve scale**, and in the context of mobilising sustainable investment they provide an opportunity to **channel capital** from investors to increase insurance coverage in LMICs. CAT bonds can also be attractive to investors because of their diversification effect stemming from their lack of correlation with other market movements and volatility of traditional asset categories. Another advantage is that the funds are available upfront, unlike in the case of insurance, where the country would have to wait for the payout in case of a trigger event.

According to a staff climate note published by the IMF (July 2022), CAT bonds are, together with green bonds, one of ‘the most prominent innovations in the field of sustainable finance in the last 15 years’<sup>54</sup>. Global issuances have continued to increase since 2000. At the end of 2022, the CAT bond market was worth USD 35.5 billion (compared to USD 467 billion in traditional insurance at end-August 2022)<sup>55</sup>. CAT bonds are however predominantly used in the US and to a lesser extent, in Europe<sup>56</sup>, with far lower coverage in LMICs. Most CAT bonds in LMICs are issued by sovereign entities.

53 Insurance linked securities (ILS) developed in the 1990s after Hurricane Andrew in Florida caused huge losses (USD 17 billion) and the insurance industry sought a way to increase risk-bearing capital. ILS securitise insurance risks, achieving risk transfer, and can involve directly the ‘sponsor’ (i.e. the insurer) or the sponsor and a reinsurer. ILS can cover life, health, property or other risks, including property losses stemming from catastrophes (CAT bonds).

54 S. Ando et al., [Sovereign Climate Debt Instruments: An Overview of the Green and Catastrophe Bond Markets](#), IMF Staff Climate Note, 2022.

55 ECB and EIOPA, [Policy options to reduce the climate insurance protection gap](#), 2023.

56 This may be partly explained by the cost and burden of setting up an ILS vehicle in Europe. ECB and EIOPA Discussion Paper: Policy options to reduce the climate insurance protection gap.

In LMICs, multilateral financial institutions (in particular the WB<sup>57</sup>), have so far helped to facilitate the market through intermediating with the private sector, reducing the transaction cost of issuance of CAT bonds in LMICs, streamlining the process and providing access to a base of private investors, pre-dominantly European institutional investors.

For example, in **the Jamaica CAT bond issued in July 2021** by the WB (see the transaction structure below), WB entered into a risk transfer agreement with Jamaica; Jamaica agreed to make premium payments to the WB, financed using **grant payments** (via the Global Risk Financing Facility and the US Agency for International Development); WB agreed to make payouts to Jamaica if a hurricane occurs that meets pre-agreed intensity thresholds, and WB issued a capital at risk bond to capital markets investors. WB pays investors a bond coupon (priced at the US overnight rate + 4.45%), passing on the risk premiums received from Jamaica under the risk transfer agreement. At maturity WB pays investors the redemption amount (proceeds minus any payouts made to Jamaica). 21 private investors (mainly European) purchased the USD 185 million bond (maturity 3 years) and agreed for the proceeds to be used to finance payouts to Jamaica if a qualifying hurricane event occurs.

**Figure 6 – Structure of the Jamaica CAT bond**



Source: World Bank, [Case study: World Bank Catastrophe Bond provides Jamaica with Financial Protection against Tropical Cyclones](#)

Since 2009 the WB has structured nine CAT bond transactions for sovereigns, sub-sovereigns, state-owned enterprises and other international organisations and funds. The investors for 3 of those issuances are summarised below.

**Figure 7 – Investors for 3 CAT bond issuances structured by the WB**

Cedent (issuance year)	By Geography	By Investor Type
Jamaica (2021)	Europe 60% North America 24% Bermuda 15% Asia 1%	ILS* fund 66% Insurer/reinsurer 17% Asset management 14% Pension fund 3%
Mexico (2020)	Europe 52% North America 42% Bermuda 5% Asia 1%	ILS* specialist fund 61% Asset management 16% Pension fund 15% Insurer/reinsurer 8%
Philippines (2019)	Europe 58% North America 15% Asia 13% Bermuda 4%	Asset management 50% ILS* fund 29% Insurer/reinsurer 13% Pension fund 8%

57 CAT Deferred Drawdown Options (DDOs) are another (non-market) instrument used by the World Bank to help IBRD countries access funds immediately after a natural disaster.

Similarly, the IDB has issued CAT bonds on behalf of LMICs. However, given the inability of LMICs to pay the premiums themselves, MDBs like IDB must seek donor capital to cover the premiums and increase CAT bond coverage. If, on the other hand, the CAT bond market itself were scaled up, it could potentially improve pricing and provide advantageous more pricing to beneficiaries.

### The importance of disaster risk finance for households and businesses

Lastly, actions need to be taken targeting **households and businesses**. This is paramount to build societal resilience to climate change, as evidence shows that businesses needing to suspend their operations for more than one month after a major natural disaster are usually forced to declare bankruptcy<sup>58</sup>.

However, there are several constraints that prevent the development of disaster risk insurance for households and businesses. First, households and businesses are often unaware of climate-related risks: they often lack data or simply lack awareness of the risks they face, or of the possibility and potential benefit of being insured against them. This **lack of awareness** of these risks can lead them to under-invest in resilience, including insurance. Second, a major constraint is the **affordability of insurance**: given that closing the protection gap requires addressing both a supply and a demand question, affordable insurance coverage needs to meet appetite from end-beneficiaries.

In order to increase private insurance coverage at the micro level, it is crucial to build capacity in the insurance supply **ecosystem**, from regulators to insurance companies to financial aggregators. Without an appropriate enabling environment (including policy, regulation, data and infrastructure) that supports sustainable supply and demand for insurance, insurance schemes that are initially subsidised by donor capital may be discontinued after the subsidisation period. There are various capacity-building and engagement activities addressing this aspect initiated by MDBs and DFIs, targeting the local financial intermediaries.

### Improving insurability through adaptation measures

The HLEG also looked at how improving the insurability of risks through adaptation measures and the associated public good, data infrastructure.

It is important to recall that 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. Moreover, not all climate-related risks are insurable. Without measures to reduce the impact of climate change, insurance could become increasingly unaffordable. There is therefore a strong **nexus between disaster risk finance and adaptation**.

Infrastructure assets in LMICs are not usually designed to withstand the impacts of climate change, and as a result are increasingly stressed by multiple effects of climate change including high temperatures, changing precipitation patterns, droughts, floods, and rising sea levels. With LMICs being the most vulnerable countries to climate change, it is imperative to mainstream the integration of climate-related risks in the design, development, construction, and operation of infrastructure assets to build resilience and adaptive capacity.

The most recent United Nations Environment Programme (UNEP) Adaptation Gap Report<sup>59</sup> estimated **the current adaptation finance gap at USD 194-366 billion per year and growing**. At the same time, it found that adaptation planning and implementation appear to be plateauing. This failure to adapt has massive implications for losses and damages, particularly for the most vulnerable, and could undermine fiscal resilience thus making it more difficult for the public and private sector to invest in achieving climate and sustainability goals. At the sub-sovereign level, ensuring resilient infrastructure and particularly **climate-adapted cities** is also gaining prominence in international discussions. Over 50% of the world's population lives in cities, and urbanisation rates are increasing globally<sup>60</sup>. As such, they are critical centres of human activity, and need specific measures to be prepared for and protected from climate-related and other natural disasters.

The European Commission and EU DFIs can play a key role by deploying blended finance at scale to de-risk and accelerate investments in **climate resilient infrastructure**. For example, the Infrastructure Climate Resilient Fund (ICRF)<sup>61</sup> supported by the Green Climate Fund, in partnership with Africa Finance Corporation, aims to drive investments in climate-resilient infrastructure projects which are planned, designed, built and operated in a way that anticipates, prepares for, and adapts to changing climate conditions. This intervention will ultimately support the delivery of

58 GIZ, [Developing risk management approaches for climate risks](#), 2021.

59 UNEP, [Adaptation Gap Report 2023](#), 2023.

60 World Bank, [Urban Development](#).

61 GCF, [FP205, Infrastructure Climate Resilience Fund \(ICRF\)](#).

reliable low-carbon and climate-proof infrastructure services to vulnerable populations in Africa. In this vein, DFIs and MDBs can consider integrating adaptation and resilience considerations into all their investment decisions in climate-sensitive sectors like infrastructure and agriculture, and the European Commission can consider ensuring that its own guarantees and other financing similarly integrate adaptation and resilience.

Insurance can also play an important role in **enabling and accelerating wider adaptation**, through de-risking otherwise challenging investments in adaptation, e.g., climate-resilient infrastructure. Hence, the HLEG encourages the European Commission and its DFIs to work with MDBs and LMICs in the context of their national disaster risk management and adaptation plans to facilitate **combined ‘insurance and adaptation finance’** solutions targeted to different end-beneficiaries (households, Small and Medium-sized Enterprises (SMEs), farmers, municipalities...). This would address a major gap in current existing 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 its DFIs can provide, where needed, **calibrated premium support** for the insurance (e.g. support that is conditional on making adaptation investments), **de-risking support** for the adaptation investments and **suitable TA** to support the beneficiary. Interesting and inspiring examples are the **Climate Insurance Linked Resilient Infrastructure Financing** (CILRIF) and the **Restoration Insurance Service Company** (RISCO)– see boxes below.

The HLEG also looked at further **innovations in financing for adaptation and resilience**, including **resilience-related bonds and blended finance arrangements for resilient infrastructure** in LMICs. Resilience-related bonds, originally pioneered by the European Bank for Reconstruction and Development (EBRD) in 2019, are becoming increasingly prevalent and offer opportunities to scale up institutional investment in adaptation. Research by the Global Center on Adaptation (GCA) and Climate Bonds Initiative (CBI) in 2021, in cooperation with the EBRD, found that more than 1000 green bonds that have been issued to date included climate resilience components. 16.4% of green bonds issued worldwide included activities related to adaptation and resilience (up to September 2020), mostly in water and water-related sectors<sup>62</sup>. Out of these, only 6% have been issued in emerging markets. In 2021, CBI produced a step-by-step guidance on how to issue a Green Bond for Resilience<sup>63</sup>.

In light of these elements, the HLEG concludes that..

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#### *Recommendation 4*

*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.*

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62 Global Center on Adaptation, [Green Bonds for Climate Resilience: State of Play and Roadmap to Scale](#), 2021.

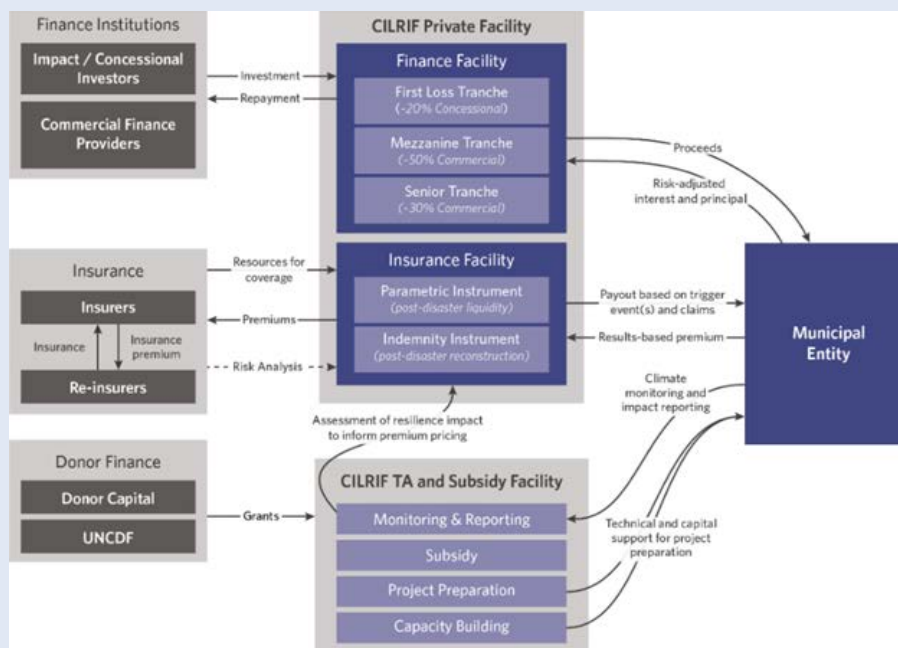
63 Global Center on Adaptation, [Green Bonds for Climate Resilience: A Guide for Issuers](#), 2021.



### The Climate Insurance Linked Resilient Infrastructure Financing (CILRIF)

The CILRIF is a structure developed by a United Nations Capital Development Fund (UNCDF)-convened working group. The CILRIF provides cities access to affordable, 10-20-year climate insurance with pre-arranged premiums – contingent upon the cities' commitment to invest in climate resiliency. In the CILRIF structure, if a city implements the adaptation measures set out in the insurance policy, the insurance premium will decrease to reflect the managed risk. Importantly, a city's access to insurance coverage is also expected to reduce the city's financing cost and allow access to relatively lower cost capital for development<sup>64</sup>. The CILRIF thus incentivises municipalities in at-risk cities in LMICs to make necessary climate resilience investments, by providing a combination of funding, insurance, assistance with monitoring and capacity-building. It benefits from a 20% first-loss tranche held by concessional finance providers, as well as grants from international donors, and mobilises commercial finance providers and insurers.

**Figure 8 – CILRIF structure**



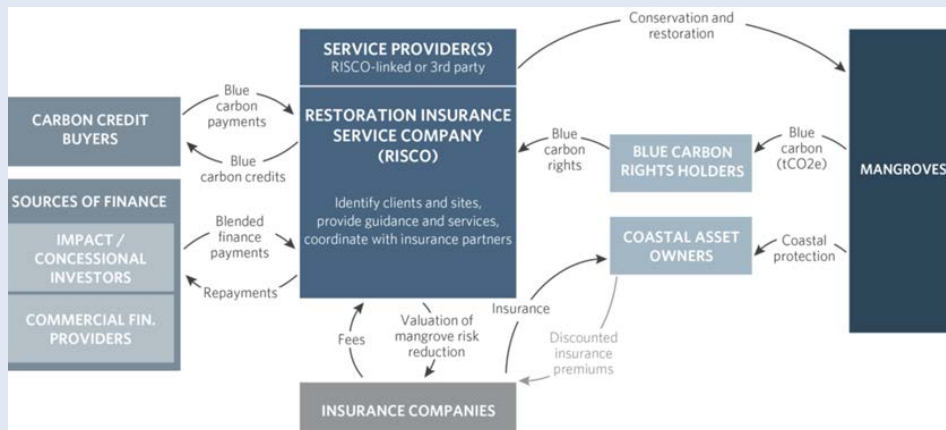
### Restoration Insurance Service Company (RISCO)

One interesting example ties together natural capital and climate-risk protection, while incorporating insurance affordability and investment for adaptation. As referred to in Section 2.1, financing the preservation of public goods such as natural capital is particularly challenging, despite the climate mitigation and adaptation benefits. Insurance is part of the toolkit that can enable such investments, as it both transfers risk to the private sector and incentivises measures to reduce the ultimate risks through variable premia. Restoration Insurance Service Company (RISCO) proposes a financial model which uses insurance premia to conserve and restore mangroves in LMICs. RISCO will be the first enterprise to assess and monetise the coastal asset risk reduction value and carbon storage benefits of mangroves. In the short-term, RISCO will rely on a blended mix of grants, equity, and loans from concessional and commercial finance providers. The model expects to become self-sufficient with revenues from insurance purchased by (private or public) coastal asset owners and blue carbon credits sold to organisations with climate targets. Thus, it should incentivise continued conservation and restoration of mangroves, directly benefiting the coastal asset owners and indirectly the rest of society<sup>65</sup>.

64 United Nations Capital Development Fund (UNCDF), [Climate Insurance Linked Resilient Infrastructure Financing](#).

65 Climate Finance Lab, [Restoration Insurance Service Company \(RISCO\)](#).

Figure 9 – RISCO structure



The planned pilot is in the Philippines, one of the most vulnerable countries to climate change. It will target 3,400 ha of mangrove conservation and 600 ha of restoration. Over ten years, the pilot will provide a climate benefit of more than 600,000 tonnes of avoided and sequestered CO<sub>2</sub> emissions and is expected to generate more than USD 10 million in revenue from the insurance sector and blue carbon markets. The five countries that are best positioned for replicating the RISCO pilot are Mexico, Malaysia, Indonesia, Philippines, and Brazil.

#### InsuResilience Investment Fund (IIF)

For example the InsuResilience Investment Fund (IIF) invests through equity and debt in local financial intermediaries and insurance companies in emerging markets, to stimulate the availability and use of climate adaptation insurance by at-risk small businesses and households. The Equity sub-fund of IIF invests in **local** insurers and brokers actively building the market for climate insurance in emerging markets, while the Debt sub-fund lends to financial institutions and aggregators in return for participation in the development and distribution of climate insurance. The debt sub-fund has senior noteholders including two DFIs and several institutional investors (an insurance company, three pension funds, a bank and a family office). The fund also has a 'premium support facility' to provide temporary subsidies to reduce insurance premiums, as well as a TA facility to help investees with their insurance offering. The IIF has business partnerships with reinsurers like Swiss Re, Munich Re and Hannover Re<sup>66</sup>.

Another example which combines support to data infrastructure with awareness raising is the Strategic Alliance GIZ-Allianz-BIMA<sup>67</sup>, a collaboration between the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH, Allianz SE, Allianz Re and BIMA MILVIK, which joined forces to support governments, SMEs and households across the globe in strengthening their risk management plans. On the topic of climate risk, the project is currently working in Morocco and Ghana, developing integrated risk management solutions that incorporate insurance products. The project does groundwork preparations covering each step for implementing risk transfer solutions for industrial parks in Morocco and for three municipalities in the greater Accra area in Ghana.

66 InsuResilience Global Partnership, [The InsuResilience Investment Fund \(IIF\)](#).

67 GIZ, [Developing Risk Management Approaches for Climate Risks](#), 2021.

# #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<sup>68</sup>. In fact, it is estimated that more than half of the world's population lacks access to social protection benefits. The estimated funding gap for extending a social protection floor for all people in developing countries is estimated to be about USD 1.2 trillion<sup>69</sup>. 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.

With this gap in mind, the HLEG examined two approaches to social finance. One – rather straightforward – approach discussed in the HLEG involves assessing social impact and **mitigating social harm in investments**, regardless of the investment's particular goal. The second approach that the HLEG discussed was how to mobilise private social finance through **actively funding activities with a substantial positive contribution to social objectives**. This second approach proved to be more complicated to assess.

### Approach one: Mitigating social harm or risk

**A first possible approach to social finance** emphasises the importance of minimising social harm from an investment, when the investment is primarily focused on achieving other sustainability goals. Various methods exist in the market to minimise social risks, of which the HLEG evaluated several examples, concluding that they are generally non-contentious and feasible.

- **Corporate governance requirements.** By holding corporates accountable for their actions and requiring them to conduct appropriate due diligence, corporate governance requirements may help prevent certain practices such as child labour, worker exploitation and other adverse social impacts. Many LMICs already have corporate governance requirements in place. For example, Brazil introduced Bill 572/22 in March 2022 which sets out mandatory human rights due diligence obligations for Brazilian companies and companies operating in Brazil<sup>70</sup>.

In the EU, the proposed Corporate Sustainability Due Diligence Directive, which is currently pending final approval by the Council, also aims to introduce mandatory due diligence requirements for large corporates. Larger corporates have a certain degree of leverage over their business chain of activities, and thus smaller suppliers based in LMICs may also be required to improve their due diligence processes and social standards as a result of the directive.

- **Exclusion of some activities:** exclusion processes are often designed to avoid investing in activities, specific sectors or companies which may not meet minimum standards of responsible business practices. For example, Argentina's Sustainable Finance Framework foresees that any eligible social expenditures shall exclude activities relating to alcohol, gambling, tobacco, child labour or forced labour<sup>71</sup>.
- **Risk assessment:** social risks have financial consequences for companies, such as reduced productivity due to labour strikes and employee turnover, as well as potential damage to the company's reputation. Investors are increasingly considering the financial impact of social risks in their risk calculations.

68 Environmental Finance, [Sustainable Bonds Insight 2023](#).

69 ILO, [Developing countries should invest US\\$1.2 trillion to guarantee basic social protection](#), 2020.

70 Brazil, [Brazil Draft Bill Proposal n.572](#), 2022.

71 Argentina, [Argentina's Sustainable Finance National Strategy](#), 2023.

- **Social lens investment strategies:** for example, Gender Lens Investing has gained more and more importance in order to promote gender equality and mainstreaming gender in investment decisions.
- **Minimum social safeguards in taxonomies** are often included in green taxonomies in order to avoid negative social impact of activities that would contribute to climate or environmental objectives. This is the case for the Colombian and the EU taxonomies<sup>72</sup>.

### Approach two: The funding of activities with a positive social impact

A second approach to social finance is to **mobilise private capital directly to address social challenges**. Social SDGs currently receive the lowest levels of funding compared to other development goals<sup>73</sup>. In fact, it is estimated that many LMICs may not be able to cover even half of their social assistance costs through public finances alone by 2030<sup>74</sup>. As a result, social finance is gaining international recognition, with the G20 Sustainable Finance Working Group being tasked with addressing social considerations. Moreover, following the Covid-19 pandemic, funding activities with a positive social impact gained more prominence<sup>75</sup>.

As a first step, it is important to contemplate the **purpose of social policy** and the **best way to deliver social services**, while ensuring **inclusiveness and equality**. Social services are to a large extent public goods and hence tend to be largely administered and delivered by public institutions. On the one hand, mobilising private social finance can help to enhance and/or diversify the capacity of public services and increase the funding to address social challenges<sup>76</sup>.

On the other hand, shifting the responsibility for funding and/or delivering certain services from the public sector to private entities **may not always be suitable and may have unintended consequences**. Private investors are often driven by the potential financial gain of an investment, and this is no different when it comes to investing in social activities. In some circumstances, the private funding of social services may lead to challenges in generating enough revenue to satisfy the expectations of private investors, where the **primary focus is on providing a social service for all rather than making a profit**. Moreover, when it is possible to generate revenue, for example in healthcare and education, it can change the nature of the social service, leading to a shift in priority from serving the community to maximising profits. Payment-by-results mechanisms may incentivise organisations to tailor their services based on contract terms rather than the genuine needs of clients. Consequently, those with the most urgent needs may be overlooked as operations focus on clients with lower needs, a phenomenon often referred to as ‘cream skimming’. This can lead to exclusion and inequality, as those who cannot afford to pay for these services are left behind. Furthermore, the structure of market instruments, firmly linked to social impact measurement, may prioritise easily measurable outcomes that generate financial returns while potentially neglecting broader, longer-term social needs. Social impact often becomes evident only over an extended period, making it challenging for investors to balance short-term financial considerations with long-term social factors.

Therefore, it is necessary to carefully consider the potential opportunities, risks and consequences of mobilising private capital for social activities in order to ensure that they **continue to serve the needs of all members of society**.

While the social SDGs address various social issues and aim to improve the well-being and livelihoods of people around the world, another challenge in scaling up private investment into social projects is the various approaches of defining social objectives, economic activities that make a substantial contribution to them, and the social risks involved. While environmental objectives and criteria can be rooted in environmental science, **social objectives** are often more **qualitative and context-specific**. Moreover, some market participants may focus on process-related impacts, such as working conditions of employees, while others may focus on the social impact of a good or a service. Having such a variety of definitions and processes increases transaction costs, as investors will be required to spend additional resources to understand the different definitions or selection procedures that are being applied.

72 The Colombian Taxonomy focuses on compliance with the six IFC performance standards, while the EU taxonomy refers to the OECD MNE Guidelines and the UN Guiding Principles on Business and Human Rights (UNGPs), the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.

73 Environmental Finance, [Sustainable Bonds Insight 2023](#).

74 ODI, [Working Paper on Financing social assistance in lower-income countries post-Covid-19](#), 2023.

75 World Bank, [Poverty and Shared Prosperity Report, 2022](#).

76 Intermediate models also exist between (1) public provision and public funding and (2) private provision and private funding, such as publicly funded private provision.

From an investor's risk management perspective, there is currently **no global framework to guide in measuring, managing, and mitigating the risks**. In other words, there is a lack of comprehensive analysis of how social-related risks can manifest as material financial risks.

Addressing specific social issues necessitates the identification of specific indicators, and impact measurement is crucial to understand how the capital invested contributed to a specific social change. While there are some international social indicators, they may not be suitable for local contexts. Several regulatory developments targeting impact have sought to address this issue.

### Recent social finance developments targeting impact

**Social considerations in taxonomies.** Many LMICs are already developing taxonomies which include social considerations.

- In January 2021, **India's** Ministry of Finance commissioned a Task Force on Sustainable Finance. The task force's terms of reference include suggesting a draft taxonomy of sustainable activities. While there is limited information available publicly on the draft, the taxonomy is expected to contain both green and social considerations<sup>77</sup>.
- The **Mexican** Taxonomy is recognised for its progressive approach in addressing environmental and social activities, with a particular emphasis on gender equality, which holds significant importance for the country. The taxonomy is structured into three sections, encompassing climate change mitigation, adaptation, and gender equality, and establishes specific criteria and point systems for each. Additionally, the taxonomy incorporates requirements for Do No Significant Harm (DNSH) and Minimum Safeguards<sup>78</sup>.
- **Mongolia** also recently converted its green taxonomy into an SDG taxonomy and now includes social sectors such as health, education, communication, and affordable infrastructure<sup>79</sup>.
- Launched in 2022, **Georgia's** Sustainable Finance Taxonomy covers both green and social aspects, including affordable basic infrastructure, healthcare, financial services, food security and education, technology, culture, fitness<sup>80</sup>.
- In a similar vein, the Principle-Based Sustainable and Responsible Investment Taxonomy for the **Malaysian** Capital Market (SRI Taxonomy) also includes a social component<sup>81</sup>.

### Reporting frameworks.

- In **India**, the Business Responsibility and Sustainability Report (BRSR) introduced by the SEBI aims to enhance disclosures on Environment, Social, and Governance (ESG) standards, with a focus on the top 1,000 listed entities. The BRSR seeks to establish a link between a company's financial performance and its ESG responsibilities. The report requires qualitative and quantitative disclosures on social and environmental aspects, with a view to promoting ethical, transparent, and accountable business conduct, respect for human rights, and the welfare of all stakeholders<sup>82</sup>.
- Similar to the Indian BRSR, the EU's Corporate Sustainability Reporting Directive (CSRD) requires certain companies to report on social and environmental issues<sup>83</sup>.
- The WB Group's Country Climate and Development Reports (CCDRs) help countries prioritise impactful actions to reduce greenhouse gas (GHG) emissions and enhance adaptation and resilience while simultaneously

77 India Budget, [Economic survey 2021-2022](#), 2022.

78 Government of Mexico, [Taxonomía Sostenible de México, 2022](#).

79 UNESCAP, [Mongolia's Sustainable Finance Journey & SDG Taxonomy](#).

80 National Bank of Georgia, [Sustainable Finance Taxonomy for Georgia](#), 2022.

81 Securities Commission Malaysia, [Principles-based Sustainable and Responsible Investment Taxonomy for the Malaysian Capital Market](#), 2022.

82 SEBI, [Business responsibility and sustainability reporting by listed entities, 2021](#).

83 European Commission, [Corporate Sustainability Reporting](#), 2023.



delivering on broader social and development goals<sup>84</sup>.

- Another noteworthy initiative is the Taskforce on Inequality-related Financial Disclosures (TIFD) and the Taskforce on Social-related Financial Disclosures (TSFD) who are joining forces to create a single initiative focused on developing a global framework for financial disclosures. This framework will address social and inequality-related risks and opportunities that impact financial stability and long-term enterprise value creation. An early priority will be to establish a governance structure that includes a balance of stakeholder representatives<sup>85</sup>.

**Other initiatives.** A noteworthy initiative is the '2X Challenge', which was set up at the G7 Summit 2018 with a goal of mobilizing USD 3 billion in private sector investments in developing countries in over 3 years to improve access for women to leadership opportunities, employment, finance, and products and services. The target was exceeded, with USD 6.9 billion invested by DFIs and a total of USD 11.4 billion with co-investments. At the G7 Summit 2021, 20 global DFIs and MDBs committed to a new target of USD 15 billion for 2021-2022. This second round of the 2X Challenge exceeded its target and raised a total of USD 16.3 billion, bringing the total investments since 2018 to USD 27.7 billion<sup>86</sup>.

## Social bonds

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, sustainability bonds, gender bonds).

The primary financial instrument used to raise finance for social impact is the **social bond**, or – in combination with finance for positive environmental impact – the **sustainability bond**. Sustainability bonds are bonds where the proceeds are used to finance or re-finance a combination of both green and social projects<sup>87</sup>. Sub-sets of social or sustainability bonds also exist, such as gender bonds, which channel finance towards women's empowerment or equality projects<sup>88</sup>.

### The International Capital Markets Association (ICMA) definition

ICMA describes social bonds as a type of bond instrument where the proceeds will be exclusively applied to finance or re-finance in part or in full new and/or existing eligible social projects<sup>89</sup>. The most common social project categories aim to provide and/or promote: (a) affordable basic infrastructure (e.g. clean drinking water); (b) access to essential services (e.g. health, education and vocational training); (c) affordable housing; (d) employment generation; (e) food security and sustainable food systems; (f) socioeconomic advancement and empowerment (e.g. reduction of income inequality).

**Social bonds have become more and more popular in recent years, and greatly increased as a reaction to the Covid-19 pandemic.** For instance, the EU issued EUR 98.4 billion in social bonds under the SURE instrument to combat the economic and social consequences of the Covid-19 pandemic in the EU. The global issuance of social bonds to fund social initiatives increased to approximately USD 150 billion in 2020, largely due to the Covid-19 pandemic. This represents an impressive seven-fold growth compared to 2019<sup>90</sup>.

84 World Bank, [Country Climate and Development Reports \(CCDRs\)](#), 2023.

85 Task Force on Inequality-related Financial Disclosure, [Joint Statement on Convergence Between TIFD and TSFD](#), 2023.

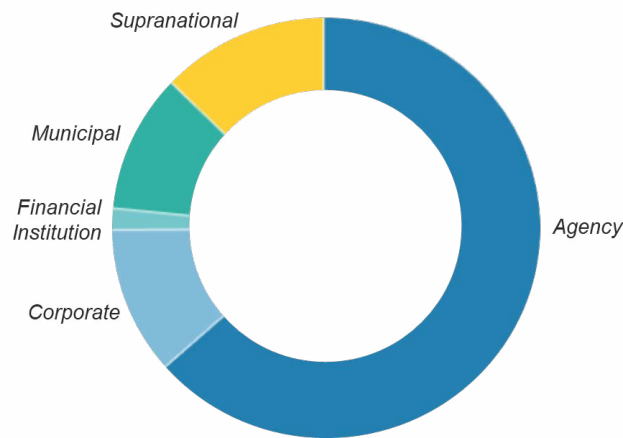
86 G7 Summit, [2X Challenge](#), 2018-2021.

87 ICMA, [Sustainability Bond Guidelines \(SBG\)](#), 2021.

88 UN Women, [Gender bonds: A promising solution to accelerate SDG5](#), 2023.

89 ICMA, [Social Bond Principles](#), 2023.

90 ADB, [Social Bonds – Recent Developments and trends: A Primer and Recent Developments in Asia](#), 2021.

**Figure 10 – Social issuer by type (2022)**

Source: Environmental Finance, *Sustainable Bonds Insight 2023*

More broadly, a stimulation of sovereign issuance of social bonds was observed, including in LMICs:

- a. Ecuador issued the world's first sovereign social bond in 2020 (targeting housing)<sup>91</sup>;
- b. Chile became the largest social sovereign issuer in 2021<sup>92</sup>, with 11 bonds raising USD 16 billion<sup>93</sup>, making social bonds the dominant component of the country's thematic issuances;
- c. Guatemala became the first social bond issuer in Central America and the Caribbean and the first Covid-19 relief bond in Latin America<sup>94</sup>.

More generally speaking, **this is a concentrated market with a prevalence of supranational, sovereign and agencies as the main issuers.**

**To guide social impact, the International Capital Market Association (ICMA) published the Social Bond Principles (SBP)**<sup>95</sup>. Like the Green Bond Principles, the SBP are voluntary guidelines. The main principles of the SBP are to promote integrity in the Social Bond market through transparency, disclosure, and reporting. They provide guidance for issuers, investors, and underwriters on key components involved in launching a credible Social Bond, and emphasise transparency, accuracy, and integrity of information disclosed and reported by issuers to stakeholders. The SBP also recommend a clear process and disclosure for issuers and promote the use of qualitative and quantitative performance indicators for reporting the impact of Social Bonds. Additionally, they encourage external reviews to confirm the alignment of Social Bonds with the SBP. For sustainability bonds, ICMA has also issued guidelines<sup>96</sup>.

Other initiatives at local or regional level include the social bond standards developed by the Central American Bank for Economic Integration (CABEI)<sup>97</sup>, the IDB Sustainable Debt Framework<sup>98</sup> or the Association of Southeast Asian Nations (ASEAN) social bond standards<sup>99</sup>:

- The CABEI Social Bond Framework is in line with the ICMA SBP and aims to fund projects in critical sectors such as essential services and job creation. The project selection is overseen by a Multidisciplinary Social

91 IDB, [Ecuador issues world's first Sovereign Social Bond, with the support of an IDB guarantee](#), 2020.

92 Environmental Finance, [Sustainable Bonds Insight](#), 2022.

93 World Bank, [Country Climate and Development Reports \(CCDRs\)](#).

94 IFC, [Emcompass: Social Bonds Can Help Mitigate the Economic and Social Effects of the COVID-19 Crisis](#), 2020.

95 ICMA, [Social Bond Principles](#), 2023.

96 ICMA, [Sustainability Bond Guidelines \(SBG\)](#), 2021.

97 CABEI, [Social Bond Framework](#), 2020.

98 IDB Invest, [Sustainable Debt Framework](#), 2020.

99 ACMF, [ASEAN Social Bond Standards](#), 2020.

Bond Working Group guided by an Environmental and Social Risk Identification, Evaluation and mitigation system. There is also exclusion criterion included within the framework;

- The IDB Sustainable Debt Framework governs the issuance of green, social and sustainability debt instruments. The framework follows the principles outlined by ICMA and is used to finance or refinance various projects, including healthcare and education;
- Issuers of ASEAN social bonds must follow the ASEAN social bond standards as well as the SBP. Eligibility criteria are linked to the ASEAN region and the standards also include exclusion criterion. The disclosure requirements in relation to use of proceeds, project evaluation and selection process, and management of proceeds are more extensive. The standards also encourage periodic reporting in addition to the annual reporting under SBP.

While social bonds hold promise, they also have **several limitations** that must be accounted for. The **average social bond deal size** tends to be **smaller than green bond deals** to date, due also to the limited pipeline of investment-ready projects.

Following the pandemic, **social bond issuance declined, which may be attributed to the reduction of healthcare spending**. Among Green, Social, and Sustainability (GSS) Bonds, the WB reported that social bonds saw the largest decline in volume (-39%) in 2022 compared to 2021<sup>100</sup>. The total volume of social bonds issued in the first three quarters of 2023 was USD 95.8 billion, marking a 25% decrease from the USD 127 billion issued in the first three quarters of 2022<sup>101</sup>. Moreover, in low- and middle-income countries, there is a clear **shift towards issuing sustainability bonds**. This contrasts with the global market trend, where over 60% of issued amounts continue to be labelled as green bonds in 2022<sup>102</sup>.

**Further, Social Impact Bonds (SIBs)** have also gained prominence in the past decades as a valuable tool for fostering social investment. SIBs are performance-pay contracts for public service provision where governments partner with private, for-profit investors or social investors to fund interventions that address social issues. Payments are made from the government to investors when predefined social outcomes are achieved, usually verified by independent evaluators<sup>103</sup>. Building on the SIBs model, **Development Impact Bonds (DIBs)** are also structured as pay-for-success schemes but are focused on developing countries. The first DIB was launched in India in 2014 and focused on girls' education. However, most DIBs are in the pipeline and are yet to be launched<sup>104</sup>.

Discussions have arisen around the effectiveness of SIBs in delivering tangible and lasting social improvements in their designated areas due to their nature and purpose. The controversy stems from early failures of SIBs, which have prompted doubts about their efficacy as a financial instrument, casting doubt on their legitimacy and performance<sup>105</sup>.

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### Recommendation 5

*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.*

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100 World Bank, [Green, Social, and Sustainability \(GSS\) Bonds, Market Update](#), 2023.

101 CBI, [Sustainable Debt Market Summary Q3](#), 2023.

102 OECD, [Green, Social and Sustainability Bonds in Developing Countries: The Case for Increased Donor Co-ordination](#), 2023.

103 OECD, [Understanding Social Impact Bonds Working Paper](#), 2016.

104 OECD, [Web Archive: Social Impact Investment](#), 2015.

105 McHugh et al., [Social Impact Bonds: A Wolf in Sheep's Clothing?](#), 2023.

# #6

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

The protection and restoration of natural capital is another sustainability objective where mobilisation of private finance in LMICs is challenging.

The need to preserve and restore natural capital was reinforced by the historic Kunming-Montreal Global Biodiversity Framework (GBF) agreed in December 2022, with the aim of halting and reversing biodiversity loss by 2030 and reaching the target of living in harmony with nature by 2050. The most recent UNEP State of Nature Finance report highlights the wide financing gap for nature recovery, requiring private flows to triple by 2030 from the latest annual level of USD 35 billion, and presents the various challenges to close this gap<sup>106</sup>. A more ambitious approach to save natural capital and combat climate change and biodiversity loss is necessary.

Part of the issue stems from the fact that biodiversity loss and other negative impacts on natural capital, similar to greenhouse gas (GHG) emissions, are **externalities** – the unaccounted-for, indirect costs and consequences of an economic activity. These indirect costs include crop damage, healthcare costs due to heatwaves and droughts, property loss from floods and rising sea levels, and reduced agricultural productivity or reduced clean water availability due to ecosystem degradation. Externalities are rarely borne by the economic actors who generate them, resulting in a **market failure**.

To address this market failure due to externalities, when it comes to the area of decarbonisation one key part of global efforts were **systems to put a 'price on carbon'** that have been established around the world. Given that **nature is an important carbon sink**, one important avenue to mobilise private finance for nature protection and recovery also revolved in recent years around **carbon taxes or carbon markets**.

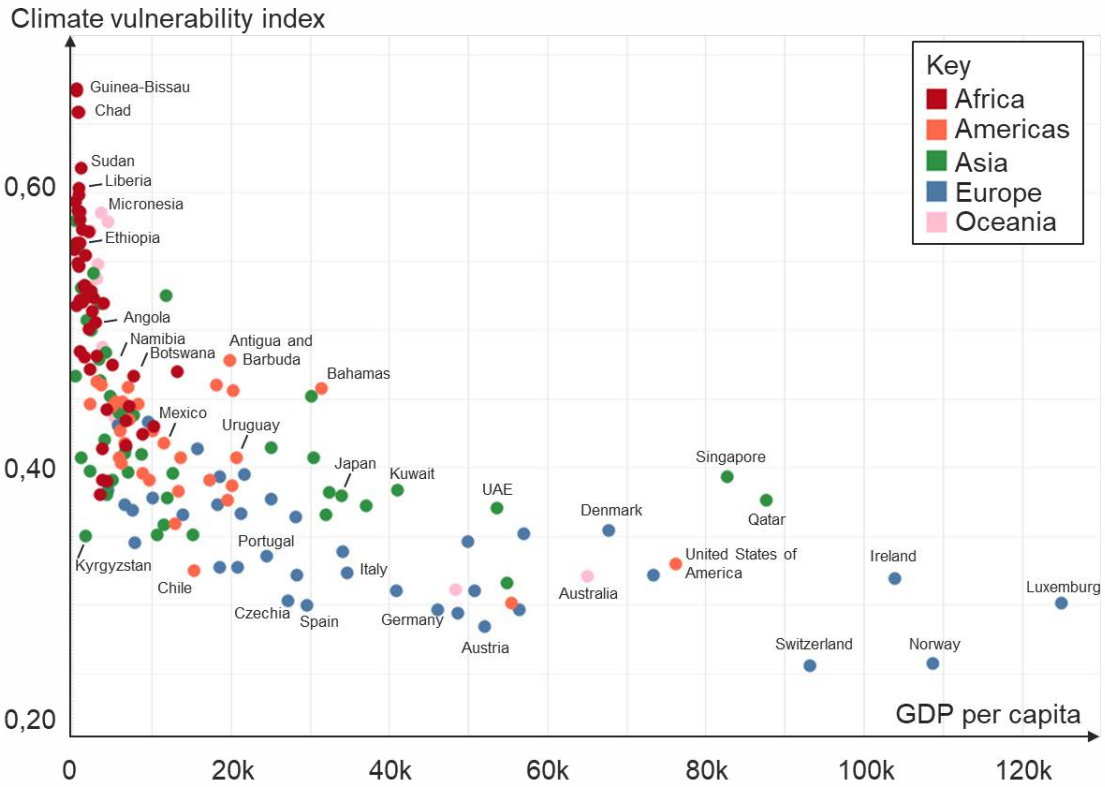
The HLEG specifically looked at the potential of carbon markets and biodiversity instruments as a way to bring more nature finance into LMICs. It is important to recognise that LMICs have **different needs** and face **different challenges**. While carbon markets that focus on emissions reduction might be more relevant for larger, industrialised LMICs that need to prioritise transitioning away from high emissions and environmentally damaging activities, they are less so for smaller emitters that possess a vast amount of natural capital, including biodiversity hotspots and carbon sinks. Support should thus be provided to these countries to encourage them to preserve such natural capital, protecting their resources, while meeting their own developmental goals.

### Carbon markets

While the share of global CO<sub>2</sub> emissions has historically been higher in high-income countries, the burden of climate change will impact countries unequally. LMICs are the most vulnerable to the effects of climate change, and they will also need to achieve carbon-neutral economic growth. At the same time, some emerging economies such as China, India, Brazil and Indonesia are currently among the seven largest GHG emitters (see figure below).

**Figure 11 – Lower-income countries are most impacted by climate change (2023)**

X-axis: GDP per capita in thousands of USD; Y-axis: Notre Dame Climate vulnerability index (0-1)



Sources: University of Notre Dame [Global Adaptation Initiative, Climate Vulnerability Index](#), World Bank Database, [GDP per capita \(current US\\$\)](#)

**Figure 12 – Shares in 2022 global emissions, yearly GHG emission relative changes over the period 2019-2022 and the compound annual growth rate (CAGR) in 1990-2022 (%)**

	Share in global	Change 2019-2022	CAGR (1990-2022)
China	29.2%	7.4%	4.3%
United States	11.2%	-2.2%	-0.1%
India	7.3%	5.7%	3.2%
EU27	6.7%	-3.4%	-1.0%
Russia	4.8%	2.0%	-0.5%
Brazil	2.4%	2.3%	2.0%
Indonesia	2.3%	6.8%	3.4%
Japan	2.2%	-3.6%	-0.3%
Iran	1.8%	3.9%	3.3%
Mexico	1.5%	3.7%	1.8%
Saudi Arabia	1.5%	6.4%	3.9%
Canada	1.4%	-2.4%	0.8%
South Korea	1.3%	-0.8%	2.5%
Türkiye	1.3%	15.8%	3.5%
Australia	1.1%	-4.1%	0.7%
South Africa	0.99%	-12.5%	0.8%
Global		2.3%	1.5%
International Aviation	0.8%	-32.1%	1.5%
International Shipping	1.4%	2.2%	2.0%

Source: European Commission Joint Research Centre, EDGAR database<sup>107</sup>

107 China, the United States, India, the EU27, Russia and Brazil were the world's largest GHG emitters in 2022. Together, they account for 61.6% of global GHG emissions. European Commission, [GHG Emissions of All World Countries 2023 Report](#).



Article 6 of the Paris Agreement establishes the conditions for voluntary cooperation between countries to achieve emission reduction targets set out in their NDCs<sup>108</sup>. This implies that countries are allowed to transfer carbon credits earned from the reduction of GHG emissions to help other countries meet climate targets. One of the main goals of carbon markets is to force emitters to pay for the environmental and societal changes caused, thereby correcting the underlying market failure. Carbon markets can take the form of voluntary or compliance markets.

### Carbon markets

**Voluntary carbon markets** are decentralised, non-regulated markets where private actors (mainly private companies and non-profit organisations) voluntarily buy and sell carbon credits and agree between them on the price of the transacted carbon credits. Private organisations develop methods and procedures to certify the quality of the credits.

**Compliance carbon markets** result from regulation by a supranational, country or regional public authority. All rules, methodologies, and goals are centrally established by the regulator and participation in the market is mandatory – companies covered by the system do not have the possibility to opt out.

The EU Emissions Trading System (EU ETS) set up in 2005 is a noteworthy example of a compliance market and works on a ‘cap-and-trade’ system.

Several LMICs have already recognised the importance of carbon markets and have either implemented them or initiated preliminary steps. Carbon markets are mainly present in LAC and APAC, and tend to be on a **voluntary** basis. In 2021 the **voluntary carbon market (VCM)** in Asia represented approximately 50% of the global market and the market in LAC about 20%<sup>109</sup>. However, carbon markets remain relatively underdeveloped on the African continent. Only a very limited number of LMICs have adopted compliance carbon markets similar to the EU Emissions Trading System (EU ETS). It is worth noting that Nigeria has taken first concrete steps toward a compliance market<sup>110</sup>.

While according to estimates the VCM is expected to increase globally by a factor of 15 by 2030<sup>111</sup>, the positive trend appears to have recently changed: the VCM has experienced a deceleration in 2022, both for issuance of new credits and end-user demand, following significant growth between 2017 and 2021. 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<sup>112</sup>.

Having said that, **the HLEG notes that for many countries, neither compliance markets nor voluntary markets may be the most suitable solution to help scale up sustainable finance flows to nature protection and preservation.** Indeed, many types of carbon credit markets (such as the ETS) need to demonstrate an additional positive change (or ‘uplift’ in terms of reducing CO<sub>2</sub>) is created, which poses a barrier to consider conservation and preservation as eligible activities under such markets. **With this in mind, the HLEG looked at biodiversity instruments.**

108 World Bank, [What You Need to Know About Article 6 of the Paris Agreement](#), 2022.

109 J.P.Morgan, [The climate opportunity: Getting ahead of Latin America’s net-zero transition](#), 2022.

110 ICAP’s [2023 Emissions Trading Worldwide International Carbon Action Partnership Status Report](#), includes a world map with the distribution of ‘cap-and-trade’ carbon markets.

111 Financial Times, [Net Positive: Why Biodiversity Metrics Make for More Effective Carbon Markets](#), 2022.

112 IOSCO, [Voluntary Carbon Markets Consultation Report](#), 2023.

## Biodiversity instruments

The urgency to address biodiversity loss and its severe consequences underscores the need for a comprehensive exploration and evaluation of innovative financing mechanisms.

**Biodiversity credits** could encourage investments in natural capital, especially in biodiversity-rich LMICs. They could represent a valid complement or alternative for restoration projects which have been included under voluntary carbon credits markets, but which do not generate a net positive CO<sub>2</sub> absorption<sup>113</sup>. In their latest analysis, the World Economic Forum Biodiversity Credits Initiative highlights the **potential for growth in the market for biodiversity credits**<sup>114</sup>.

### Biodiversity credits

**Biodiversity credits** are defined as **tradable units representing conserved or restored biodiversity**. These credits can channel finance towards biodiversity while benefiting Indigenous Peoples and Local Communities<sup>115</sup>.

The term biodiversity credit is used as an umbrella concept encompassing different instruments, such as biodiversity offsets, biodiversity insets, philanthropic claims or biodiversity-linked carbon credits. An emerging type of biodiversity credits which is receiving international attention is the biodiversity certificate (or voluntary biodiversity credit), which focuses on net positive biodiversity gains beyond simple offsetting of harm<sup>116</sup>.

Similar to many carbon credit markets, biodiversity credits in general necessitate that an additional positive change is created, which here as well prevents conservation and preservation from being eligible activities. Biodiversity credits are therefore **not a panacea** and must be supplemented by broader measures to address systemic threats like habitat loss and deforestation<sup>117</sup>. Moreover, biodiversity credit markets will need to **overcome significant other challenges to reach scalability**<sup>118</sup>. These include defining and quantifying internationally recognised biodiversity units, setting up pricing mechanisms, adopting regulatory and integrity safeguards, including on additionality, and preventing leakage (where the conservation project simply pushes the threat into another area), which highlights the **need to establish a coherent and commonly agreed methodology**<sup>119</sup>. Beyond the methodology challenge, attracting buyers for biodiversity credits seems a priori difficult. Hence, **implementing policy measures** such as **mandatory disclosure targets** and **compliance markets** could be considered in order to generate demand for biodiversity credits.

**Nature-based solutions (NbS)** have been studied by the HLEG as another mechanism to **mobilise private funding for nature**, some of which could also bring additional climate resilience on top of their biodiversity and nature protection benefits.

### Nature as Infrastructure and nature-based solutions (NbS)

Infrastructure and the environment are significantly interconnected, which is evident in instances like fishing ports relying on healthy habitats and water purification systems being affected by watersheds' upstream conditions. In this context, a holistic approach to infrastructure design is essential, considering the needs of people, the economy, and the planet. Nature-based Solutions have emerged as a vital tool to support LMICs in delivering on their international commitments (Convention on Biological Diversity (CBD), United Nations Convention to Combat Desertification (UNCCD), United Nations Convention on Climate Change (UNCLC), the Ramsar Convention and the Agenda 2030), often contributing to more than one of these commitments, thus having transversal benefits. NbS have been formally defined as 'actions to protect, conserve, restore, sustainably use and manage natural or modified terrestrial, freshwater, coastal and marine ecosystems'<sup>120</sup>.

113 UNEP, [State of Finance for Nature. Time to Act: Doubling Investment by 2025 and Eliminating Nature-Negative Finance Flows](#), 2022.

114 WEF, [Biodiversity Credits: Demand Drivers and Guidance on Early Use](#), 2023.

115 UNDP, [Biocredits to Finance Nature and People: Emerging Lessons](#), 2022.

116 Ibid.

117 Global Center on Adaptation, [Financing Nature-Based Solutions for Adaptation at Scale : Learning from Specialised Investment Managers and Nature Funds](#), 2023.

118 Nature Finance, [Harnessing Biodiversity Credits for People and Planet](#), 2023.

119 WWF, [Beyond Carbon Credits: A Blueprint for High-Quality Interventions that Work for People, Nature and Climate](#), 2021.

120 UNEP, UNEA [Resolution 5](#), 2022.

NbS not only focus on preserving nature and addressing biodiversity loss but also on tackling social and economic challenges and promoting human well-being<sup>121</sup>, thereby supporting sustainable development. Examples of NbS include mangroves or reefs, natural ponds to prevent floods, green roofs and walls to reduce noise, pollution, heat and stormwater. NbS generate additional benefits through the ecosystem services they support such as carbon sequestration, pollination, and water and nutrient cycling.

Despite their potential, NbS are significantly underfunded. The State of Finance for Nature report highlights that annual investments need to triple by 2030 and quadruple by 2050 to effectively address climate, biodiversity, and land degradation challenges. However, the financing of NbS faces a prominent obstacle due to the limited attractiveness to the private sector, with public funding currently dominating. According to the EIB, only 3% of related projects receive significant support from the private sector<sup>122</sup>. The current annual financial flows are USD 154 billion per year, which is inadequate to meet the required USD 384 billion per year by 2025 and USD 484 billion per year by 2030<sup>123</sup>.

**Nature as infrastructure or combined with traditional infrastructure, could contribute to the EU's Global Gateway strategy, while aligning with LMICs' climate and biodiversity goals.**

An essential issue is that the benefits of NbS projects are mostly public goods. Usually, they can provide substantial public benefits for the environment and society but generate limited financial profits, which may discourage potential private investors. Other specific challenges to attract private investors on NbS projects include limited scaling potential due to location-specificity, lack of harmonised data and metrics and the long time to generate benefits<sup>124</sup>. Furthermore, they require a high level of concessional finance. Against this background, their potential for scaling up or replication is limited. **For certain specific and limited cases, however**, innovative solutions can be found to create an enabling environment for private investment. To date, there are already a set of specialised financial entities<sup>125</sup> involved in mobilising private investments for nature finance solutions, using **first loss capital, guarantees, technical assistance facilities and hedging mechanisms** to reduce the overall portfolio risks and improve returns of these projects.

The **Holistic 'landscape approach'** (also known as Integrated landscape management (ILM)) is another financial mechanism considered that the HLEG studied as an instrument to finance nature, given that carbon and biodiversity credits come with some 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'** in the context of its new strategic engagement model.

#### Integrated landscape management (ILM)

The ILM approach seeks 'to provide tools and concepts for allocating and managing land to achieve social, economic, and environmental objectives in areas where agriculture, mining, and other productive land uses compete with environmental and biodiversity goals'<sup>126</sup>. This interdisciplinary, cross-sectoral, and holistic approach is used to plan natural resources in a collaborative way, in contrast to the sector-based solutions (e.g., water, health, agriculture)<sup>127</sup>. The aim is to enhance people's livelihoods, security, and resilience to climate variability and change. The landscape approach has the potential to have a more significant impact than a single project, as well as being more 'bankable' thanks to the incorporation of various economic activities and revenue streams. However, it is important to be able to track and measure the use of landscape approach, to be able to scale it up.

An example of an organisation working with this method is the World Wide Fund for Nature (WWF), which has developed a 'landscape finance lab'<sup>128</sup>.

121 UNEP, [State of Finance for Nature. Time to Act: Doubling Investment by 2025 and Eliminating Nature-Negative Finance Flows](#), 2022.

122 EIB, [Investing in Nature-Based Solutions](#), 2023.

123 UNEP, [State of Finance for Nature. Time to Act: Doubling Investment by 2025 and Eliminating Nature-Negative Finance Flows](#), 2022.

124 Van Raalte D. and Ranger N. *Nature Positive Investing: The role of Specialised Investment Managers and Nature Funds*, Oxford University.

125 The &Green Fund, [FP190: Climate Investor Two, Green Climate Fund/Climate Investor Two – Climate Fund Managers; Aqua Spark](#).

126 Sayer J. et al., [Ten Principles for a Landscape Approach to Reconciling Agriculture, Conservation, and other Competing Land Uses](#), PNAS, 2013.

127 UNEP, [A Landscape Approach to Development](#), 2016.

128 WWF, [Sustainable Landscapes](#).

There are successful examples of projects using the landscape approach in LMICs. The Great Green Wall, the African Union's initiative to develop a green belt from Senegal to Djibouti, is an excellent example of a transnational landscape approach. The belt is meant to protect the land against desert encroachment and soil erosion. It will enable each country to set its local goals and address environmental issues within the local context. Through initiatives aimed at soil quality improvement, it will work with local communities to increase crop yield and agricultural production, benefitting local livelihoods<sup>129</sup>. Another thriving example of a landscape approach project is the Gabon Special Economic Zone (GSEZ), a public private partnership between Arise Integrated Industrial Platforms and the Republic of Gabon. GSEZ is the first carbon-neutral certified industrial zone in Africa, integrating sustainable practices like green energy, low carbon transport, sustainable forestry management, and economic growth in alignment with national climate goals. GSEZ ensures the natural regeneration of forests, timber, and traceability. Moreover, it has expanded to special investment zones like Ikolo ZIS and Mpassa Lebombi, providing direct and indirect jobs in the region and scaling up sustainable practices.

Furthermore, there are other innovative financial instruments that could be explored, such as **sovereign green bonds covering nature and biodiversity projects**. For instance, the Seychelles with the support of the WB issued the world's first **blue bonds specifically designed for marine conservation**<sup>130</sup>.

**The HLEG notes the important role played by DFIs and MDBs in mobilising finance for nature**, as well as the complementary role of speciality investment managers in connecting local knowledge and projects to global pools of capital. The HLEG believes the European Commission could have a role in scaling up new innovative financing models in this area, working closely with investors and partners in LMICs.

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#### *Recommendation 6*

*The European Commission, together with DFIs and MDBs, should help LMICs tap more private capital for restoring their natural capital, including by helping 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, which can yield benefits in the short to medium term.*

*In particular, the HLEG believes the EU should **play a frontrunner role for the development of robust biodiversity credit markets** by contributing to LMIC governments' efforts to set up appropriate transparency around these instruments, ensuring their integrity and developing measurement, verification and pricing frameworks.*

*The HLEG also encourages the European Commission to further explore and scale up the use of **landscape approaches** in LMICs.*

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129 World Bank Group, [A Framework for Action for Sustainable Development, Landscapes – FAQ](#), 2012.

130 World Bank, [Seychelles Launches World's First Sovereign Blue Bond](#), 2018.

## #7

## HOW CAN THE EU HELP BOLSTER THE SIZE AND DEPTH OF LMICS' 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 towards sustainable investments in LMICs. They also foster sustainable economic growth and assist LMICs in diversifying their sources of financing for a sustainable and fair transition. Capital markets indeed play a **pivotal role** in the global economy by facilitating the allocation of financial resources from savers to borrowers, thereby fuelling economic growth and development. Developing robust market infrastructures is crucial for LMICs to attract investment and foster development. Enabling efficient capital allocation, capital markets **contribute to economic stability, innovation, and job creation**.

One key advantage of developing **local capital markets** is the ability to support the issuance of financial products denominated in **local currencies** in LMICs. Promoting the development of local currency financial products can 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 strengthen resilience to external shocks.

**Today, the majority of local capital markets in LMICs lack the required size and liquidity as well as the necessary regulatory building blocks, market supervision and infrastructure** to scale up capital markets.

Of the 70 major stock exchanges worldwide (with a total market capitalisation of USD 113 trillion)<sup>131</sup>, the 15 largest account for 70% of the total market capitalisation. None of these is located in Africa nor in the LAC region. In LMICs the largest exchanges are concentrated in China<sup>132</sup>. When looking at the securities exchanges per country in financing the economy, it also appears clear that **LMICs' local exchanges contribute much less on average to financing the economy than they do in advanced economies**.

Among LMICs, the APAC has the largest regional market capitalisation, surpassing **USD 8.38 trillion**, constituting 7.5% of the global market capitalisation. India plays a pivotal role contributing over 50% to the total regional capitalisation. In particular, the National Stock Exchange of India (NSE) stands out with an impressive market capitalisation of USD 3.39 trillion, securing its position as the 9<sup>th</sup> largest stock exchange globally in 2022<sup>133</sup>.

When zooming in on the stock exchange in **LAC**, the landscape is quite distinct. The regional market capitalisation in LAC stands at **USD 1.52 trillion**, constituting a modest 1.4% of the total global market capitalisation (see first row of the chart 'overview of stock exchanges' below). The largest stock exchange in the region, B3 (Brazil, Bolsa, Balcão) in Brazil, has a market capitalisation of USD 794 billion, representing **49% of the country's Gross Domestic Product (GDP)**. However, this figure is notably lower than the leading stock exchanges in the APAC and SSA<sup>134</sup>.

African exchanges, particularly those in **SSA**, stand out with relatively smaller profiles compared to their counterparts in LAC or APAC. They are characterised by low market capitalisation totalling **USD 1.34 trillion**, which represents **only 1.2% of the global market capitalisation**<sup>135</sup>. SSA exchanges often grapple with challenges such as high transaction costs, including clearing and settlement fees, brokerage commissions, and exchange fees. A notable exception to this situation is the **Johannesburg Stock Exchange (JSE)**, which dominates the SSA market capitalisation. The JSE alone boasts a market capitalisation of **USD 1.17 trillion**, equivalent to nearly 300% of South Africa's GDP, securing

131 As of June 2021. ITF Impact Taskforce, [Mobilising Institutional Capital towards the SDGs and a Just Transition](#), 2021.

132 ITF Impact Taskforce, [Mobilising Institutional Capital towards the SDGs and a Just Transition](#), 2021.

133 Based on an analysis commissioned to the Frankfurt School of Finance and Management by the HLEG, using data from World Federation of Exchanges, Sustainable Stock Exchanges Initiative and securities exchanges' own websites.

134 Ibid.

135 Ibid.

its position as the 21<sup>st</sup> largest exchange globally in 2022. **Excluding the JSE**, the collective market capitalisation drops significantly to **USD 279 billion**, constituting **a mere 0.25% of the total global market capitalisation** of exchanges.

In the context of the European Neighbourhood and Middle East and North Africa (MENA), the market capitalisation for the entire region stands at **USD 517 billion**, constituting a modest 0.5% of the total global market capitalisation. Borsa Istanbul dominates as the largest stock exchange, contributing over 60% to the regional market and representing 40% of Turkey's GDP<sup>136</sup>, followed by Morocco and Egypt, which jointly constitute 20% of the total regional market capitalisation.

**Figure 13 – Overview of stock exchanges in Low- and Middle-Income Countries per region (2022)<sup>137</sup>**

	Asia-Pacific	Latin America Caribbean	European Neighbourhood and MENA	Sub-Saharan Africa
Total regional market capitalisation (USD bn)	<b>8 376</b>	<b>1 517</b>	<b>517</b>	<b>1 338</b>
Average company market capitalisation (USD bn)	<b>0,640</b>	<b>0.907</b>	<b>0,218</b>	<b>1,497</b>
Largest stock exchange in the region Domestic market capitalisation (USD bn)	National Stock Exchange India <b>3 387</b>	B3- Brasil Bolsa Balcão Brazil <b>794</b>	Borsa Istanbul Türkiye <b>330</b>	Johannesburg Stock Exchange South Africa <b>1 172</b>
2nd largest stock exchange Domestic market capitalisation (USD bn)	Tehran Stock Exchange Iran <b>1 423</b>	Bolsa Mexicana de Valores Mexico <b>454</b>	Bourse de Casablanca Morocco <b>54</b>	Nigerian Exchange Nigeria <b>91</b>
3rd largest stock exchange in the region Domestic market capitalisation (USD bn)	Bombay Stock Exchange India <b>1 116</b>	Bolsa de Valores de Lima Peru <b>71</b>	The Egyptian Exchange Egypt <b>39</b>	Nairobi Securities Exchange Kenya <b>16</b>

*NB: The table only included exchanges from countries listed on the OECD DAC List. China is excluded from the table. NBB: SSA figures are skewed by the large total as well as average company market capitalisation on the Johannesburg Stock Exchange*

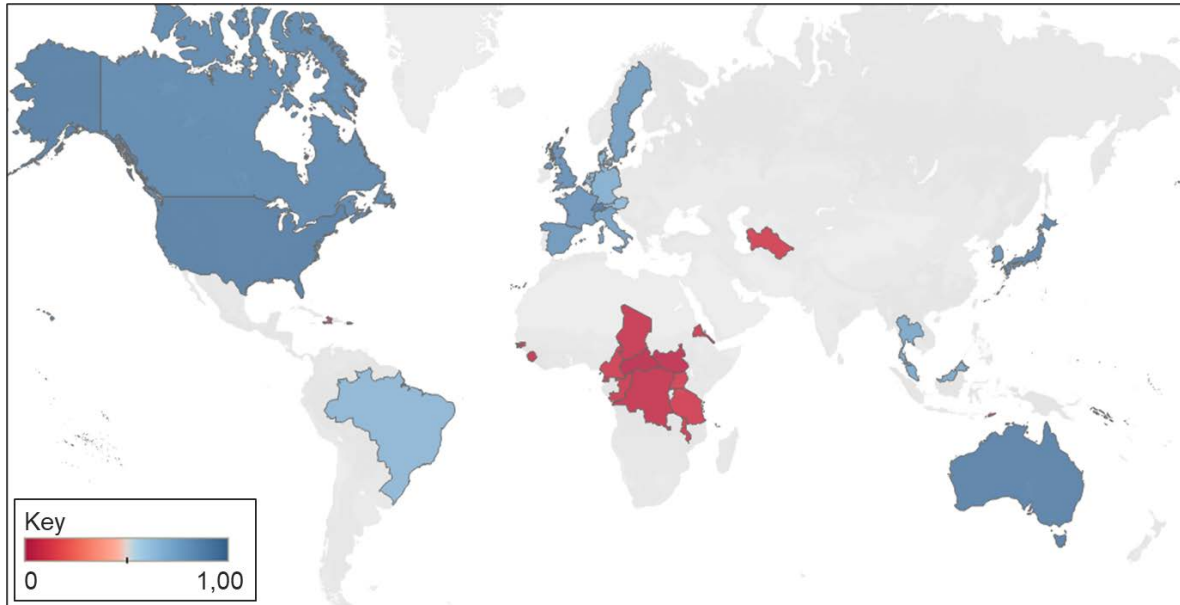
Looking at another indicator of financial development, the IMF's **Financial Development Index** clearly shows the **underdeveloped state of financial markets in LMICs**, particularly when compared to advanced economies. This discrepancy is particularly pronounced in SSA, as illustrated in the Figure below. The findings of the IFC Domestic Capital Markets Size, Access, and Activity Index mirror these observations, accentuating the ongoing challenges faced by LMICs in achieving robust financial market development<sup>138</sup>.

136 Computed from Frankfurt School of Management data.

137 Computed from Frankfurt School of Management data.

138 IFC's Domestic Capital Markets Size, Access and Activity Index, 2020 figures.



**Figure 14 – Top 20 and lower 20 countries ranked by IMF’s Financial Development Index (2024)**

Source: IMF Database, *Financial Development Index*

These analyses show that the maturity of local capital markets varies significantly between LMICs. There is thus no ‘one-size-fits-all’ approach, but rather a scaling-up vs. a developing approach, depending on the level of maturity of capital markets the country/region.

The HLEG believes that the development of robust and liquid (green) capital markets is a **cornerstone** to foster sustainable economic growth, attracting the needed private capital at scale, and, thereby, **assisting LMICs in their sustainable and fair transition**. To embark on this journey, countries must put in place **adequate legislation** to infuse credibility among market participants, inspire confidence, and uphold macro-financial stability. This **involves adopting insolvency laws, implementing prudential rules, enhancing market transparency, fortifying market integrity safeguards, and enacting legislation that provides sufficient protection to investors and ensures the seamless operation of local market infrastructures** — including stock exchanges, clearing and settlement systems, and credit rating agencies. In addition, a crucial component is the establishment of an **independent market supervisor** tasked with monitoring and enforcement of these rules.

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

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#### *Recommendation 7.1*

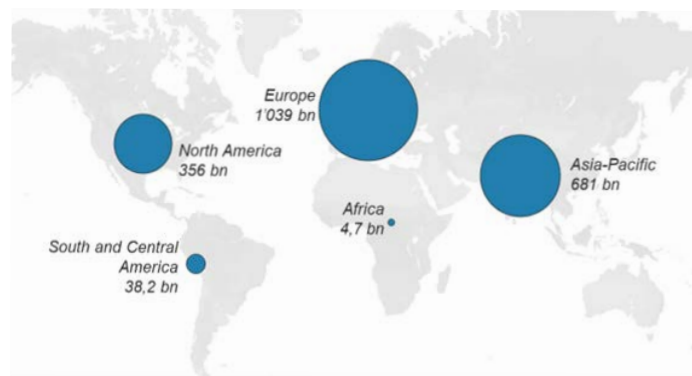
*The European Commission should step up its support to help partner countries put in place the **building blocks and legal reforms**, underpinning the development of **well-functioning local capital markets** (including insolvency laws, prudential rules, market transparency and market integrity safeguards, 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.*

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Developing local capital markets will also help spur the issuance of sustainable finance instruments in LMICs, and vice-versa. Despite a remarkable growth in recent years (witnessing a nine-fold increase between 2014-2017 and 2020-2023)<sup>139</sup>, **the green, social, and sustainability (GSS) bond markets<sup>140</sup> in LMICs continues to account for merely a small fraction, approximately 4%, of the GSS bond global market<sup>141</sup>.**

Moreover, **the recent evolution of the GSS bond market** in LMICs hides significant variations across regions, **mirroring the different maturity levels of local capital market** as mentioned above. Between 2020 and 2023, almost half of LMICs' issuances took place in the APAC region (excluding China), followed by the LAC region and the European Neighbourhood and MENA. With only 4% of total issuances over the period, **SSA is still lagging behind** (see below).

**Figure 15 – Total Amount of outstanding GSS bonds by region based on 2020-2023 issuances only**



Source: HLEG computations based on CBI database

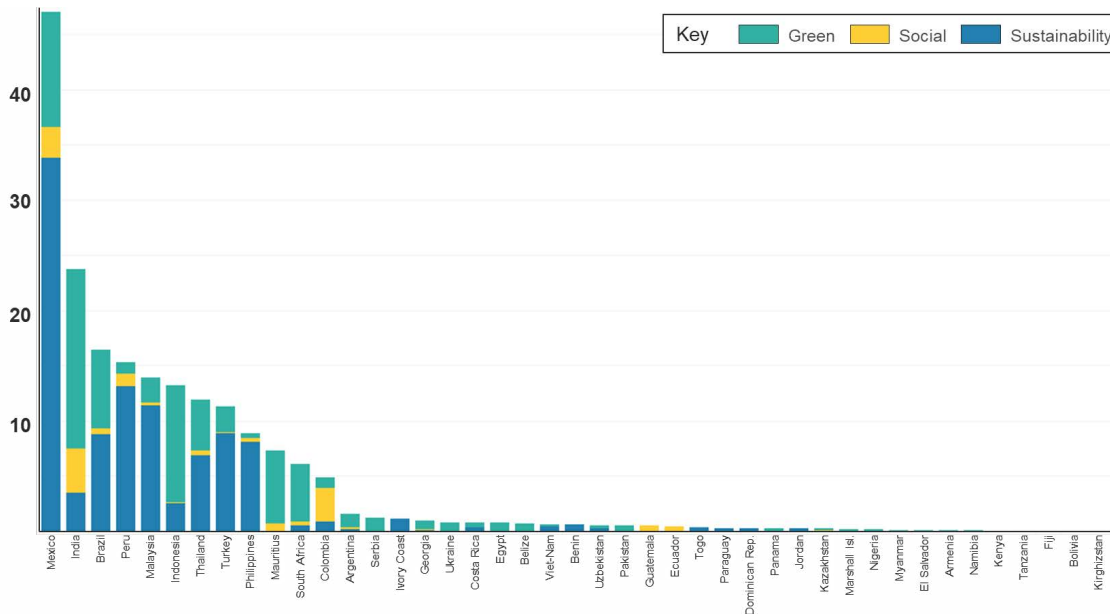
Regarding countries' specificities, between 2020 and 2023, of the LMICs (excluding China), the largest cumulative issuers of GSS bonds were **Mexico** (USD 38 billion), **India** (USD 22 billion), **Brazil** (USD 16 billion), followed by **Peru** (USD 15 billion) and **Malaysia** (USD 13 billion)<sup>142</sup>. There has been a clear growth coming from the LAC region, where **policies, government-led initiatives and taxonomies have allowed GSS bonds to develop.**

139 Data provided by the Luxembourg Stock Exchange, 2024.

140 GSS bonds are fixed-income debt instruments with a use-of-proceeds mechanism with a focus on activities or assets with a sustainable purpose. The HLEG follows the same definition provided by the OECD in its [June 2023 Report](#).

141 Data provided by the Luxembourg Stock Exchange, 2024.

142 Data provided by the Luxembourg Stock Exchange, 2024.

**Figure 16 – Cumulative GSS bond issuances by LMICs (2020-2023)**

Source: Data provided by the Luxembourg Stock Exchange (2024)

#### Issuances of green, social and sustainability bonds by Sovereign and Supra-National issuers to promote sustainable finance across the West African Region

In January 2021, the West African development bank issued its first sustainable bond, marking a significant milestone for the bank and the Sub-Saharan African region. The EUR 750 million, 12-year inaugural sustainable bond attracted over 260 global investors and was oversubscribed by six times. The bond's proceeds will be used to finance projects in priority sectors such as agriculture, renewable energy, and social housing.

GSS bonds are **more liquid compared to direct investment** into sustainable infrastructure projects and so are preferred by many investors. Through GSS bonds, LMIC issuers can effectively attract substantial capital from investors, tapping into their growing interest in environmentally and socially impactful investments. This, in turn, assists public authorities — whether governmental or local — in securing essential funding from a diverse investor base for their green and social initiatives. For **sovereign issuers**, issuing GSS bonds sends a strong signal about their commitment to meet the Paris Agreement, the Kunming-Montreal GBF and the SDGs, which can have reputational benefits.

GSS bond markets in LMICs, however, **face major challenges**, on both the demand and the supply side. EU and international investors often exhibit a shortfall in demand, exacerbated by a **lack of information** and **high perceived/real risks** associated with investments in LMICs. Moreover, investors may also be deterred by concerns over **reputational risk**, stemming from the potential accusation of greenwashing tied to insufficient information available about the allocation of the proceeds and the environmental and/or social impact of the underlying projects financed by GSS bonds. LMIC issuers on the supply side often face a **shortage of sustainable project pipelines** and the **technical capacity** to issue GSS bonds, particularly for first-time issuers. The associated **issuance costs** for green or other thematic bonds are also often **prohibitively high**, discouraging LMIC issuers from taking the leap. Each of these challenges is examined in greater detail in various sections throughout the report.

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.

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### Recommendation 7.2

*To support fully-fledged local sustainable capital markets in LMICs the European Commission should launch **a bold and transformative initiative** in a Team Europe approach to support the development of **GSS bond**, and particularly **green bond, markets in LMICs**, addressing the challenges at both sides of the investment chain, i.e. investors' and local issuers' side.*

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#### Sustainability-linked bonds (SLBs)

Over the past few years, **SLBs** have gained some interest mostly in developed markets and driven by corporate issuances. Unlike green or social bonds, which proceeds are allocated to specific green, social and sustainable projects, SLBs are linked to the achievement of pre-defined Sustainable Performance Target ("SPTs") against which a set of KPIs are set. Depending on the terms of the bond, adjustments can happen in both directions: if targets are met, coupon rate decreases, otherwise a penalty mechanism is triggered that can take the form of a coupon increase<sup>196</sup>.

SLBs provide higher degree of flexibility and are attractive in situations where the development of a sustainable pipeline is difficult. Having said that, many uncertainties and limitations remain: the lack of sectorial and locally adapted SLB guidelines and principles<sup>197</sup>, the often immaterial, poorly ambitious and difficult-to-compare KPIs and SPTs, as well as the lack of availability and quality of data necessary to monitor KPIs and SPTs<sup>198</sup>. Additional challenges such as a lack of analysts with the right skillset to assess the feasibility and reliability of SLB KPIs is exacerbating the issues around a potential uptake of SLBs and increasing the risk of greenwashing. Within this context, the HLEG believes it is worth assessing and scrutinising SLBs when moving forward.

The EU could also promote the development of **local currency sustainable financial products** in LMICs. 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.

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### Recommendation 7.3

*The European Commission should support the issuance of local currency-denominated GSS instruments and, to do that swiftly, consider establish a sizeable local currency sustainable facility (exploring the possibility to build on an existing initiative). Relying on the presence and appetite of institutional investors, notably local ones, this facility would provide sustainable financing to LMICs by issuing local currency-denominated GSS bonds in those countries. From a capital market perspective, this facility would greatly support the development of local capital markets while eliminating the burden of foreign exchange (FX) risk on the LMIC borrowers' shoulders – an important element that is thoroughly analysed in the next section.*

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## #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 investor's 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. To this end, the HLEG scrutinised data and conducted interviews and analysed the investment portfolios held by EU insurance companies and pension funds<sup>143</sup>.

### EU institutional investors' capital is only marginally invested in LMICs

**In Europe** alone, total assets under management amounted to **EUR 27,8 trillion** at the end of 2022<sup>144</sup>, 70% of which lie with institutional investors, such as pension funds and insurance companies<sup>145</sup>. However, data shows that only a very marginal portion of the assets of EU insurance companies and pension funds<sup>146</sup>, respectively 1,3% and 4,1%, is allocated in LMICs (see below). Importantly, most of these LMIC assets (around 85%) are concentrated in upper-medium income countries – especially in LAC (with top 3 countries being Mexico, Brazil, and Colombia), and APAC (with top 3 countries being China, India, and Indonesia), leaving out lower-income countries such as in SSA where 63% of investments are concentrated in South Africa.

Regarding asset allocation, a large part of EU insurance and pension funds' portfolio (about 48% and 42% respectively) is invested in fixed income assets (bonds), reflecting their appetite for more liquid assets with a stable yield (see graphs below). **When investing in LMICs**, their preference for **fixed income** assets (bonds) is even more striking. EU insurance companies and pension funds allocate respectively 74% and 70% of their investment in LMICs through bonds, of which a significant part is indirect – **through funds** (75% and 30% respectively). Their investment through funds is even more pronounced when investing in lower-income countries, notably in SSA. Indeed, indirect investment provides EU investors with a means of consolidating multiple small and geographically scattered investment opportunities in LMICs. Importantly, investing through funds offers EU investors enhanced **access, liquidity, scalability, diversification, and cost savings**, notably in terms of **research and due diligence**.

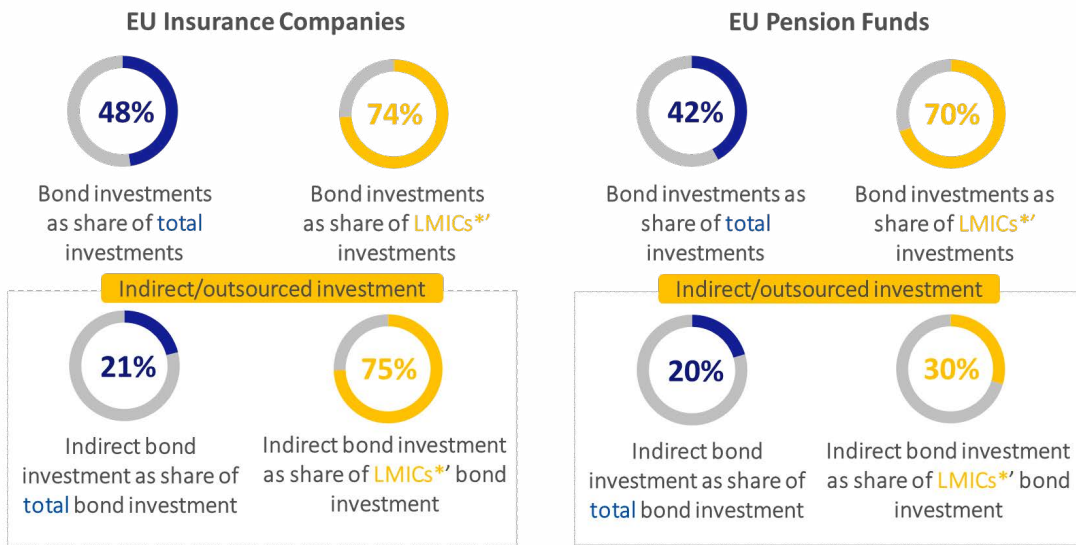
143 HLEG computations presented throughout this section are using EIOPA's aggregated data provided on the basis of the 2022 reporting of all EEA solo insurance and reinsurance companies subject to Solvency II; and on the basis of the 2022 occupational pension funds reporting covering EU countries that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

144 EFAMA, Asset management in Europe: An overview of the asset management industry. Includes UK., 2023.

145 Ibid.

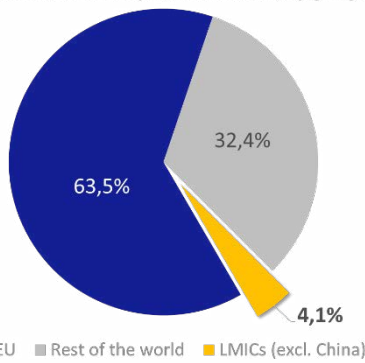
146 HLEG computations based on EIOPA aggregated data.

### Asset allocation of EU insurance companies and pension funds



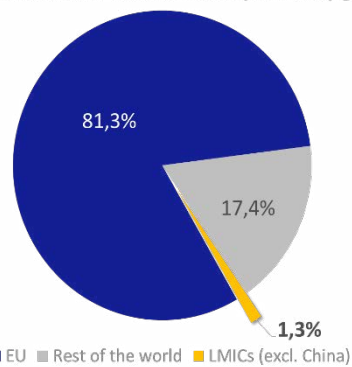
Source: European Commission computations based on EIOPA\* aggregated data (2022)

#### Portfolio allocation of EU pension funds, by geography



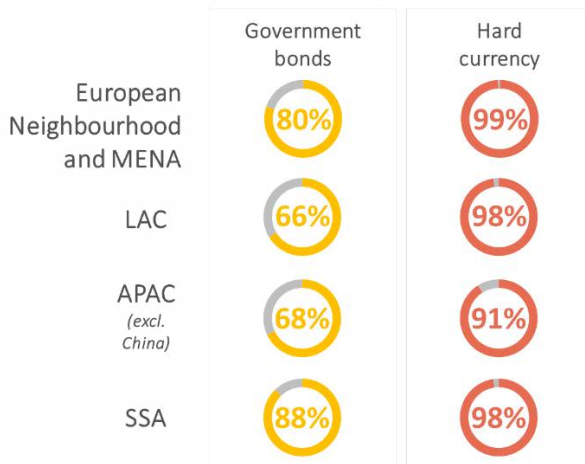
Source: European Commission computations based on EIOPA\* aggregated data (2022)

#### Portfolio allocation of EU insurance companies, by geography

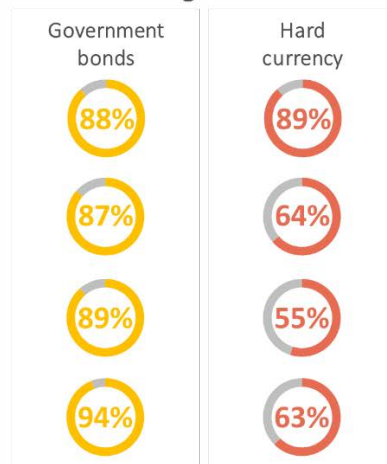


Source: European Commission computations based on EIOPA\* aggregated data (2022)

#### EU Insurance Companies, key investment characteristics of bond investments by region



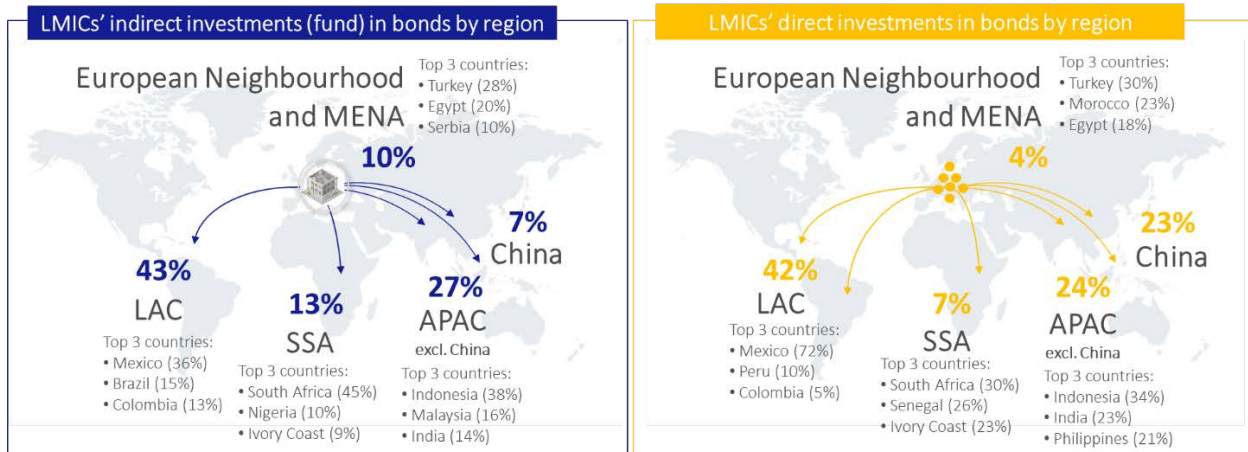
#### EU Pension Funds, key investment characteristics of bond investments by region



Source: European Commission computations based on EIOPA\* aggregated data (2022)

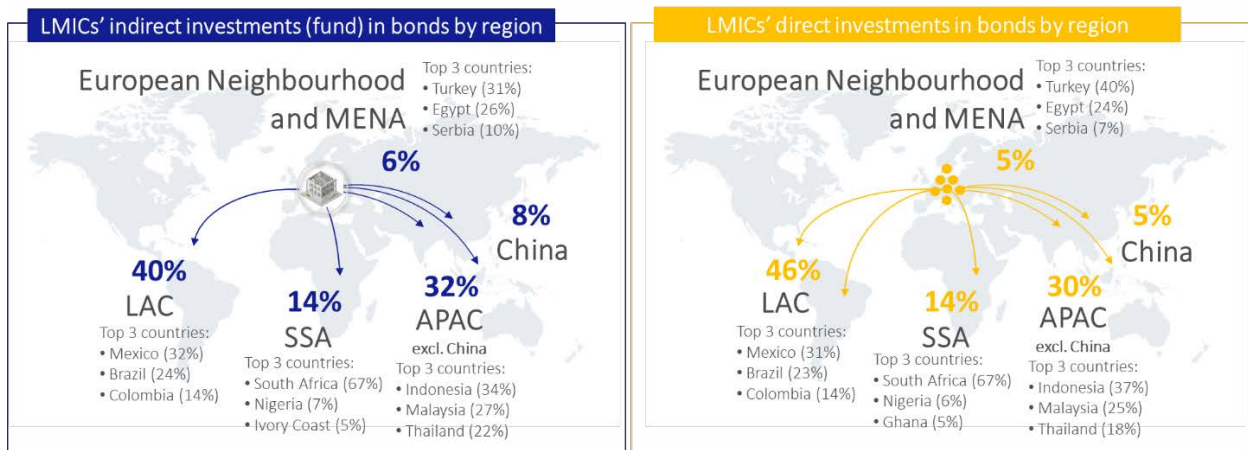


## EU Insurance Companies, geographic allocation of direct and indirect bond investments



Source: European Commission computations based on EIOPA' aggregated data (2022)

## EU Pension Funds, geographic allocation of direct and indirect bond investments



Source: European Commission computations based on EIOPA' aggregated data (2022)

Overall, investment strategies of EU insurance companies and pension funds are likely shaped by three distinct types of drivers: (i) those linked to **the nature of their business as liability-driven investors**; (ii) those linked to **financial and prudential regulatory frameworks** (including the implications of their fiduciary duty) and to the implication for their **credit rating**; and (iii) those linked to **sustainability considerations**.

Due to the **nature of their business characterised by long-dated liabilities** (e.g., pension and life insurance), they are regarded as long-term investors. To be able to meet their obligations, they need to adopt a liability-driven investment strategy consisting in trying to match their assets with their expected liabilities. As prudent investors, they tend to invest in instruments with a predictable return, denominated in **hard currency** and that are **standardised** and **easily tradable**. As they usually have large investment amounts available, they seek **sizeable** investment opportunities for cost-efficiency reasons.

The asset allocation of EU insurance companies and pension funds is also influenced by the **capital charge** of their investments, as per the **EU prudential frameworks, as well as the need to maintain a good credit rating**. According to the EU prudential framework, insurance companies are required to hold more capital for riskier exposures, which is essential to ensure financial institutions' solvability and resilience. As shown in the box, the prudential treatment can vary significantly depending on the type of investment (asset type, credit rating, maturity, geography).

Although riskier exposures offer a potential higher return, they often require higher capital charges. Depending on their weight on the overall investment portfolio, riskier exposures might also negatively impact investors' **credit ratings and hence increase their cost of funding**. In those cases, investors' preference for good credit ratings as well as an affordable cost of capital might outweigh the potential higher returns associated with riskier assets.

#### Illustration under the standard formula of Solvency II

- an investment in a **10-year duration bond**<sup>147</sup> costs
  - 8,4% capital charge if AA rated<sup>148</sup>
  - 20% capital charge if BBB rated<sup>150</sup>
  - 58,5% capital charge if B rated<sup>150</sup>
- an investment in **equity** costs
  - 39%<sup>149</sup> if invested in an EEA country (+/- 10% Symmetric Adjustment)
  - 49%<sup>151</sup> if invested in LMICs (+/- 10% Symmetric Adjustment)
- an indirect investment into LMICs through an EU fund that is rated shall **require a look-through approach**<sup>150</sup>
  - capital charges are linked to the rating of the EU fund and related financial product maturity

**Sustainability considerations** are a third important driver for EU insurance companies and pension funds when making long-term investment decisions, given the impact of sustainability on the long-term asset value and the expectations from stakeholders. A vast majority of large European insurance companies and pension funds<sup>151</sup> have made **public net-zero 2050 commitments** and have joined **ambitious climate-related alliances** like the UN-convened Net-Zero Asset Owner Alliance (NZ AOA), Glasgow Financial Alliance for Net-Zero and the Race to Zero. In their endeavour to meet their commitments, they are **actively seeking to green their portfolios**. To include investments in the **green asset ratio (GAR)**<sup>152</sup> that they need to disclose in their sustainability report, insurance companies and pension funds need to ensure that such investments are compliant with the **EU taxonomy**. Similarly, to disclose financial products as sustainable, EU asset managers and financial market participants must ensure that they meet the disclosure requirements under **Article 9 of the Sustainable Finance Disclosure Regulation (SFDR)**<sup>153</sup>.

### Barriers investors face when investing in LMICs

The very limited percentage of EU investments in LMICs by insurance companies and pension funds results from a **lack of investment opportunities** that **match** the **characteristics** they are looking for risk-adjusted return, size, liquidity, currency, and sustainability.

**First**, the **risk-adjusted return** of investments in LMICs is often not deemed competitive when compared with similar investments in developed economies. Returns are often deemed insufficient to meet the expectation of investors when factoring in the risks, the cost of capital, as well as the cost of research and due diligence related to an investment in LMICs. The higher interest rate environment that is recently characterising developed markets has exacerbated this aspect, rendering investments in LMICs even less attractive. As for the risks, and in particular the **credit risk** of LMIC issuers, the majority of sovereign issuers in low-income countries, especially in SSA are rated **sub-investment grade**

147 Applicable to any type of bond (incl. sovereign, corporate) Article 176(a) Commission Delegated Regulation (EU) 2015/35 – except for specific exposures under Article 180 Commission Delegated Regulation (EU) 2015/35.

148 Before considering various mitigating factors such as 'diversification effects' which reduce the final cost.

149 Article 169 Commission Delegated Regulation (EU) 2015/35.

150 Article 84 Commission Delegated Regulation (EU) 2015/35.

151 To illustrate, amongst the top ten biggest insurance companies and pension funds in Europe, respectively 70% and 100% of them are members of the GFANZ (specifically, the Net-Zero Insurance Alliance) and of the Race to Zero global campaign. European ranking taken from InsuranceBusiness and VisualCapitalist, 2022.

152 Article 8.1 Regulation (EU) 2020/852.

153 Financial market players in the EU should demonstrate that the financial product has sustainable investment as its objective. Article 2.17 of Regulation (EU) 2019/2088 (SFDR) defines sustainable investment. Please also refer to Commission Notice on the interpretation and implementation of certain legal provisions of the EU taxonomy Regulation and links to the Sustainable Finance Disclosure Regulation 2023/C 211/01.

or speculative (see below). LMIC corporates, if rated at all, are often not rated better than the sovereign, as their sovereign rating generally acts as a cap<sup>154</sup>. Further, EU investors often lack the necessary **in-country knowledge and expertise**. This is aggravated **by a lack of information**, market research about **historical performance data**, including on **default and recovery rates**. This can result in higher due diligence costs. Finally, when hedged, returns can be very negatively affected by **high cost of hedging currency risks** that reduce investment attractiveness.

**Second**, there is a lack of pipelines of **sufficiently large** and **bankable** investment opportunities in LMIC capital markets and private debt and equity markets. Indeed, while there has been some targeted progress in this area, many LMIC economies lack regulated and mature capital markets. Where they exist, investment opportunities are often small and lack liquidity. The latter is related to the limited trading activity and volume resulting from **few publicly listed shares and bonds** – as thoroughly analysed in the previous section. Individual investment opportunities are also often **too small** to attract institutional investors, especially considering the one-off research costs per project. When they are large enough, for example infrastructure projects led by the public sector, they often lack the necessary **visibility** or are regarded as **not bankable** by the private sector. Likewise, private investment transactions are often non-standardised with limited information and high uncertainty around exit opportunities. For these reasons, as mentioned above, EU institutional investors display a **marked preference for indirect investments** via funds when **investing in LMICs**.

**Third**, given their importance for investors, **sustainability considerations** related to investment opportunities in LMICs can also pose an additional barrier for EU investors. While the latter are increasingly looking to green **their portfolios**, sustainability criteria in LMICs might be different than the ones used in the EU. Indeed, investment opportunities in LMICs frequently do not comply with the European sustainability-related disclosure requirements that EU investors must fulfil to claim that their investments are **EU taxonomy-aligned** or ‘sustainable’ according to the SFDR. Indeed, most investments in LMICs either do not fulfil or are not able to demonstrate that they **fulfil the Do No Significant Harm (DNSH) principle** and/or the governance criteria of **Article 9 of the SFDR**, preventing EU asset managers to disclose them as ‘sustainable’. One key challenge here is **the lack of capacity of LMICs to provide the relevant sustainability data** (discussed in more depth in section 9), which is fundamental for EU investors to assess whether an investment is ‘sustainable’ or ‘Taxonomy-aligned’ as per the EU sustainable finance framework. This challenge comes in a context where EU investors are increasingly fearing **reputational risks** and facing mounting **pressure and criticism** from various stakeholders such as NGOs as regards what they claim as ‘sustainable’ or ‘Taxonomy-aligned’. It is important to note that the work on the EU sustainable finance framework and the EU taxonomy is ongoing, notably through the technical input brought by the Platform on Sustainable Finance<sup>155</sup>. This will, among others, seek to advise the Commission on the coherence, useability and effectiveness of the wider EU sustainable finance framework, as well as on the international interoperability and usability of the EU taxonomy. The issues around sustainability data as well as sustainable finance frameworks are further addressed in sections 9 and 10.

## Leveraging innovative financial approaches to attract EU institutional investors

Taking into account EU institutional investor behaviour and preferences, DFIs 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 risks investors are not willing to take while ensuring them an ‘acceptable’ risk-adjusted return.

These structures leverage the **expertise of DFIs** and **asset management companies**. Indeed, 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. However, despite some promising initiatives, the number and scale of public-private funds involving DFIs/MDBs/donors **remain limited**. The HLEG has conducted a comprehensive analysis (details in Annex) of six European public-private funds: Planet Emerging Green One (EGO); the Real Economy Green Investment Opportunity (REGIO) Fund; the Latin American Green Bond (LAGreen) Fund; the Emerging Market Climate Action Fund (EMCAF); the AfricaGrow Fund; the Climate Finance Partnership (CFP) Fund.

From this analysis, the HLEG noted that most of the funds analysed have failed to reach their initial target size. In most of the cases, the actual size was much lower than the intended target. For example, prominent asset management companies with a large client network like Amundi and BlackRock fell short of their intended fund sizes, showing the difficulty to onboard private investors. Concretely, **EGO** (IFC-Amundi) aimed for a fund size of USD 2 billion but only

154 Impact Taskforce, [Mobilising institutional capital towards the SDGs and a Just Transition, Workstream B](#), 2021.

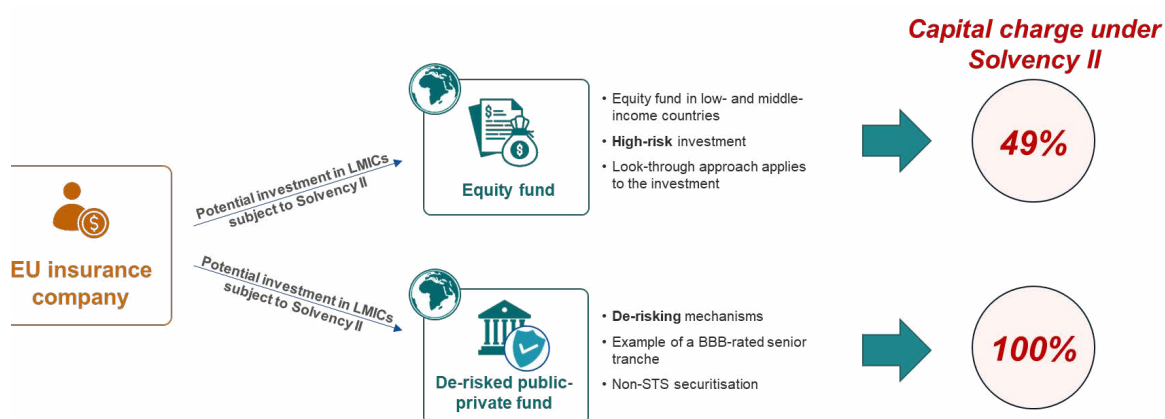
155 European Commission, [Platform on Sustainable Finance](#).

achieved USD 1.5 billion, while the **CFP Fund** (DFIs – BlackRock) aimed for USD 1 billion but only reached USD 673 million. While de-risked public private funds have a huge potential to further mobilise EU institutional investors into LMICs, the HLEG noted that they face key hurdles that prevent them from reaching scale, replicability, and speed.

**The HLEG analysed the main obstacles faced by these funds:**

- **The main hurdle can be attributed to the cost of capital.** These de-risked funds aim to provide private investors with an adequate risk-adjusted return, as DFIs/donors take the part of the risk private investors are not willing to face. Typically, DFIs take on the riskier (junior) tranche while private investors opt for the safer (senior) tranche within the fund, leading to a multi-layered financial structure. However, because of their tranching, many of these funds have been requalified by European national supervisors as ‘non-simple, transparent and standardised (non-STIS)’ securitisations, making them fall into an asset class under the EU prudential framework which imposes substantial prudential costs (capital charges), and especially for notably **insurance companies** – as well as for DFIs<sup>156</sup>. This classification greatly diminishes their attractiveness and undermines the intended objective they are meant to achieve. As a matter of illustration:

**Figure 17 – Illustration of Solvency II<sup>157</sup> capital charges<sup>158</sup>**



**For European DFIs** regulated under the EU’s Capital Requirements Regulation (CRR), investing in the junior tranche of non-STIS de-risked fund incurs **substantial costs**. As an illustration, for a 10-year non-STIS-securitisation junior tranche rated BBB, the capital charge can be as high as **1250% of the risk-weighted assets**, requiring approximately **100% provisioning**. This substantial capital requirement poses a financial challenge for DFIs, **impacting the feasibility and attractiveness** of such investments and potentially hindering the funds from reaching their initial target size.

**For insurance companies**, governed by Solvency II prudential regulation, investing in the **senior tranche** of a non-STIS de-risked fund can paradoxically be twice as costly than investing directly in equity from a LMIC, despite the equity investment carrying higher inherent risk.

- **De-risked funds face another significant challenge with their excessively prolonged time-to-market**, numerous hurdles contribute to the extended duration from conception to launch, including prolonged DFIs’ due diligence and procurement processes, comprehensive risk assessments, and the challenge to find an appropriate balance between commercial interest and policy objectives (i.e. alignment of private and public stakeholders’ interests). Decision-making processes, particularly those of DFIs, further contribute to delays. Asset managers also grapple with complexities and costs in establishing and promoting these funds. All in all, this results in a protracted time-to-market of at least 18-24 months, compared to just a few months for traditional funds.

Given the nascent stage of these initiatives, **standardisation** and ‘time to market’ are currently not optimal but are **essential**. Standardisation would offer **clear and consistent information**, particularly regarding

156 Those under the scope of the EU Capital Requirement Regulation.

157 Solvency II is the prudential regime for insurance and reinsurance undertakings in the EU.

158 These capital charges do not apply to insurance companies using internal models.

risks, facilitating timely and well-informed decisions by both private and public investors. Additionally, it can enhance market efficiency by improving liquidity, reducing transaction costs, and enhancing risk management practices.

- **Another critical aspect is the sustainability challenge.** Specifically, the lack of ready-to-invest strong and credible pipelines of green projects in LMICs (as developed in section 2). Faced with this issue, many public-private funds adopt a **'greening over time'** investment strategy rather than a **'green from the start'** approach. In the **'greening over time'** strategy, the entire capital is initially deployed, gradually transitioning the portfolio from non-green to green assets over a specified period. In contrast, the **'green from the start'** strategy begins with a smaller scale, gradually expanding as more green projects in LMICs become available, ensuring a 100% green portfolio from the outset. Regardless of the strategy chosen, these funds suffer from insufficient volumes of green pipelines to achieve their target size. For this reason, the vast majority of these funds is supported by a robust **technical assistance program**.

To create the conditions for a mature market for de-risked sustainable/transition public-private funds in LMICs allowing scale, replicability and speed, there is a need to **provide clarity** and **confidence** to investors and broader stakeholders about the key features of this type of structures. To do so, the most effective and ambitious solution – although long term – would be to frame de-risked sustainable/transition public-private funds in LMICs as a new type of **EU financial product**, recognised in the EU financial legislation – through a **dedicated EU** legal framework. To this end, the European Commission should first explore the policy choices involving the relevant EU supervisory authorities, and look into the **specific key standard features** that such funds would need to comply with to be considered 'de-risked', 'sustainable' or 'transition' funds. This framework would also include **a set of comprehensive standardised criteria**. It would establish consistent rules regarding authorisation, prudential treatment, operating requirements, and marketing procedures of such funds.

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#### *Recommendation 8.1*

*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.*

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### The other side of the coin: higher costs of financing for LMIC borrowers...

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. Therefore, the HLEG tackled the first crucial question: **'Is there a high perceived risk in Africa?'** When comparing bonds (with the same characteristics and ratings) issued by LMICs and developed markets, it appears that LMIC issuances are charged on average 78 basis points (bps) more. Zooming on geographies, SSA stands out as facing the highest financing costs even when compared to its peers. Proving the point, a recent IMF study<sup>159</sup> 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. Examples at issuance include South Africa and Kenya paying higher coupon rates than, respectively, Brazil and Bolivia despite having similar credit ratings (see Box). Indeed, other risks aside from those which are reflected in the ratings seem to be considered by investors when deciding a price, which results in higher borrowing costs compared to other local issuers in different regions: the IMF showed that when accounting for structural factors such as the transparency of budget process, the importance of the informal sector, the level of financial development, and the quality of public institutions, 'the results show that the excess premium estimated for SSA countries vanishes'<sup>160</sup>.

159 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.

160 Ibid.



### SSA countries pay higher coupons than their peers

Recent study from IMF (June 2023) shows that SSA countries pay significantly higher coupon at issuance and higher refinancing costs in the secondary market compared to their peers from other regions.

Examples include:

#### **South Africa (BB-/Ba2/BB-) vs Brazil (BB-/Ba2/BB)**

- **South Africa:** 10Y USD bond at **5,875%** (issued in 2022)
- **Brazil:** 10Y USD bond at **3,75%** (issued in 2021)

#### **Kenya (B/B3/B) vs Bolivia (B-/Caa1/B-):**

- **Kenya:** 10Y USD bond at **7,25%** (issued in 2018, rated B)
- **Bolivia:** 11Y USD bond at **4,5%** (issued in 2017, rated B-)

Source: Refinitiv

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**.

Another crucial question has to do with credit ratings provided by the Big Three Credit Rating Agencies (CRAs), as EU investors often rely on these ratings for their investment decision. This leads us to the **second question** tackled by the HLEG: **Is there a bias in the assessment of CRAs?**

**Credit ratings** can prove instrumental for SSA sovereigns and corporates to attract at scale EU and international investors. Not only because they are a 'must' when tapping international capital markets, but the analysis and assessments on SSA countries provided by the Big Three CRAs<sup>161</sup> can help EU investors bridge the data and in-country knowledge gap, which can be very expensive to accomplish in-house. In particular, LMIC sovereign credit ratings are important as they serve as a benchmark for corporate ratings. In this context, it is important to note that in 2003 UNDP partnered with Standard & Poor's (S&P) and funded the agency's rating activities of African sovereign borrowers. Thanks to the UNDP programme, Africa has seen more and more countries included in the S&P ratings: from 13 in 2004 to 32 in 2023<sup>162</sup>. While this is a very positive development, 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'<sup>163</sup>. 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.

When trying to address the aforementioned concerns about Big Three CRAs, the **African Union** has called for the establishment of a **Pan-African credit agency** and its related regulatory framework, currently missing at a continent level. This initiative follows the path of growing activities from African CRAs, predominantly focusing on financial and non-financial institutions tapping domestic markets.

However, concluding on **this issue is not straightforward** and is subject to split views. 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<sup>164</sup> 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.

### LMIC sovereign credit rating

Sovereigns with at least one Big Three credit rating

SSA	65%	6%
LAC	85%	18%
APAC (excl. China)	79%	27%

Source: Refinitiv

161 Moody's, Standard & Poor's, and Fitch.

162 Dunand, E., [Moody's has bought a leading African rating agency: why it's bad news](#), 2022.

163 Africa Peer Review Mechanism, [Africa Sovereign Credit Rating Review, 2023, Mid-Year Outlook](#), 2023.

164 Kraemer, M., [African criticism of credit ratings is a red herring](#), Financial Times, January 19, 2024.



Regardless, LMICs should have a clear understanding of credit rating methodologies to engage with the Big Three CRAs on their own ratings. Providing, where relevant, **technical support to SSA to build expertise on the methodology of the Big Three CRA** can therefore contribute to ensuring an accurate final creditworthiness assessment. However, the creditworthiness, 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. These are **long-term objectives** that should be pursued and supported by the EU through its **budget support programmes** aimed at helping develop and/or scale up LMICs' financial market infrastructure and related regulatory frameworks as well as other structural reforms including governance.

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### Recommendation 8.2

*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...

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### Recommendation 8.3

*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.*

### ...and addressing the foreign exchange risk weighing on LMIC borrowers

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. Indeed, EU institutional investors have a strong preference for hard currency-denominated investments also when investing in LMICs. Even in the sphere of development finance, about 80%-90% of DFI/MDBs loans are still provided in hard currency<sup>165</sup>.

The issue of high LMIC FX risk and resulting unaffordable hedging costs has become even more pressing in the current macroeconomic context of rising interest rates and inflation in developed economies. **Interest rate hikes** can lead directly to significant capital outflows from some LMICs and **currency depreciation** against hard currencies. Depending on LMICs' exposure to hard currency, this can amplify their cost of debt, negatively impacting their risk profiles and financial stability.

The cost of hedging, if hedging is at all offered on the market, is prohibitive mainly due to the **lack of liquidity associated with money markets in frontier countries** (see Box). Even when funds are provided on 'concessional' terms by DFIs, the combination of interest and currency swap costs nowadays results in the **total cost of funding reaching double digits**.

The complex question of affordable LMIC currency hedging has long been a focal point for policymakers, investors, and investees. **Various initiatives or approaches** from the private and/or public sector have emerged as ways to address the issue at hand. However, limitations related to replicability and scalability remain. One of the most widely known initiatives is **TCX**, a fund based in the Netherlands with USD 1.3 billion of capital (from various DFIs) and around USD 5 billion of hedging capacity. TCX provides over-the-counter hedging solutions (FX swaps) primarily to its shareholders' transactions for different maturities and in up to seventy currencies in the absence of a market offer in LMICs, and in particular in frontier markets. The **price** of TCX's swaps for exotic currencies with a very limited commercial offer is often reported as (too) **high**. Since 2020, TCX has also benefited from substantial increases

165 International Growth Centre, [Mitigating foreign exchange risk in local currency lending in fragile states](#), 2023.

in capital as well as a guarantee from the European Commission<sup>166</sup> to ensure a minimum portfolio return and to aim at lowering the price of swaps it offers. However, the required resources to achieve such result on a large scale may be **too substantial to be practical**. Importantly, TCX operates **offshore**, meaning outside of its recipient countries, hence risks related to **transferability and convertibility (T&C)** remain high.

Indeed, T&C risks constitute **important barriers** to consider when addressing the issue of FX risk, related hedging, and local currency financing in LMICs. Whether in hard currency or in local currency through TCX, investors (incl. DFIs) often face limitations to lend in the presence of T&C risk. As evidenced by the latest International Growth Centre (IGC) report on this matter, 'for some institutions, T&C risk is enough to discourage [LMICs] investment altogether. Some opt for including a T&C risk premium in the cost of borrowing, which again raises the all-in lending rate'<sup>167</sup>. For these reasons, one should not overlook the need and related potential of developing **onshore solutions**. Not only it minimises T&C risks but working onshore is also beneficial for LMICs' local capital market development. In this context, different routes could be explored. These include **hedging with local counterparts** (i.e. managing local currency exposure locally) or **seeking liquidity at the source by hedging directly with the central bank**. A few of these examples are presented in the Annex. However, unlike operating outside the country (offshore), operating onshore entails abiding by the rules and guidelines of the country's financial authorities and poses additional challenges. These include limited local market infrastructure, lack of regulatory frameworks, lack of appropriate risk management tools, limited expertise, political instability, and corruption.

**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.

#### Snapshot of selected swap markets

##### Currency swap costs\* as of 9 February 2024

EUR – EGP (Egypt)	95.20%
EUR – ZAR (South Africa)	5.12%
EUR – RWF (Rwanda)	No market
EUR – CFA (Central African Franc)	No market
EUR – KES (Kenya)	8.31%
EUR – NGN (Nigeria)	11.18%
EUR – GHS (Ghana)	14.48%
EUR – ZMW (Zambia)	12.93%
EUR – UGX (Uganda)	6.83%
EUR – BRL (Brazil)	5.50%
EUR – COP (Colombia)	7.78%
EUR – PEN (Peru)	1.71%
EUR – JMD (Jamaica)	No Market
EUR – DOP (Dom. Rep)	No Market
EUR – INR (India)	3.59%

\* 1y cost of carry p.a implied from the forward

Source: JP Morgan

#### Recommendation 8.4

*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 macrofinancial 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.*

166 EUR 165 million 'EU Market Creation Facility' under the EFSD in 2020 and additional EUR 326 million was requested under EFSD+ in 2022.

167 International Growth Centre, [Mitigating foreign exchange risk in local currency lending in fragile states](#), 2023.

# #9

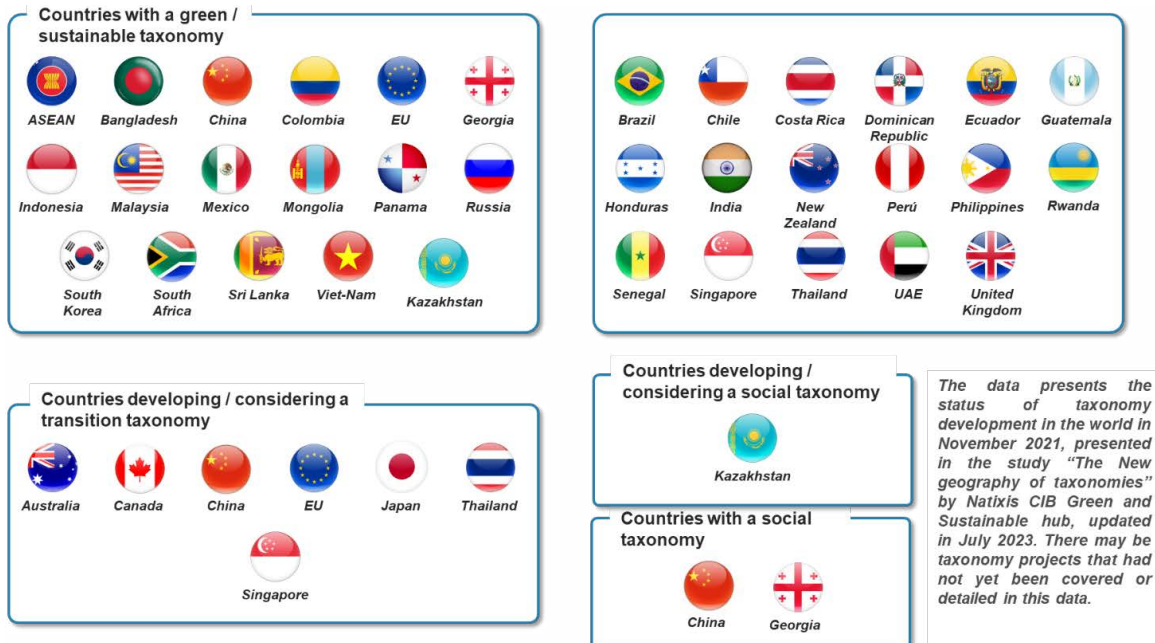
## WHAT IS NEEDED TO FOSTER CREDIBLE AND INTEROPERABLE SUSTAINABLE FINANCE FRAMEWORKS IN LMICs?

As appetite for sustainable investments has increased significantly, so have demands from investors for more transparency and clarity on what can be considered a **green/sustainable/transition investment**, both in their home markets and in their target countries. To meet this need, **sustainable finance frameworks have been and are being developed across the globe**, including in LMICs. By clarifying sustainability criteria for project developers, these frameworks can help facilitate informed investment decisions, avoid greenwashing, reduce transaction costs and scale up sustainable investments.

However, with at least 37 taxonomies published or under development globally, coupled with the multiple principles, standards, labels and disclosure requirements that exist on the market, there is an increasing risk of **fragmentation**, which could severely impede transnational capital flows. EU and international institutional investors investing in LMICs seek framework interoperability in order to avoid costly alignment with different frameworks and to ensure clarity on what is sustainable. Hence, **interoperability is key** to enhancing the up-take of sustainability by project developers and promoting cross-border capital flows towards sustainable investments across the globe. In this report, the HLEG has proposed measures to **mobilise global capital** and lay a **strong foundation for local capital markets** ready for sustainable finance – interoperable frameworks are the needed cornerstone to bridge the gap between local and international sustainable capital markets.

As it is essential that sustainable finance frameworks continue to recognise specificities of countries, regions, and jurisdictions, the HLEG views **greater interoperability** as the objective, instead of fully-fledged harmonisation.

**Figure 18 – Countries with taxonomies or developing / considering taxonomies as of July 2023**



Source: Natixis CIB Green and Sustainable hub, *The New Geography of Taxonomies*, November 2021 (updated July 2023)

## Financing green: the need for credible sustainable frameworks

At the core of most sustainable finance frameworks are classification systems, also known as **taxonomies**, that determine what economic activities or investments can contribute to sustainability goals. The objective of taxonomies is to provide transparency and clarity on which investments are aligned with, for example, the Paris Agreement objectives, the Kunming-Montreal GBF and/or the SDGs.

Taxonomies provide investors with a transparent and credible definition of what is considered ‘sustainable’, thus allowing investors to invest in sustainable assets with **greater confidence**. For issuers, taxonomies provide a clear set of **principles or requirements to fulfil** for their activities to be considered sustainable without the risk of being accused of greenwashing. When it comes to taxonomies, most efforts are government-led and developed within a specific regulatory context (such as the EU taxonomy), while others are market-driven and usually provide global guidance (such as the Climate Bonds Taxonomy). As such, most existing taxonomies reflect national and regional climate, environmental and/or social ambitions. In total, there are 37 sustainable finance taxonomies around the world either adopted, in development, or at an initiation phase<sup>168</sup>. More recently, stakeholders have also started designing transition and social finance taxonomies.

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** and for **issuers to demonstrate their degree of alignment with sustainability objectives**. Reporting by companies on sustainability aspects enables investors and financial institutions to assess companies’ long-term value creation, including their exposure to sustainability risk or impacts.

According to recent analysis from the International Platform on Sustainable Finance (IPSF) and the United Nations Environment Programme World Conservation Monitoring Centre (UNEP-WCMC) with United Nations Environment Programme Finance Initiative (UNEP-FI), there is a wide landscape of sustainability-related disclosure measures, including in a number of LMICs (e.g. Argentina, Brazil, India, Kenya, Malaysia, Philippines). Existing approaches differ in terms of content, mandatory vs. voluntary disclosure, scope, assurance, materiality, disclosure channels and reporting standards<sup>169 170</sup>.

### Organisations working on international disclosure requirements, standards and recommendations (non-exhaustive)

Several global initiatives and frameworks have been developed to guide organisations in disclosing their sustainability-related information:

1. **International Sustainability Standards Board (ISSB):** The ISSB, created by the International Financial Reporting Standards (IFRS) Foundation, aims to develop a global sustainability reporting standard. As a first step, it seeks to establish consistent and comparable reporting of climate-related financial information;
2. **European Financial Reporting Advisory Group (EFRAG):** EFRAG is mandated by the European Commission to work towards the development of European sustainability reporting standards, aligning them with existing frameworks and initiatives. The standards will be applicable to listed companies in the EU, as well as non-EU companies with significant business activities within the EU;
3. **Task Force on Climate-related Financial Disclosures (TCFD):** Established by the Financial Stability Board (FSB), the TCFD provides recommendations for disclosing climate-related risks and opportunities. It focuses on four key areas: governance, strategy, risk management, and metrics and targets. As of December 2023, the TCFD has been officially dissolved and the IFRS Foundation will take over the work;
4. **Taskforce on Nature-related Financial Disclosures (TNFD):** The TNFD is an initiative that aims to create a framework for organisations to measure their nature-related risks and report on their impact, building upon the guidance of the TCFD;

168 Natixis CIB Green and Sustainable hub, The New Geography of Taxonomies, November 2021 (updated July 2023)

169 For instance, MDBs and DFIs have developed their own methodologies to align their investments with the Paris Agreement and the SDGs. Several MDBs and DFIs have also undertaken different efforts to create common approaches to provide transparency. A group of MDBs, for instance, has endorsed the ‘MDBs Common Principles for Climate Mitigation Finance Tracking’

170 UN WCMC and UNEPFI, [Accountability for Nature: Comparison of Nature-Related Assessment and Disclosure Frameworks and Standards](#), 2024

5. **Global Reporting Initiative (GRI):** The GRI is an independent organisation that helps businesses and other organisations to understand and report on the economy, environment and people in a comparable and credible way, thereby increasing transparency on their contribution to sustainable development. The GRI Standards are a voluntary public interest framework, used by some 14,000 companies around the world.

Many initiatives for disclosure requirements and guidance have also been developed at the national level in LMICs. While the level of development and implementation vary, there are some key initiatives to consider<sup>171, 172</sup> :

In **Argentina**, listed companies are required to report on the compliance with the Corporate Governance Code<sup>173</sup>,

- a. In **Brazil**, financial institutions must publicly disclose information on social, environmental and climate matters<sup>174</sup>;
- b. **Chile** requires that regulated entities (listed companies and financial institutions) report on ESG related matters in annual reports as of 2022<sup>175</sup>;
- c. **India** has developed the BRSR<sup>176</sup> for the top 1000 listed entities (by market capitalisation), which includes reporting on ESG factors;
- d. In **Indonesia**, issuers of public offerings must report on multiple sustainability aspects. Further, limited liability companies that utilise or impact natural resources are required to disclose environmental and social issues<sup>177</sup>;
- e. In **Kenya**, the Nairobi Securities Exchange (NSE) has published the ESG Disclosures Guidance Manual<sup>178</sup> in 2021. The manual provides listed companies with a practical handbook detailing the process of acquiring, assessing, and transparently disclosing crucial ESG information;
- f. **Malaysia** introduced mandatory ESG reporting standards for all publicly listed companies in 2016. Furthermore, recent proposals have been made to gradually align Malaysian ESG reporting standards with those laid out by the FSB's TCFD;
- g. In **Morocco**, listed companies have non-financial disclosure requirements related to ESG measures<sup>179</sup>;
- h. Since 2019, the **Philippines** has maintained national ESG disclosure regulations for publicly listed companies. The Philippine Securities and Exchange Commission (SEC) also strongly recommends that listed companies adopt reporting practices to publicise their sustainability policies in ESG matters<sup>180</sup>.

Moreover, **green and sustainable labels and performance standards** for financial products and instruments are key tools to increase trust in the sustainable financial market and enable investors' access to sustainability-related financial products such as, for example, **green, social, and sustainability bonds**. Several approaches have been developed to provide assurance and transparency about the sustainability of investment products. For instance, ICMA published the Green Bond Principles (GBPs) in 2014, setting the first global high-level principles to define 'green bonds'. Public actors, including in LMICs, followed suit by establishing national or regional green bond guidance in line with the GBPs (e.g., Japan, ASEAN, Mexico, Nigeria).

In fact, both public authorities and the private sector have started introducing more detailed and mandatory sustainability criteria, for instance, by defining standards based on an existing taxonomy (e.g., China with the Green Bond Endorsed Catalogue or the private sector-led CBI Climate Bond Standard). This is also the case for the proposed EU Green Bond Standard, which requires at least 85% of European Green Bond proceeds to be aligned with the EU taxonomy.

171 International Platform on Sustainable Finance, [State and Trends of ESG disclosure and policy measures across IPSF jurisdictions, Brazil and the US](#), November 2021.

172 Yu, Abigail, Convene ESG, [The Global State of Mandatory ESG Disclosures](#), 2024.

173 CNV, [Corporate Governance Code](#).

174 Banco Central do Brasil, [Resolução CMN nº 4.945 de 15/9/2021](#).

175 CMF, [CMF Issues Regulation Incorporating Sustainability and Corporate Governance Requirements in Annual Reports](#), 2021.

176 SEBI, [Guidance Note for Business Responsibility & Sustainability Reporting Format, Annexure II](#).

177 KPMG, [Sustainable Finance in Indonesia](#), 2020.

178 NSE, [Nairobi Securities Exchange ESG Disclosures, Guidance Manual](#), 2021.

179 Bourse de Casablanca, [Guide RSE et Reporting ESG](#).

180 Sustainable Stock Exchanges Initiative, [Philippine Stock Exchange](#), 2023.



## Financing green across borders: the need for interoperable frameworks

Despite efforts to coordinate the development of sustainable finance frameworks around the world, **the regulatory landscape is nevertheless characterised by fragmentation and complexity**, which may undermine the transparency and credibility that these frameworks seek to establish. Moreover, fragmentation creates additional costs for investors who need to comply with and report on several different regulatory frameworks, and thus undermine the redirection of capital flows towards sustainable objectives. At the same time, it is important to recognise that a single global sustainable finance framework would fail to account for different local and regional contexts, development priorities or sustainability ambitions, especially of LMICs. Ideally, national and regional frameworks should be coherent with international best practices while adapting to the specific development needs and objectives.

### Interoperability

**In broad terms, ‘interoperability’ refers to the ability of a product or system to work with other products or systems.** In information technology and systems engineering, where the term was first applied, interoperability is the ability of two or more systems to exchange information and to use the information that has been exchanged. Interoperability does not mean that all systems and tools need to operate in the same way but that there should be clarity regarding how the tools interact, and sufficient comparability between approaches so they are usable and accepted as credible across multiple jurisdictions.

Diverging frameworks, either at international, regional, or domestic level, can represent a challenge for cross-border investors seeking sustainable investment opportunities outside their countries. For example, when it comes EU investments in LMICs, it is important to keep in mind that EU investors are required to disclose the extent to which their investments are EU taxonomy-aligned, including for their investments outside the EU. In the absence of local standards, data, or clarity on the extent to which a partner country’s taxonomy is aligned to the EU one, it becomes very challenging for EU investors to identify what investments in LMICs they can or cannot report as EU taxonomy-aligned. In general, investments in LMICs are likely to become more attractive to EU investors if they can be reported as EU taxonomy-aligned under the EU disclosure regime. To date however, it can be difficult to assess whether relevant projects in LMICs can be reported as aligned with the EU taxonomy. This is notably because:

- a. The EU taxonomy has been designed to reflect the EU’s economic, geographical and technological development;
- b. Currently, alignment with the EU taxonomy for non-EU companies remains challenging as some taxonomy criteria (e.g. some DNSH criteria) have been designed with reference to specific EU legislation and standards;
- c. There is often a significant gap in LMICs 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 order to leverage the significant number of local taxonomies developed by LMICs, comparisons between EU and frameworks of LMICs can provide much-needed clarity. Lacking such clarity, investors might be discentivised from investing in LMICs.

In 2021, the G20 called for greater comparability and interoperability of approaches to align investments with sustainability goals<sup>181</sup>. As outlined in the G20 Sustainable Finance Roadmap, more needs to be done to improve coordination at the regional and international level to facilitate the comparability, interoperability, and (where appropriate) consistency of different alignment approaches. The Roadmap calls on jurisdictions to use similar language when developing taxonomies, (e.g., international industry standards), to use other taxonomies or common taxonomies as reference, and calls for **regional collaboration** in the development of taxonomies.



### Regional approaches to framework development

Regional approaches to sustainable finance frameworks can be effective in promoting harmonisation, sharing best practices, and driving consistent implementation across multiple jurisdictions. These regional approaches demonstrate the importance of collaboration and coordination in developing sustainable finance frameworks and taxonomies. They enable jurisdictions to learn from each other, pool resources, and collectively address sustainability challenges, fostering a more consistent and effective implementation of sustainable finance practices at the regional level. Beyond the EU, there are some notable regional approaches in this regard:

- **Association of Southeast Asian Nations (ASEAN):** ASEAN has been working towards enhancing sustainable finance frameworks in the region. The ASEAN Capital Markets Forum has established guidelines for the issuance of green bonds and sustainability bonds. Moreover, ASEAN has launched the ASEAN Green Bond Standards and the ASEAN Social Bond Standards to facilitate the development of sustainable finance instruments. In parallel, ASEAN is developing its regional sustainable taxonomy.
- **Green and Sustainable Finance Network in Arab Countries (AGREFIN):** the Arab Monetary Fund (AMF) established AGREFIN in January 2023. The AGREFIN provides a forum for peer-to-peer learning and exchange of experiences, sharing knowledge, and enhance coordination on sustainable finance issues to stay up with the changing landscape of sustainable financial activities and services. This network brings together senior officials from ministries of finance, central banks, and capital market authorities, as well as experts from international institutions' partners such as IMF, WB and the Bank for International Settlements (BIS).
- **Africa Sustainable Finance Institute (ASFI):** ASFI is a collaborative effort among African countries to advance sustainable finance in the region. It seeks to create a common understanding of sustainable finance principles, develop guidelines and frameworks, and facilitate knowledge sharing and capacity building.
- **Working Group on Sustainable Finance Taxonomy in Latin America and the Caribbean (LAC Taxonomy Working Group):** the Working Group, which includes the European Commission as external advisor, is a collaborative effort to respond to the growing momentum for LAC Taxonomy Working Group member states to establish compatible and interoperable frameworks on sustainable finance.

There are international or global efforts to develop and align sustainability-related **disclosure standards** in order to further contribute to comparable sustainability data in the market. The International Sustainability Standards Board (ISSB) of the International Financial Reporting Standards (IFRS) Foundation aims to develop a global baseline of sustainability disclosures for capital markets seeking to overcome the fragmentation of existing and emerging sustainability disclosure requirements<sup>182</sup>. The European Financial Reporting Advisory Group (EFRAG) is currently developing sustainability reporting standards at EU level, the European Sustainability Reporting Standards (ESRS) and is committed to closely working with IFRS Foundation to ensure alignment. The same is true for efforts to align between the ESRS and the Global Reporting Initiative (GRI) reporting standards. For instance, GRI is developing a detailed mapping of the disclosures from both sets of standards to guide GRI reporters on how to use their GRI reporting practices and processes to also meet the ESRS requirements<sup>183</sup>. The Taskforce on Nature-related Financial Disclosures (TNFD) also has partnerships focused on knowledge-sharing with these stakeholders. National disclosure requirements are often based on, or explicitly incorporate, global methodologies. For example, Egypt has mandated GRI-based sustainability reporting for businesses in the financial sector, taking effect in 2024.

Several international organisations have developed guidance documents to help countries develop **interoperable taxonomies** (e.g., IPSF and the UN Department of Economic and Social Affairs (IPSF-UNDESA), Bank for International Settlements (BIS)<sup>184</sup>, United Nations Principles of Responsible Investment (UN PRI) and WB<sup>185</sup>). For instance, the IPSF published the Common Ground Taxonomy (CGT), a comparison between the EU taxonomy and the Chinese taxonomy.

However, according to the G20, the lack of capacity and knowledge, notably for developing credible and interoperable sustainable finance frameworks, remains a major obstacle. In a recent survey conducted among the members of the UNDP-led financial centres for sustainability (FC4S), almost half of the respondents (mostly public-private partnerships or market associations) noted that a **lack of capacity** and **of workforce qualified in sustainable finance** are among the top barriers to scaling up sustainable finance<sup>186</sup>. In its 2021 Sustainable Finance Roadmap, the

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

183 GRI, [GRI and the European Sustainability Reporting Standards \(ESRS\)](#), 2022.

184 BIS, Paper No. 118, [A Taxonomy of Sustainable Finance Taxonomies](#), 2021.

185 UNPRI, [How policy makers can implement reforms for a sustainable financial system: taxonomies](#), 2022.

186 FC4S, [Leading Financial Centres Stepping Up Sustainability Action](#).

G20 called for **better coordinated technical assistance and capacity-building**, recognising a lack of capacity as a major obstacle to align investments to sustainability goals<sup>187</sup>. It also reflects the limited existing international work or coordination to scale up sustainable finance. These calls acknowledge the clear need for capacity-building to support countries in developing credible sustainable finance frameworks, as well as for international organisations and technical assistance providers to better coordinate their efforts contributing to international interoperability.

With this in mind, the **European Commission has stepped up its efforts to contribute to support the development of credible and interoperable sustainable finance frameworks in LMICs**. 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 taxonomy and South African taxonomy was published in 2022<sup>188</sup>, with a view to provide clarity and transparency between the two taxonomies to avoid greenwashing, create trust to attract EU investors and promote cross-border capital flows. Several other similar comparisons are currently being carried out in LAC (Mexico and Colombia) and APAC (Mongolia). The comparison between EU and local taxonomies in LMICs is an **important step towards increased interoperability**.

### Integrating climate risks and sustainability in the financial sector

Last but not least, a closely related aspect is **greening finance**, particularly for the banking sector. 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.

#### Transmission mechanisms

Climate change affects the financial sector primarily through two 'transmission mechanisms': physical risk and transition risk<sup>189</sup>. Banks are exposed to financial losses from climate-related physical risks through damage to their own assets or to their debtors' assets. Transition risks, on the other hand, refer to 'financial risks which can result from the process of adjustment towards a lower-carbon and more circular economy, prompted, for example by changes in climate and environmental policy, technology or market sentiment.' Banks' business models can be exposed to transition risks through a concentration of carbon-intensive creditors, even leading to high exposures to 'stranded assets' – assets that need to be written down prematurely due to incompatibility with transition policies and pathways<sup>190</sup>.

**Climate and environmental risk exposure can impact financial stability** in the long run. Evidence by the Task Force on Climate-related Financial Disclosures (TCFD) and the Financial Stability Board (FSB) shows that these risks are currently underpriced in markets. Besides posing potential risks for financial institutions, the under-pricing of risks within financial markets exacerbates the problem itself: by fully pricing risks, capital will begin to flow away from activities that create the risks and towards the solutions. Given these potential risks, central banks and other financial supervisors across the globe are working on measures to **integrate sustainability considerations and risks into the financial system, while** ensuring the banks they supervise follow suit. As in other areas of sustainable finance, various methods and guidelines to this end have been and are being developed by different jurisdictions. To determine and promote best practices, the Network for Greening the Financial System (NGFS) was formed in December 2017. Since then, this group of central banks and supervisors has grown to a membership 121 organisations across advanced and developing economies, notably covering all the globally systemically important banks<sup>191</sup>. In 2022, the Basel Committee on Banking Supervision (BCBS) published 'Principles for the effective management and supervision of climate-related financial risks'<sup>192</sup>.

187 G20 [Sustainable Finance Roadmap](#), 2021.

188 National Treasury, Republic of South Africa, [A Comparison Between the EU Green Taxonomy and South Africa's Green Taxonomy](#), 2022.

189 NGFS, [Guide for Supervisors: Integrating Climate-Related and Environmental Risks into Prudential Supervision](#), 2020, ECB, [Guide on Climate-Related and Environmental Risks](#), 2020.

190 NGFS, [Guide for Supervisors: Integrating Climate-Related and Environmental Risks into Prudential Supervision](#), 2020.

191 NGFS, [Annual report 2022](#), 2023.

192 Basel Committee on Banking Supervision, [Principles for the Effective Management and Supervision of Climate-Related Financial Risks](#), 2022.

### Examples among LMICs of sustainability in the banking sector

A number of authorities globally, including in LMICs, have already issued specific guidelines for financial institutions in their jurisdictions, while many more are working on guidelines to be issued in the near future. Most of these guidelines are in line with the principles described above, while there are some variations in the focus of the guidance, the methodology adopted and the scope of the risks taken into account. The examples provided below are for illustration purposes and are not exhaustive.

- As early as 2014, **Central Bank of Brazil** (Banco Central do Brasil, BCB) published its ‘Resolution on Social and Environmental Responsibility Policy’<sup>193</sup>. This resolution required financial institutions and other institutions authorised to operate by the BCB to each establish an internal policy on social and environmental responsibility, addressing the governance and management of relevant social and environmental risks. Furthermore, the institutions subject to the resolution were required to prepare a plan of action to implement the policy. In 2017, the Resolution on Integrated Risk Management<sup>194</sup> followed, mandating that financial institutions should perform integrated risk management which should include the social and environmental risks.
- In 2017, the **Bank of Bangladesh** issued ‘Guidelines on Environmental & Social Risk Management (ESRM)’ for Banks and Financial Institutions in Bangladesh<sup>195</sup>. In order to identify, manage and mitigate Environmental and Social (E&S) risks in lending, all banks were required to develop a robust ‘Environmental and Social Management System’ (ESMS), i.e. policies, procedures, tools and internal capacity to identify, monitor and manage a bank’s exposure to the E&S risks of its clients.
- In 2020, the **Central Bank of the Philippines** (Bangko Sentral ng Pilipinas) published the ‘Sustainable Finance Framework’, serving as the overarching framework governing the sustainability-related policies and practices of banks. According to the framework, banks are required to detail their strategies and policies integrating sustainability principles into their corporate governance and risk management frameworks as well as their strategic objectives and operations<sup>196</sup>.
- In 2021, the **Central Bank of Kenya** published ‘Guidance on climate-related risk management’, covering requirements on governance, oversight, strategy, risk management and reporting. Banks subject to the guidance were requested to submit a board-approved implementation plan to the supervisor.
- In 2022, in order to align with the BCBS’ Principles, and drawing from that document, the **Bank of Tanzania** published its ‘Guidelines on Climate-related Financial Risk Management’<sup>197</sup>.
- Also in 2022, the **Reserve Bank of India** (RBI) published a Discussion Paper on Climate Risk and Sustainable Finance<sup>198</sup> to gather stakeholder views on – among other topics – guidance for regulated entities to have the appropriate governance, strategy and risk management to address climate change risks. Based on the feedback, the RBI is currently working on a disclosure framework on ‘Climate-related Financial Risks’ and guidance on Climate ‘Scenario Analysis and Stress Testing’.

Given the novelty of the field and the fact that guidelines and methodologies are still developing, both supervisors and supervised entities face **a number of challenges in climate risk management**. According to a 2020 BCBS survey<sup>199</sup> conducted amongst 27 supervisory authorities, about half of the surveyed jurisdictions observed that banks were still in the early stages of developing their approaches to managing climate-related financial risks, indicating a need for improvement. The most commonly cited challenges in this survey related to **data availability, methodology, mapping transmission channels and lack of capacity**, both for central banks, supervisors and financial institutions themselves. In particular, it is to be noted that the NGFS also set up a workstream ‘Bridging the Data Gap’ to assess data gap issues in detail, and published recommendations in its final report in 2022<sup>200</sup>.

193 Banco Central do Brasil, [Resolução Nº 4.327, De 25 De Abril De 2014 on Social and Environmental Responsibility for Financial Institutions](#), 2014.

194 Banco Central do Brasil, [Resolution CMN 4.557 of February 23](#), 2017.

195 Bangladesh Bank, [Guidelines on Environmental & Social Risk Management \(ESRM\) for Banks and Financial Institutions in Bangladesh](#), 2017.

196 Green Finance Platform, [Sustainable Finance Framework \(Circular No. 1085\) for banks](#), 2020.

197 Bank of Tanzania, [Guidelines on Climate-Related Financial Risk Management](#), 2022.

198 Reserve Bank of India, [Discussion Paper on Climate Risk and Sustainable Finance](#).

199 Basel Committee on Banking Supervision, [Climate-Related Financial Risks: A Survey on Current Initiatives](#), 2020.

200 NGFS, [Final Report on Bridging Data Gaps](#), 2022.

It is important to note that the above challenges are universal, and do not affect LMICs central banks and supervised entities only. Despite the advanced stage of sustainable finance in the EU, European banks are also struggling to fully integrate climate and environmental risk management into their operations as attested by the 2022 European Central Bank (ECB) thematic review<sup>201</sup>. Hence, in the context of the EU supporting its partner countries' sustainable transitions, it is imperative to work together to protect financial stability by appropriately integrating sustainability considerations into the financial sector.

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#### *Recommendation 9*

*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 (including the EU taxonomy) for the LMICs. Moreover, the Commission should continue working towards interoperability in international fora as well as with global standard setters.*

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201 [ECB, Walking the Talk: Banks gearing up to manage risks from climate change and environmental degradation – Results of the 2022 thematic review on climate-related and environmental risks, 2022.](#)

# #10

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

The HLEG looked in detail at how to support SMEs in accessing sustainable finance in LMICs, and particularly how to encourage and enable widespread and robust sustainability reporting in LMICs. SMEs are the backbone of low- and middle-income countries' economies: they contribute up to **40% of the GDP** in emerging economies<sup>202</sup> and account for up to **90% of employment** in some countries<sup>203</sup>. Nevertheless, they face significant hurdles in accessing sustainable finance, including – but not limited to – increasing demands related to sustainability reporting.

### The case for support to greening SMEs

LMIC SMEs are crucial stakeholders in climate and sustainability-related discussions: on the one hand, they are faced with the negative impact of climate change and need to invest massively in adaptation and resilience. On the other hand, SMEs are large contributors to GHG emissions and therefore need to be supported in their transition efforts to sustainable activities. To date, most support to greening SMEs relates to mitigation rather than adaptation.

In particular, SMEs in LMICs in global sustainable value chains increasingly need to **improve, measure and report their sustainability performance** to meet the demands of their clients (both in advanced economies and in LMICs)<sup>204</sup>. Not doing so might severely jeopardise their competitiveness. At the same time, financial institutions will increasingly seek to align their activities with net zero targets, which will increase the level of scrutiny on their financing activities, including to SMEs. But SMEs need to invest in more than climate: global value chains and customer behaviour will also increasingly require SMEs to invest in environmental, social and governance issues: higher due diligence requirements in advanced economies will require SMEs to address suitable labour conditions, corporate governance, workplace safety, etc. For SMEs not yet included in global value chains, but who wish to expand and integrate these global value chains, sustainability reporting should not be a barrier.

Notwithstanding their importance for the transition, SMEs are not receiving adequate amounts of finance for their own transition activities: nearly **half the SMEs in LMICs have no access to formal credit**<sup>205</sup>. Research by the Global Partnership for Financial Inclusion (GPFI) for the German G20 Presidency of 2017 showed that lack of access to finance was the main obstacle for SMEs who wanted to join sustainable global value chains<sup>206</sup>. Recognising this priority, the European Commission has launched several initiatives, such as the Team Europe Initiative flagship Investing in Young Businesses in Africa (IYBA), which aims to increase the number of new micro, small and medium enterprises (MSMEs) and help grow (very) early-stage companies in African partner countries<sup>207</sup>.

202 World Bank, [SME finance](#).

203 Finance Watch and Green Economy Coalition, [Financing local green enterprises](#), September 2022.

204 OECD, [Financing SMEs for sustainability: Drivers, Constraints and Policies](#), *OECD SME and Entrepreneurship Papers, No. 35*, 2022.

205 World Bank, [SME finance](#).

206 Global Partnership for Financial Inclusion (GPFI), [Financing for SMEs in Sustainable value chains](#), 2017.

207 European Commission, [Investing in Young Businesses in Africa](#), 2023.

### Different types of Small and Medium-sized Enterprises

The term Small and Medium-sized Enterprise (SME) encompasses different realities, in terms of size, business model, capacity to grow, and sustainability goals. Some SMEs are part of complex, international value chains, while others are local in nature, often family-owned businesses. These differences mean that different types of SMEs have different sustainable finance needs, and tailored solutions must be developed to reach them.

The distinction must also be made when it comes to the degree in which ‘sustainability’ features in SMEs’ ambitions and business models. While any SME can adopt sustainable practices aimed for instance at reducing their GHG emissions, reducing waste and water consumption and optimising the use of resources (among others), other SMEs have sustainability at the core of their value proposition. When looking at the latter sub-set, a further distinction can be drawn between highly innovative SMEs from a technology standpoint, and more traditional SMEs which mainstream sustainability in their core business: ‘sustainable’ SMEs range from eco-entrepreneurs and cleantech startups, to local agri-businesses working exclusively with fair trade produce.

### What are SMEs’ sustainable finance needs?

To understand how to best support SMEs, it is first important to understand their needs for sustainable finance. As SMEs search for favourable financing terms, **it is up to financiers and policymakers to steer them towards sustainable** financing which can also help them in their sustainable transformation. Some needs that can be covered with sustainable finance solutions are listed below:

#### Climate adaptation, resilience and climate mitigation

It is absolutely crucial that SMEs gain access to sustainable finance, all the more so that SMEs are at the forefront of investment in **adaptation finance**: on the one hand, they are worst affected by the adverse effects of climate change, often lacking the financial protection needed in case of extreme weather events. On the other hand, a majority of adaptation projects are local by nature, and involve SMEs in their implementation.

SMEs also need support when it comes to **reducing their operations’ climate impact (mitigation)**. While some SMEs have already begun transitioning to sustainable practices, others will have to transition due to exogenous factors that force them to implement mitigation solutions: new regulation in the context of national transition plans and NDCs, clients’ requirements, consumer and community pressure, etc.

These investment needs in adaptation and mitigation can be broken down to several projects and activities that are eligible for sustainable financing.

#### Global value chains sustainability requirements and advanced economies regulations

**SMEs are increasingly intertwined in complex global and transnational value chains.** When investing in partner countries, companies from advanced economies often look for local, reliable partners, with whom they can engage and create strong business connections. In this context, SMEs can act as local counterparts for international companies, and take advantage of these investments to develop and grow their business at scale. However, as mentioned in section nine, sustainability reporting is becoming increasingly mainstream and influential in investor decisions: as large corporates at the pinnacle of these global value chains strive to make their operations more sustainable, this impacts smaller companies and SMEs down the line: sustainability and disclosure requirements from the final client in the value chain trickle down and have operational consequences for SMEs. These requirements can either be voluntary or regulatory.

### The main barriers to SMEs’ access to sustainable finance

While SMEs have needs that can be financed through sustainable finance instruments, several barriers prevent them from accessing these solutions. Listed below are some of the most relevant ones:

- **Lack of information:** many SMEs lack awareness and information on sustainable practices and their benefits. As highlighted by research, ESG is often associated with high costs and little benefits for SMEs, meaning that most SMEs will naturally be reluctant to spontaneously undertake sustainability practices. For those SMEs interested in making their operations more sustainable, or forced by external players, there is often a lack of available information on how to achieve this. Therefore, even when they wish to make their businesses more sustainable, SMEs might just not know how to proceed.



### Banking - The crucial role of the banking sector in SME sustainable financing

**Banks have a key role to play in financing SMEs.** This is generally true in all countries of the world, and even more so in countries where capital markets (including private equity) remain shallow. They have a broad geographic presence and knowledge of the markets in which they operate, they are recognised and trusted providers of finance, and they have expertise tailoring products for clients of different size.

However, local banks – particularly in Africa – refrain from expanding their operations to the SME market segment to generate further business, because this segment is considered as riskier and less profitable than other market segments. In several geographies, when banks offer finance to SMEs, the high risk-levels of SME lending mean banks lend to SMEs at very high interest rates. Any action from the EU must therefore ensure incentives for banks are large enough for the action to be impactful and lead to lower cost of finance for SMEs.

Banks and local financial institutions (FIs) are often the recipients of support from MDBs and DFIs in the context of intermediated lending (guaranteed or subsidised lines of credit for banks to extend credit to SMEs fulfilling certain criteria). Given the small average loan size for SME lending and the very high number of ultimate recipients of intermediated lending, MDBs and DFIs are not in a position to lend directly to SMEs, but rely on local banks and FIs to reach SMEs. The HLEG takes note of the fact that in several geographies, there are banks and large established financial institutions who do have dedicated operations for SMEs. Several banks in LMICs, both local and international, have gone one step further and developed dedicated sustainable finance products for SMEs. Banco Bilbao Vizcaya Argentaria (BBVA), for instance, developed a range of sustainable loans tailored for SMEs that cover energy efficiency, solar panels, electric mobility, green mortgages, digital accounts. These loans are supported by DFIs and MDBs, especially by IFC208. For instance, IFC provided several concessional loans in Latin America (USD 200m in Colombia, USD 60m in Perú) for BBVA to provide sustainable loans to SMEs.

It is important to note that while banks are today, overall, still the largest providers of SME finance, there are other intermediaries that have been increasingly active in this area: microfinance, fintech lenders, asset-based lenders, etc. In the same vein, loans remain by far the largest tool to provide SMEs with the much-needed funds to invest in sustainable practices, but new financial instruments are emerging, such as factoring and leasing.

Lastly, innovative SMEs require specific support to grow and develop. While finance is a major component of an innovative company's success, it is not the only factor of success. SMEs need advice, connection to similar companies, and interface with investors, which are often provided by equity finance. While the topic of equity finance transcends the scope of the report, SMEs have been increasingly relying on innovative hubs and platforms that provide an area for SMEs to innovate and develop. These hubs and platforms act as a springboard for innovative SMEs seeking funding, investors and grants, and could be leveraged to support innovation and creating links with financial institutions. Several innovative hubs and platforms have emerged globally to support the innovation ecosystem such as Endeavor, UpLink and IDBLab. These contribute greatly to sustaining the growth of innovative SMEs worldwide and offer a potential matchmaking platform for investors looking to invest in SMEs.

- **Burdensome ESG data requirements:** SMEs in advanced economies and LMICs alike might already struggle to provide the financial information needed to obtain regular financing – obtaining a sustainable-labelled loan compounds this problem by adding another layer of information requirements, adding an **additional burden for SMEs**. These reporting needs should comply with the principle of proportionality to ensure that SMEs can follow the appropriate reporting standards. There is thus a need for simple data solutions for reporting for SMEs in LMICs, potentially through a digital solution, to make ESG reporting as light a process as possible.

## How to address these challenges

It is therefore absolutely crucial for financial institutions and policymakers to provide **sizeable incentives** for SMEs to adopt sustainable practices and report on their ESG performance. These incentives should target both the end beneficiaries (the SMEs) as well as the intermediaries (e.g. DFIs and private FIs).

The challenges faced by SMEs can be addressed on two levels. First, SMEs can be supported through **non-monetary incentives** such as guidance, trainings and capacity-building to help them understand the ESG requirements of their clients. Corporates 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 invest to make their business more sustainable. These grants and subsidies could also potentially support lower cost of green finance for SMEs. Finally, to make ESG reporting process as light as possible there is a need for **accessible data-reporting tools** for SMEs in LMICs.

## Deep-dive into sustainability reporting in LMICs

Sustainability or ESG reporting is becoming increasingly mainstream in investor decisions worldwide. Nevertheless, SMEs in LMICs face several challenges when it comes to reporting on their sustainability performance.

First, as mentioned above, LMICs often lack **clear mandatory standards** against which to report. Until now, most firms have been relying primarily on voluntary standards in their reporting on sustainability data due to the former lack of mandatory standards. This leads to fragmentation of required reporting for SMEs, as different clients might require different reporting – leading to duplication of work for SMEs.

Second, there is a **lack of resources, capacity and in-house expertise**. The most often cited costs associated with publishing sustainability reports include complying with regulations, recruiting, and training new staff to prepare the reports<sup>209</sup>. Even if a company decides to bear the financial costs associated with sustainability reporting, whether as a result of a legal requirement or a voluntary commitment, companies might find it difficult to build in-house expertise. This often results in having to rely on external consultants, but firms might struggle to access even external expertise, due to the scarcity and price of these services. The lack of green and sustainability expertise is especially challenging for financial institutions and LMICs. For example, according to 2021 data by HSBC, 40% of Asian institutional investors are struggling to find qualified sustainability staff, holding them back from ESG investing<sup>210</sup>.

## LMIC SMEs reporting in the value chain

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. 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.

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### Recommendation 10

*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.*

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209 Amina Mohamed Buallay, [Benefits and Costs of Disclosing Sustainability Reports](#).

210 HSBC, [ESG Talent Shortage Holding Back Sustainable Investing in Asia](#).

