THE PRINCIPLES FOR RESPONSIBLE INVESTMENT PODCAST TRANSCRIPT

BRIDGING THE FINANCING GAP – HOW BLENDED FINANCE CAN HELP CAPITAL MARKETS DELIVER SUSTAINABLE INVESTMENT IN EMERGING MARKETS

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Simon Whistler

Welcome to the PRI podcast. My name is Simon Whistler and I lead the PRI's work on infrastructure and on emerging markets. And today's subject is relevant to both of those. We're gonna be talking about blended finance in particular, how blended finance can be a critical tool for investors to support the achievement of climate and sustainable development goals in emerging markets. The pressing need for greater flows of sustainable capital into emerging markets was brought into sharp focus again at the recently concluded COP26 Climate Summit in Glasgow, poorer countries urgently require greater resources to tackle the impacts of climate inch and to achieve the sustainable development goals more broadly by 2030, we're already talking about an annual financing gap of trillions of dollars. On the investor side, we know that the capital that can make the differences there. In Glasgow, for example, much was made of the $130 trillion of private money committed to the transition to a global net zero economy through the Glasgow Financial Alliance for Net Zero (GFANZ). So now it's really a question of understanding how we can get more of this capital to be committed to the right projects and investments in emerging markets and blended finance can be one of the tools to do just that, to explain how I'm delighted to be joined today by Nadia Nikolova, Lead Portfolio Manager, Development Finance, Allianz Global Investors and Chris Clubb, Managing Director, Convergence, the global network for blended finance.

Nadia, Chris, welcome to the PRI podcast. And Chris, if I may, I'm going kick things off with a question for you. Can we break down what blended finance is to start with and why is it regarded as such an important tool for scaling up finance for sustainable investments in emerging markets?

Chris Clubb

Simon, thanks so much for that introduction. That introduction really leads into this answer. So, as you rightly identified, the investment needs on an annual basis to achieve the sustainable development calls and climate objectives in these 140 developing countries is around four and a half trillion dollars per year, but the actual level of investment is only around one and a half trillion. So there's around a 3 trillion dollar per year funding or financing gap. Now, if we look at the conventional forms of capital to fill that investment in finance gap, we you'd obviously would immediately look at the financial assets, the investment resources that are available in these developing countries. The IMF estimates, there's around 380 trillion of global financial assets, but only 4% of those assets are located in these countries. So, we have the systemic lack of capital within these countries. So at the core of blended finance is to mobilise more investment on a cross-border basis into developing countries to achieve the SDGs and climate objectives.

Now, when one looks at the existing flows that happen without blended finance, we have around 200 billion a year in what's known as portfolio investment, equity investment in a nonstrategic way. We have around 500 billion a year in foreign direct investment, and we have a hundred million, a hundred billion a year in net debt investment flowing into these countries from the market itself. That's all great. We'd love to see those numbers grow, but one of the impediments is the risk of these markets. There's a perceived risk in the form of high country risk, for example, Moody's S&P and Fitch identify the median sovereign risk rating of these countries as around B plus. So, a lot of conventional investors look at these markets and see a risk that is beyond their mandate and their criteria. So the core of blended finance is to deploy some of the official development finance community’s funding, and which is around 160 billion a year from the 30 OECD DAC members in the form of official development assistance and around 170 billion a year from the multi-development banks and DFI, can we use some of this public funding in a way that can mix with this private funding in order to create a market equivalent risk adjusted returns that are attractive to the private investors that will mobilise those investors to cross-border investment that as otherwise not happening. So that's blended finance in a nutshell, Simon. Thanks,

Simon Whistler

Chris. That's a great introduction. So, Nadia picking up on that from an investor perspective active. Chris has mentioned some, a little bit about the kind of the risk profiles and some of the work that blended finance can do to reduce those risk levels to make, to make them more attractive. But what, what is it specifically about blended finance that is kind of encouraged at Allianz global investors? And you're also involved, I know with the Net Zero Asset Owners Alliance, and you've been looking at blended finance through that as well. What is it specifically about blended finance that has encouraged you to go down that route?

Nadia Nikolova

Well, we started our journey in blended finance back in 2015 when we first talked to the international finance corporation, IFC who was capital constrained and was looking to mobilise private capital into emerging markets in particular, in infrastructure. And when we spoke to our investor base, very quickly, it came to the crux of exactly what Chris was talking about. Insurance companies in Europe, that's about 8 trillion are very much incentivised by prudential regulation to get to the so-called investment grade. Now, Chris very eloquently elaborated on the fact that 88% of the emerging markets countries are actually known investment grade. So by definition, they were not suitable for the majority of the locations on the balance sheet. Now blended finance allowed us to de-risk, using portfolio P portfolio approach allowed us to de-risk the individual investments to a more suitable investment grade profile for investors, therefore unlocking large scale capital.

One of the issues that we often see in blended finance is that the scale is really missing. And the reason for that is that sometimes the de-risking isn't sufficient. The other side though, and I think that's quite interesting is the traditionally investors have invested in emerging markets has been through public indices, I don’t know take the JP Morgan, JP Morgan broadly diversifying index and through public capital markets. Now, a lot of the countries that need the most financing are actually don't have the well-developed public capital markets. So what we found very useful is to partner with developing finance institutions who are investors in this markets for many years, decades. They have established track records and they have the local presence on the ground and are good partners for institution we investors to co-invest alongside them in this markets in order to really invest in the sectors that are generating growth, those are small medium enterprises infrastructure agriculture.

Unlike what some of the public indices have been investing in, which is mostly financial institutions in real i.e asset class is less correlated with GDP growth. So blended finance has been really a solution to mobilise large scale capital. And I think this is something that the Alliance very much recognised, and that's what there was a call to action in February of this year, with where the Alliance requested various asset managers and stakeholders to make proposals for blended finance vehicles. So recognising in particular in climate, we definitely recognise that the battle of over the battle over climate, it will be one or lost in emerging markets. So, and the role of blended finance is absolutely core to attract some of that capital flowing into these markets.

Simon Whistler

So by the sounds of it, I mean, there there's a lot to like here, but de-risks potential investments. It gives you access to investments and opportunities that you wouldn't have through publicly listed opportunities and in emerging markets, and you can partner with organisations that have been in emerging markets for a long time. So you build up capability or, or you work with existing capabilities there. And those are all things that a lot of let's say, asset owners sort of looking at emerging markets or have always questioned. So this idea of blended finance or the, these blended finance vehicles, it's nothing that's necessarily new at this point. It's been talked about in responsible investment circles and emerging market circles for a long time.

So Chris, can you just run us through kind of, I mean, you've talked about some figures, but just to give a quick sort of high level view of where the market's at and perhaps some of the, some of the successes to this point, but also some of the high level challenges that we still face.

Chris Clubb

Yes, you're absolutely correct though. The expression blended finance, which is inextricably linked to, you know, private investment mobilisation. The mobilization agenda has been around for a while. Blended finance has been practiced into emerging markets for probably 15 to 20 years or so. What I would say is that 2015 was a watershed event for the official development community. That's the year when the UN member states agreed the Sustainable Development Goals, a lot of work done to identify, the amount of annual investment required to achieve the Sustainable Development Goals. Also 2015 was when the Paris agreement was signed. So, 2015 were these two watershed events, which really clearly identified and quantified the amount of an investment that is required to achieve these objectives and clearly identify the size of the investment gap. And that gap is large relative to official development finance resources.

But as, as I mentioned, it's not large relative to the $380 trillion of global financial assets. So although, been around a lot, it's been much more emphasised since 2015. One of the challenges we have is that, although it is discussed a lot, when we look at the underlying levels of mobilisation and blended finance that are unfolding, unfortunately the numbers have not gone up much since pre

2015. I'll give you an example, the multi-development banks and DFI every year report on the level of mobilisation from their regular development, finance activities. They have been mobilising around 18 to 20 billion per annum in what they call direct private. Those numbers are largely unchanged or similar since 2013. So, although very important, the MDBs and DFI's are really are not mobilising much more than they were since before the SDGs. Now, when one looks at financial resources coming from another of the official development finance community that called aid or grants or official development assistance. By our best estimates in partnership with the OECD, we think that the aggregate amount of blended finance and mobilisation activity that involves a level of concession or catalytic funding from this community, in aggregate, it's around 15 trillion, 15 billion per year, but that's only around 6 billion from private investment. And the other 9 billion comes from either the donors or the multilateral development banks or DFI. So when one adds those two numbers up, our best estimate is that the amount of private investment being mobilised by official development finance is around 30 billion a year. And that number has not gone up considerably.

So we at convergence have been working very closely in the last 12 of months with some of the key donors in the development, finance community, especially the UK foreign Commonwealth development office and US Aid to really look at why is scale not happening and what needs to be done differently to achieve scale. And we've come up with a diagnosis that we're working with the donors and with private investors to move this 30 billion towards a hundred billion in the next couple years, and hopefully towards 300 billion by the time 2030 comes. So, the status quo is not working, although the ambition is there.

And really there needs to be two orientations in the official development, finance community. 1) the ODA donors should be allocating some of their funding with the express intent of achieving strong development impact. But also as Nadia said, creating that risk return that will actually work to mobilise private investors. Some people use the expression de-risking, which is fine, but we need to create market equivalent risk, return opportunities for private investors. Otherwise, they will not and should not be investing. And secondly, our colleagues in the multilateral development banks in DFIs do an excellent job of originating and arranging good financial assets, but still today in 2021, on route to our 2030 agenda mobilization of private investment continues to be a secondary and indeed some cases tertiary business of the MDBs and DFI. So those that own the MDBs and DFI that govern them need to be establishing clear mobilisation objectives because they are great systemically underutilised resources to get more SDG and climate investment undertaken.

And most importantly, I've been involved in development finance for 25 years now, and I've never seen the momentum coming out of the private sector, like colleagues that, Allianz global investors like Nadia are trying to harness. There is a huge flow of funding coming today, many thanks to the UN Principles for Responsible Investment under the banners of responsible investment ESG, investment, climate investment, green finance, sustainable finance. This is all great, super, much more assets under management in this area. But unfortunately today in 2021, that investment is largely staying invested in developed countries. So, the opportunity is excellent for the official development finance community to embark and engage in blended finance, to channel these assets under management that are coming into these investment strategies and themes, but to get those that funding into developing countries, and we at convergence on our website have a roadmap as to the key metrics that should be a, a pursued and the key measures and reforms that are required to achieve this mobilisation.

Simon Whistler

Thanks, Chris. I mean, there's obviously a lot to pick up on there. There's, there's lots of different stakeholders involved here. There's the MDVs, the DFI's, there's governments. It's obviously a role for corporate entities as well, in large part in terms of creating the right projects and investments.

But Nadia obviously wants to pick up with you in terms of the investor role and two parts of the question. Firstly, can you give an idea of what it has taken for Allianz global investors to get to where it is in relation to, to blended finance? And then secondly, what would be your message to that effect, to that wall of private capital that, that Chris has referenced to support others or get others moving in more more in the same direction

Nadia Nikolova

What's has stake as to where we are, has been two things. One is incredible senior management support, it has really been a top down initiative of continuing investing in innovation, in blended finance and really trying to create a new asset class. And the second thing that has helped us a lot during that time has been endurance. In curiosity, really, you need to have both in order to start understanding the development community and I have to say it's a lot of learning on both sides. There has been a lot of, I remember the first time I met, I met Chris a few years ago. We were in a room full of donors and, and private sector and public sector participants. And it was very clear that there were different languages spoken in the room. Same words were used, meaning different things.

And I think over the years we've helped and facilitated a bridge, that I think it's a very important time as Chris suggests, it's extremely important time to build more bridges and make them stronger. There are two critical concerns that I continue seeing. Then one is the lack of availability of de-risking solutions. What we see the donor community doing a lot of is providing financing to the same parties they've been providing financing for the last 20, 30 years direct engagement with the private sector is not as easy to achieved. Although there it's a lot of what donors preached. Unfortunately, it's not what happens in reality. And also the narrow scope of a lot of the instruments that are available there. For instance, when it comes guarantees and first loss, donors have this very often the focus of, um, very narrow segments say Sub-Saharan Africa, female empowerment, this is all women empowerment, that's all brilliant. But unfortunately that doesn't drive scale and it's scale what investors are after. So there needs to be so some sort of convergence in there between the scale that investors require to achieve in order to even start investing and donors familiarity mostly with the, with the development banks and the MDBs and a few asset managers that there needs to be a little bit more of both moving closer to each other in that respect. The second thing is around data. I think there's been some improvements and Chris will laugh at me cause he keeps on hearing me talk about the global emerging markets database, the Gem's database, which is database of historic performance of development banks. We are very often told that perceived risk is, it's higher than actual risk, but unfortunately we haven't seen the recovery rates of development banks to actually illustrate that, which will drive a lot more investor appetite into this market.

The third thing is lack of projects. I think we are seeing that blended finance vehicles are being put out there at so much bigger scale than others, but deployment has been somewhat disappointing. And I think that goes through what Chris was talking about is that the actual mobilisation ratios are actually coming down development banks are putting or on their balance sheet, but the actual mobilisation numbers are the same making the mobilisation ratios actually coming down over time. So, there's still challenges ahead of us, I think very important times. So, I think we really need to get all stakeholders on the table and get them to speak more and more of the same language.

Simon Whistler

Yeah so, challenges ahead but let's try and end on an optimistic note. We're coming up to Christmas, you're both writing your Christmas wish list for father Christmas. If there's anything that you could put down in relation to blended finance, what would that be? What would that be in terms of addressing some of the challenges that you've identified? Nadia, maybe you can go first.

Nadia Nikolova

For me, it would be the willingness of donors to work directly with private sector on vehicles that are going to attract large scale mobilisation into emerging markets for sustainable development. I think you would've seen the recent publications of the Alliance on scaling blended finance. I really hope we have a positive discussion and engagement with all stakeholders in this position and discussion paper. So that would really be around my wish list.

Simon Whistler

And Chris?

Chris Clubb

Wow. My Christmas blended finance wishlist? Thank you Simon. Hopefully Christmas will come a little later cause it's not going to happen before Christmas, but listen I think the number one thing on my wishlist would be really, it's a strategy and action plan from the official development finance community that is more oriented around aggregate SDG and climate investment. The reality is we have, for example, the OECD Dac community 30 members allocating around 150 to 160 billion a year. They're allocating this funding individually towards good development impact. Each of those individual projects is achieving good development impact, but there's no strategy or action plan as to beyond the individual projects that are supported by that 150 to 160 billion. What should they be doing to really see this investment gap narrow from 3 trillion a year to 2 trillion and then one trillion. There needs to be a strategy and an action plan and a change from the status quo.

We are six years into the SDG agenda. The investment gap is larger than it was back in 2015, the OECD Dac members largely engaged in the that they were undertaking prior to 2015. There needs to be a much more concerted identification that there needs to be a prioritisation to narrow this investment gap. And some of their funding needs to go directly to narrowing that investment gap. That strategy and action plan will then move forward to our colleagues within the multilateral development banks and DFI. As I mentioned, I think they do a very good job of going out and placing around 180 billion of financing a year in the form, mostly of sovereign loans, but also private sector investment around 45 billion. I think the assets that they are undertaking are pretty darn good. They're achieving development impact and they are achieving reasonable financial objectives, but it's still a tertiary secondary business activity of theirs to be thinking about the aggregate SDG investment gap and what they need to do more, more of to narrow that gap.

They need to be arranging and originating a lot more assets than they are, and then distributing those assets to investors that are more than willing to invest in these investment themes and strategies that we've been talking about. But they're not going to do it voluntarily. We loved the billions to trillions document that the MDBs wrote in 2015, as we embraced the Sustainable Development Goals, huge aspirations, a relatively good roadmap on how to achieve it. But the reality is six years later, the numbers have knock on up. They're probably down and the gap needs to be narrowed. So that would be my wishlist.

Simon Whistler

Let's hope that those Christmas wishes do indeed come true. Chris, Nadia, thank you so much for joining me today. There are clearly lots of challenges ahead, but also so much potential. So, fingers crossed we can see blended finance net truly take off in 2022. If you'd like more information about blended finance, the convergence website is a great place to start while the scaling blended finance report mentioned by Nadia can be found at the Net Zero Asset Owners Alliance website. Finally, for more on responsible investment in emerging markets in general, please look out for a new discussion paper on the topic from the PRI in January. For that and more visit our website, www.unpi.org. That brings us to the end of this episode of the PRI podcast and in fact, this is the last podcast of 2021. Remember if you like this episode, please do rate and subscribe. Thank you so much to everyone who's listened to our podcast this year and we look forward to seeing you again in 2022.