# High-Level Expert Group

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

*Mandated by the European Commission*

# Preliminary Findings & Recommendations

# DISCLAIMER

This document is not an official European Commission document nor an official European Commission position. Nothing in this document commits the European Commission nor does it preclude any policy outcomes. This document represents the overall view of the Members of the High Level Expert Group on Sustainable Finance in Low- and Middle- Income Countries. However, although it represents such a consensus, it may not necessarily, on all details, represent the individual views of members. Members also benefited from the input of observer institutions and experts. This document does not reflect the views of the European Commission nor its services.

This document outlines some of the Group's preliminary recommendations to the European Commission, ahead of the publication of the final report, by Q4 2023. It offers an overview of the progress to date, and provides a provisional first batch of recommendations indicating the direction of travel of the Expert Group and synthesising the discussions and joint efforts that have been ongoing since end September 2022. The analysis and recommendations are subject to potential revision and elaboration prior to the publication of the final Report based on further work that will take place between June and the final report.

# (NOT) JUST ANOTHER PAPER?

Summary of preliminary findings and recommendations of the High Level Expert Group on Scaling Up Sustainable Finance in low- and middle-income countries mandated by the European Commission.

**Eight years on from the global commitments to the Paris Agreement and the sustainable development goals (SDGs), and with just seven years left to change trajectory, the UN has sounded the alarm**[1]**.** 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 investment across the board to realise a just sustainable transition, from sustainable infrastructure to resilient agriculture, natural capital to health and education, climate adaptation to clean 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, for all countries, growing food and energy crises, raw material concerns and a changing geopolitical environment are creating hurdles – to different degrees - in realizing the transitions. 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)[2] at USD 3.9 trillion per annum, and for LMICs (excluding China), a relative slowing of trends in investment in clean energy relative to advanced economies.

**Increasingly stretched public funds are clearly not sufficient to bridge this gap - but global private capital is.** Private investors increasingly seek sustainable investment opportunities to green their portfolios. This represents a window of opportunity for LMICs. How can we best direct the former (public capital) and mobilise the latter (private capital), against the tide of increasing macroeconomic pressures across international markets, structural barriers to investment in LMICs and the growing fiscal challenges facing many of the most climate-vulnerable countries?

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

The HLEG was asked to propose **specific and concrete actions** that the European Commission can take to make a real difference. With this summary of preliminary findings and recommendations, the HLEG is making its first contribution to the debate by tackling one question in particular: "**what should the European Commission do more of, less of, or simply differently?**"

1 https://press.un.org/en/2022/sgsm21228.doc.htm, https://press.un.org/en/2021/sgsm20847.doc.htm

2 https://www.oecd.org/dac/global-outlook-on-financing-for-sustainable-development-2023-fcbe6ce9-en.htm

# #1

The HLEG believes a **new model for strategic engagement between the EU and partner countries** is needed to transform the respective sustainable development challenges into a mutual opportunity for inclusive growth.

**Mobilising investment in sustainable and resilient infrastructure and ensuring sustainable supply chains are clear win-wins for the EU and its partner countries**, and as such form a cross-cutting theme for the HLEG's work. As of 2022, LMICs need up to USD 2 trillion a year[3] of investments in sustainable infrastructure which cannot be provided by public finance alone. EU institutional investors' capital and increasing appetite for long-term sustainable investment can and should help. Advancing the development of sustainable and resilient infrastructure in LMICs can power inclusive and sustainable growth, helping to create new green industries and jobs, boosting economic resilience. At the same time, the EU needs to diversify and secure its supply of affordable, clean energy and critical raw materials, and partner countries can benefit from tapping into this growing demand. The Global Gateway strategy – with which the European Commission pledged to mobilise €300 billion for sustainable and high-quality projects – expresses this twin ambition of helping partner countries develop, while also creating opportunities for EU Member State private sectors to invest responsibly and remain competitive.

Beyond investment in sustainable infrastructure, which is a core issue, there is also a pressing need to mobilise capital in other economic and strategic areas including resilient agriculture, natural capital, health and education, climate adaptation and clean energy, leveraging on technology transfer.

**As a first and natural step of a new transformative approach to scaling 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[4], and – crucially – involving 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 businesses.** 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 Viet Nam, South Africa, and Indonesia, and the Climate Finance Leadership Initiative (CFLI), currently operating in India and Colombia. 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: transport, climate and energy. Simply put, this is about bringing together all the key players around the table so they can understand each other's priorities and identify a coherent set of actions to move together towards shared goals.

This approach would reinforce the coherence and breadth of the EU's offer towards its partner countries, which should not just be limited to EU development tools (guarantees and technical assistance (TA)) but encompass trade, energy and industrial policy aspects, while reflecting key priorities of the EU. In particular, it would allow the EU to exchange with its partner countries and provide support on the most needed policy and regulatory reforms to strengthen local financial and capital markets, reinforce governance and enhance the pre-conditions for spurring further sustainable investments and solid trade relationships. In practice, EU partner countries' governments would have the opportunity to clarify their sustainable roadmaps and related investment plans (e.g. integrated national financing frameworks) so the private sector sees the direction of travel, figuring out which reforms and policies are necessary for local and global private investors. It would also allow to determine what form of EU external support from donors, DFIs and others is best suited, designing the necessary mechanism to provide finance and TA, and so on. If this sounds (relatively) straightforward, the story does not end there...

3 McKinsey & Company, Unlocking private-sector financing in emerging-markets infrastructure, available at: Unlocking private-sector financing in emerging-markets infrastructure | McKinsey.

4 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.

# #2

**The HLEG recommends that a single EU platform for supporting the development of sustainable projects through their lifecycle is created ensuring timely involvement of key relevant actors and EU instruments to strengthen and scale up collective action.**

**As part of the new partnership model, the HLEG encourages the EU to provide more coherent support along the whole investment chain and project lifecycle while involving private investors in a timely way.** One of the main expected outputs of the high-level dialogue should be the identification of priority investment areas in which the partner country and the EU agree to collaborate. However, much more is needed to translate those investment priorities into pipelines of bankable sustainable projects. For example, in sub-Saharan Africa today, 80 percent of infrastructure projects fail at the earlier stages of development[5]. How can the EU further - and better - support LMICs in actually bringing to life sustainable projects with high potential? Through **coordinated and effective support for project preparation**.

Today, there is a landscape of numerous fragmented project preparation facilities (PPFs), which are specialized entities or programmes that aim to bolster pipelines by providing financial resources, technical expertise, and advisory services to governments, project developers and other stakeholders. Ideally, this should help mitigate early-stage risks and enhance the quality and bankability of projects, attracting suitable investment. But, with PPFs not always covering the very early stages of project preparation and with varying but often limited private sector involvement, there is clearly room to efficiently coordinate and pool efforts to both achieve scale and increase project take-off.

In practice, **this one-stop-shop platform would be the operational and financial arm of the new partnership model**, dedicated to developing sustainable projects from their onset to their closure allowing timely involvement of relevant stakeholders and EU instrument (grants, TA, guarantees, etc.). The platform should leverage on the EU-led sustainable finance local currency facility (see below) to provide financing in local currency to the extent possible. The platform would offer **standardised processes and contracts**, both for the project preparation and for the commercialisation, to provide clarity and protection for investors and end-beneficiaries. It would also offer support on key regulatory reforms necessary for private investment, both sectoral and sector-agnostic business-oriented reforms, as well as supporting relevant technology transfer. It would add value as a single-entry point for all stakeholders, systematically involving private players in the various steps of project preparation.

5 McKinsey & Company, Solving Africa's Infrastructure Paradox, available at: Solving Africa's infrastructure paradox | McKinsey

**Looking at public finances**, many LMICs are currently reeling from the effects of several consecutive and concurrent crises. Interest rate hikes in advanced economies, global inflation, high levels of indebtedness – each have taken their toll and many LMICs do not have sufficient fiscal space to fulfill the critical and usually public function of funding new or existing infrastructure. Indeed, sustainable infrastructure projects are crucial to promote development, growth, and social well-being. Hence, increasing fiscal space is the order of the day, with the International Monetary Fund (IMF) and World Bank seeking solutions for meaningful debt restructuring and debt relief. The HLEG looked at commercial debt-for-nature swaps (DFNS)[6] and concluded that these are sophisticated instruments that cannot be easily replicated at scale and need to be assessed on a case-by-case basis.

On a parallel track, the HLEG has rather focused on what role the private sector can play, and in particular, how it would make most sense for them to do so. Asset recycling (like regular recycling) can offer many **benefits.** Essentially, existing public infrastructure can be sold or leased to private parties, monetizing the value of those assets for the government. This unlocks cash for (sustainable) infrastructure spending at no cost to taxpayers, and no additional government debt. As always, there is a price for these benefits, and asset recycling mechanisms such as securitisations can be complex, and hence costly, to structure. However, they have the potential for bringing in 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 in itself can be a beneficial exercise. Many of these public assets, such as state-owned power generation facilities, may require transition finance to decarbonise (including in hard-to-abate sectors) or adaptation finance to strengthen their resilience to climate change (e.g. for transport, water or energy infrastructure), and here green securitisation can provide an opportunity to mobilise support, including finance and TA to transform those assets. And what can the European Commission bring to the table? Knowledge, expertise and financial resources to help LMICs identify and assess relevant assets, build or develop a framework for securitisation and maximize societal and environmental outcomes such as transition and adaptation. As such...

# #3

The HLEG believes the European Commission together with Multilateral Development Banks (MDBs), including the World Bank, the IMF and DFIs should set up a bold **Initiative for sustainable asset recycling and securitisation (asset-backed securities) in LMICs** to create the fiscal space needed for their sustainable and resilient infrastructure investments, and to help making sustainable infrastructure a liquid asset class.

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

**In parallel to supporting partner country efforts, the HLEG encourages the EU to continue to play its part in transforming the global financial architecture to ensure that global capital can be effectively mobilised to support local sustainable development in LMICs**. The HLEG focused initially on what the EU can do from home to better mobilise EU institutional investors. The HLEG noted that only a very marginal portion of EU institutional investors' assets are invested in LMICs, most of which is concentrated in upper-middle income countries. Private investors' decision-making processes are significantly influenced by the need to optimize risks and returns, and maintain exposure to a highly diversified pool of sustainable exposures. Thus, when investing in LMICs, data shows that institutional investors significantly prefer investing through funds. Funds offer a sizeable ticket– achieving the needed scale – as well as maturity, liquidity, diversification, and cost savings for research and due diligence.

Taking into account institutional investors' preferences, DFIs/MDBs have started to launch innovative **financial structures through de-risked public-private funds, where DFIs/MDBs** absorb the first losses **through investing in junior equity to cover part of the risks investors are not willing/able to take**. These structures also leverage on the combined expertise of DFIs with their deep knowledge of LMIC markets, and of asset management companies with their large institutional client network and their expertise to set up and run a fund.

**De-risked public private funds have a huge potential to further mobilise EU institutional investors into LMICs, but they face hurdles that prevent them from reaching scale, replicability and speed**. First, unintendedly, these **de-risked public-private funds** fall into an asset class under the EU prudential framework which imposes substantial prudential costs (capital charges) for notably insurance companies – as well as for DFIs[7], which greatly diminishes the funds' attractiveness, and undermines the intended objective they are meant to achieve. Other hurdles include a lack of market visibility of these funds and their lengthy time-to-market due to a lack of standardisation, the challenge for LMICs to comply with EU sustainability frameworks, and the lack of pipelines of bankable and sustainable investment opportunities on the ground. To create the conditions for a mature market allowing scale, replicability and speed...

# #4

The HLEG believes the European Commission should propose to frame de-risked public-private transition and/or sustainable funds in LMICs as a **new type of EU financial product**, recognised in the EU financial legislation through a **dedicated EU legal framework.** To do so, the European Commission should first explore the policy choices and options through an impact assessment considering the relevant EU supervisory authorities' views.

This impact assessment should 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 ensure that relevant EU prudential treatments accurately reflect the associated risks taking into account the de-risking mechanism of the structure and the quality of underlying assets.

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

**The HLEG has also identified the need to explicitly address foreign exchange (FX) risk.** The high FX risk and the related prohibitive hedging costs pose another significant barrier preventing EU capital flows into LMICs. Indeed, EU institutional investors have a strong preference for hard currency-denominated investments in LMICs. Even in the sphere of development finance, about 80%-90% of DFI/MDBs loans are still provided in hard currency. This keeps the currency risk – and associated costs – with the most vulnerable parties, the LMIC borrowers. 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 LMICs and currency depreciation against hard currencies. To illustrate, JP Morgan[8] upwardly revised its 2022 emerging market bond outflow forecast to US$80bn, reflecting the fact that soaring rates in advanced economies make the typically high yields of LMIC debt less attractive. This leads to higher FX volatility in LMIC currencies – for example, the Nigerian Naira has fallen 50% against the US dollar since 2020, currently hitting a five-year low. Depending on LMICs' exposure to hard currency, this can amplify their cost of debt, negatively impacting their risk profiles and financial stability.

The HLEG has reflected on a basket of different solutions considering cost-effectiveness and impact on local capital markets, building on existing experiences, practices and lessons learnt so far notably by some DFIs and MDBs – as well as trying to think a little outside the box.

# #5

The HLEG believes the European Commission should significantly step up its efforts to support local currency denominated financing. To do so, it should **engage with central banks and relevant market authorities to accelerate the needed reforms to deepen the local financial and money markets**. In addition, among one of the solutions of the basket and relying on the input of a dedicated Task Force, the European Commission should support the creation of a **sizeable EU-led sustainable finance local currency facility**.

The EU-led sustainable finance local currency facility would provide local currency in a cost-effective manner, by issuing local currency-denominated bonds and passing the funding to public and private financial intermediaries wishing to make sustainable investments in LMICs. It would also contribute to local capital market development by issuing local currency-denominated bonds. While the facility may bring added value in a number of LMIC markets, in other instances other solutions might be more suited. For the latter, the European Commission should also seek arrangements with central banks and/or relevant market authorities to be able to operate onshore (locally). In less liquid markets, this should allow accessing local currencies at a cheaper rate, as compared to working offshore (abroad), while boosting liquidity. Given the burden and resources required to be granted the right to operate onshore, the European Commission should assess the potential for the centralisation of such efforts.

8 Outflows from emerging market bond funds reach $70bn in 2022 | Financial Times (ft.com)

Beyond the specific measures to accelerate the flow of EU private capital to LMICs, the HLEG recognises the importance of **well-developed and liquid local capital markets** for LMICs' sustainable growth. Deep capital markets in particular can play a key role in supporting economic growth and job creation, by providing scale and diversified investment allocation/funding. While much progress has already been made in capital market development across many LMICs, the European Commission can do more to help partner countries tap their full potential.

# #6

The HLEG recommends that the European Commission coordinate with the European Investment Bank (EIB), MDBs and DFIs to provide **targeted technical assistance** (TA) and capacity-building to help LMICs build or strengthen and mainstreaming sustainability in their capital markets.

Within the capital markets, green, social, sustainable, and sustainability-linked (GSSS) bonds in LMICs have experienced growth in recent years (witnessing a five-fold increase between 2014-2016 and 2020-2022). However, despite this expansion, it continues to account for merely a small fraction, approximately 3%, of the global market for thematic bonds. GSSS bonds are more liquid compared to direct investment into green infrastructure projects, and so are preferred by many investors. To tap into the potential of these instruments...

# #7

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

**Being the world leader in green bond issuance, the EU is best placed to launch a bold and transformative initiative to coordinate efforts and pool resources to support the development of 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 include a TA programme contributing to reinforcing the partner country's local capital market ecosystem, notably through capacity building to stock 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 including through supporting investment in the required data, standards and capacity building.

The HLEG encourages the European Commission to work with DFIs and MDBs to explore how local capital markets can be leveraged to mobilise more private capital as well as support countries to build the ecosystems of financial intermediaries required. **DFIs and MDBs are well positioned to help unlock much needed private capital at local, EU and international level**, given their long-standing experience and in-depth understanding of risks and opportunities in investing in LMICs. However, to date, DFIs and MDBs have overall mobilised limited private capital with insufficient de-risking mechanisms, and sometimes even crowded out private capital. This is due to various reasons including their business models, incentives structure and mandate which traditionally centered around **direct loans and grants for development**. Now, with the need to make best use of limited public resources and official development assistance (ODA) to maximise private resources for the SDGs, DFIs/MDBs need to further differentiate their interventions between the contexts where the **private sector can be mobilised** and those where concessional finance is rather needed. In this context, more needs to be done also to provide transparency by DFIs and MDBs on their transactions, including the risk taken, the concessionality granted and the sustainability performance. MDBs and DFIs possess vast amounts of credit, market and economic data on developing economies in their Global Emerging Markets (GEMs) Risk database that is not available elsewhere.

# #8

In the context of the ongoing MDBs reform efforts, 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 and 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 and granting public access to the GEMS database. To ensure a coherent reform, the European Commission together with the Council of the EU should coordinate this exercise.

**The HLEG is proposing measures to mobilise global capital and to lay a strong foundation for local capital markets ready for sustainable finance – finally, how to connect the two and attract investment aligned with local needs and priorities?** For one, institutional investors favour clear (and recognised) frameworks. Indeed, as appetite for sustainable investment with impact has increased significantly in the past five years, so too have sustainable finance frameworks proliferated across the globe, including in LMICs. These frameworks can help facilitate informed investment decisions, avoid greenwashing, and scale up sustainable investments, also by clarifying sustainability criteria for project developers. However, with at least 29 taxonomies initiated globally, and multiple and diverse principles, standards, labels and disclosure requirements, there is increasing risk of fragmentation and unnecessary complexity. As such, interoperability is key to enhancing the up-take of sustainability by project developers, and promoting cross-borders capital flows towards sustainable investments across the globe.

**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**. The HLEG views greater interoperability as compared to harmonisation as a desirable objective. It is essential to recognise specificities among countries, regions, and jurisdictions.

To date, it can be very challenging for EU investors to assess whether relevant projects in LMICs can be reported as aligned with the EU Taxonomy (with the exception of e.g. renewables such as solar or wind). In order to ease this challenge and leverage on the local taxonomies developed by LMICs, comparisons between EU and LMICs' taxonomies can provide much needed clarity. Going further, the HLEG suggests that **EU legal recognition of the conclusions of comparisons carried by the EU and partner countries on their taxonomies may provide legal certainty to investors on whether their investments can be reported as aligned with the EU Taxonomy**. In the long run and with a particular attention to low-income countries, the EU should continue its work on enhancing the international interoperability and usability of the EU taxonomy. The HLEG also suggests that the EU do more to support local sustainable finance markets through helping partner countries to access global data and build the local capability and data architectures to access global sustainable finance markets. Furthermore, capacity development support should be provided for private sector entities in these markets to enable their compliance with the taxonomies and access to finance from within the EU.

# #9

The European Commission should **coordinate with EU implementing partners their TA support, through a dedicated sustainable finance hub,** aiming at helping LMICs to develop **credible sustainable finance frameworks** to attract capital, including for social and transition finance, while promoting interoperability. It should consider a series of identified criteria to ensure local suitability.

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, following recognised methodologies and common principles. In the medium term, the European Commission should establish a process to legally recognise the conclusions of the comparisons.

In the long term, the Commission should explore modalities to support greater interoperability, including the potential for flexibility (e.g. a longer transition period) in the EU taxonomy as regards investments in LMICs.

Finally, the Commission should continue working towards interoperability in international fora like the G20 Sustainable Finance working group and the International Platform for Sustainable Finance as well as with global standard setters.

**In parallel, there is much to do to support partner countries to build resilience to climate change. The HLEG focused here on what the private sector can do. Adaptation protects people and assets, but also strengthens financial and fiscal resilience to disasters and so brings the co-benefit of improving the investment climate overall and helps to unlock the growth of sustainable financial markets.** The initial recommendations focus on **insurance as one component of adaptation and an opportunity to unlock adaptation finance across the wider economy**. It also examined the question of how climate-related risks should be distributed across actors (DFIs, private capital, etc.) to minimize possible impacts on economic and financial stability that could arise if LMIC governments and businesses remain uninsured. 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.[9] Notably, a staggering **1 billion children** live in 33 countries classified in UNICEF's Children's Climate Risk Index as "extremely high-risk", meaning they face a deadly 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.[10] 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 120 billion, compared to a 10-year average of annual USD 81 billion losses.

It is important to systematically address this protection gap because if governments, businesses and households are not adequately protected against the financial costs of climate-related risks, the possible impacts on economic and financial stability can be severe.

9 V20 (2022), Climate Vulnerable Economies Loss Report

10 UNICEF (2022), Children's Climate Risk Index

Hence, **loss and damage** and **climate justice** have become critical policy questions in international climate negotiations; most recently 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.[11] Insurance, and insurance-based instruments like catastrophe (CAT bonds) and risk pools, effectively share (or redistribute) risk globally, allowing the insured to access predictable and cost-effective finance when disasters strike, so building resilience.

Among this widespread reflection, the HLEG looked at various examples of insurance and other risk financing currently being rolled out to see what could have the potential to maximise long term risk distribution and also **attract private capital at scale**. Some, like CAT bonds and regional risk pools have shown promise and are already in use by various LMICs, supported by MDBs and DFIs. CAT bonds in particular are instruments that have the advantage of being uncorrelated with other traditional asset classes, while being relatively standardized, and so attractive to some institutional investors as well as lower cost for LMICs countries, households and businesses. While the CAT bond market is well-developed in the US, for various reasons coverage is lagging behind in the EU and very limited in LMICs.

# #10

The HLEG believes the European Commission should promote disaster risk financing, such as CAT bonds and risk pooling, in LMICs – and link this to adaptation/resilience financing to increase focus on scaling investments in climate resilient infrastructure. This should be, as appropriate, through a new dedicated facility or through support to existing mechanisms.

**Of course, insurance in no way replaces adaptation: losses, even if spread out, are still losses and an insurance payout will itself not save a life or prevent assets being destroyed by a flood or typhoon**. However, insurance can be instrumental to enable and accelerate wider adaptation, both directly through using insurance to de-risk adaptation finance and create incentives for resilience at the project-level, and by indirectly through strengthening the overall investment climate of the country and potentially improving sovereign creditworthiness. 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 plans to facilitate combined “insurance and adaptation” solutions targeted to different end-beneficiaries (households, small and medium-sized enterprises (SMEs), farmers, municipalities…). The European Commission and its DFIs can provide, where needed, calibrated premium support, loss coverage for the adaptation investments and suitable TA.

Infrastructure assets in LMICs are not routinely designed to withstand the impacts of climate change, and as a result are increasingly stressed by multiple drivers 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.

11 Germany pledged EUR 170 million and other countries’ commitments reached EUR 40 million so far. V20 and G7 jointly launch Global Shield against Climate Risks at COP27 | BMZ

# WHAT NEXT? **THE WORK CONTINUES...**

Even with the new strategic engagement model and powerful toolbox described above that the European Commission could offer partner countries to improve the local investment climate, the HLEG knows that the picture is still bigger, and key topics remain to be addressed. Beyond investment in sustainable infrastructure, there is also a need to mobilise increased sustainable finance from the local banking sector to enterprises, SMEs and households and importantly, to strengthen financial stability by integrating sustainability risks.

Another, and not the least, is finance for human and social development (including the potential of social bonds), adaptation and transition, and the protection and restoration of natural capital. These needs are woven throughout the HLEGs initial recommendations but require also further consideration and more targeted solutions. In short, the work is not yet finished for the HLEG, which will monitor developments in the international debate and continue to reflect on these issues ahead of the publication of its final report expected before the end of this year. This is to say, ***stay tuned***...

# BACKGROUND

In July 2021 the European Commission adopted its *Strategy for Financing the Transition to a Sustainable Economy,* an ambitious package of measures for the internal market that established the EU as a leading actor in sustainable finance. However, sustainable finance should be available for all - so the Commission simultaneously committed to developing a strategy for scaling up sustainable finance in its partner countries, particularly LMICs. The HLEG was established in September 2022 to support the Commission in this endeavour, bringing together a balanced selection of senior experts from the financial services, public sector, industry, civil society and academia.

The HLEG has reflected on **transformative and innovative actions** that the European Commission should take to scale up sustainable finance in LMICs. As is the case for every complex, multi-dimensional issue, the first challenge was to specify the problem statement and identify the main areas of concern. This was no easy task within a subject where the very definitions (what it means to finance *sustainable, green, social, transition, etc. activities*) are multiple and evolving – in itself a significant difficulty. Beyond the question of terminology, there is also a clear tension between views on the origins of the finance gap. *Is it due to a low appetite of private investors for sustainable finance in LMICs, or is it rather a shortage of visible and attractive sustainable investment opportunities? Is it that the enabling environment is not in place, so there is insufficient clarity and structure to encourage the actual flow of sustainable finance from one to the other?* Perhaps unsurprisingly, the HLEG concluded that it is often a combination of all of the above.

It then set out to analyse what is already happening in this area – gathering 'lessons learned' – as well as what does not seem to be happening yet, and why. In its exploration of innovative ideas, the HLEG has been guided by two considerations: (i) the potential **scale** of private capital that can be channelled towards sustainable investments and (ii) the most **effective** use of limited public funds to do so. The bad news is that there is no one-size-fits-all, silver bullet solution to be found – even outside the box. The good news is that there can be true impact through **a thoughtful combination of incremental changes and bolder actions**, with consideration for the specificities of the LMIC in question.

To that end, the HLEG presents its preliminary findings and recommendations to the European Commission, ahead of the publication of the final report by Q4 2023. The analysis and recommendations remain subject to revision and elaboration based on further work that will take place before the publication of the final report.

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