



KfW Development Bank

»»» Innovative Development Finance Toolbox

Authors: Anja-Nadine König, Chris Club and Andrew Apampa

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Foreword



Roland Siller

Member of the Management Committee
KfW Development Bank

Dear readers,

In 2015, the third international development conference took place in Addis Ababa. Representatives of 193 states discussed global development challenges resulting in the Addis Ababa Action Agenda. The agenda contains policy actions and measures contributing to the 2030 Agenda for Sustainable Development.

The financing gap to reach the Sustainable Development Goals (SDGs) was estimated by the UN to be approximately USD 2.5 trillion per year. This gap cannot completely be covered by public or philanthropic resources.

To address this issue, the “Billions to Trillions Campaign” was established, focusing on how to close the financing gap in order to achieve the SDGs. But it is not only a question of the quantity but also the quality of capital raised and deployed. Bi- and multilateral development banks can build a bridge between public and private capital and play an important role to mobilise additional private capital as well as to support our partners and help strengthen markets locally.

Among others, development banks can cover the political and economic risks private investors often face in developing countries, facilitate private investments by improving framework conditions or set incentives as anchor investors and by financing smart subsidies.

In order to increase the attractiveness of projects for private investors and thereby mobilise additional capital, development banks need to use innovative financing mechanisms. On the one hand, those instruments and approaches aim at using public resources to leverage private capital and on the other hand, they target the effective and efficient use of capital.

Acknowledging the relevance of this topic for the achievement of the SDGs, KfW on behalf of the Federal Ministry for Economic Cooperation and Development (BMZ) commissioned an assignment on Innovative

Development Finance with the goal to enhance the knowledge on innovative development financing mechanisms within KfW as well as with peers and other stakeholders.

In a first step, the focus of the work was to take stock of relevant German and international developments and experiences and to identify priorities for German Development Cooperation (stocktaking report). This toolbox publication has then been developed based on information gathered and insights gained in the stocktaking exercise. In the next stage of this assignment innovative instruments and approaches of the German financial cooperation will be further explored, refined or newly developed.

The present Toolbox provides an overview of innovative development finance mechanisms, its terminology and concepts. Twelve factsheets offer descriptions of families of Innovative Development Finance mechanism (InnoFin) that were selected based on priorities of German Financial Cooperation. The toolbox lists key facts of the instruments, outlines basic structures, variations and identifies success factors. It also provides an opinion with regard to the effect of each InnoFin on key impact areas of the Addis Ababa Action Agenda, namely on mobilising additional private capital, strengthening local capital markets and promoting debt sustainability.

The amalgamation of different sources of finance and other resources in close cooperation with our local and international partners is critical in bridging the financing gap and in achieving a transformational impact. Let us dive deep into the instruments and approaches presented in this toolbox and how they can help in bridging that gap and contribute to achieving the SDGs and Paris Goals.

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Abbreviations

AAAA	Addis Ababa Action Agenda
ADB	Asian Development Bank
AEGF	African Energy Guarantee Facility
AFD	Agence Française de Développement
AfDB	African Development Bank
AGF	African Guarantee Fund
ALCBF	African Local Currency Bond Fund
AMC	Advance Market Commitments
ATI	African Trade Insurance Agency
BOAD	West African Development Bank
BOLD	BlueOrchard Loans for Development
BoP	Bottom of the Pyramid
CCT	Conditional cash transfer
CDO	Collateralised debt obligation
DAC	Development Assistance Committee
DC	Development Cooperation
DFI	Development Finance Institution
DFID	Department for International Development (UK)
DIB	Development impact bond
DS	Debt Sustainability
EDFI	European Development Finance Institutions
EFSD	European Fund for Sustainable Development
EFSE	European Fund for Southern Europe
EIB	European Investment Bank
EIF	European Investment Fund
EM	Emerging Markets
ESG	Environmental and Social Governance
FC	Financial Cooperation
FDI	Foreign Direct Investment
FX	Foreign exchange
GAVI	Global Alliance for Vaccines and Immunization
GIIN	Global Impact Investment Network
GRiF	Global Risk Financing Facility
IBRD	International Bank for Reconstruction and Development
ICRC	International Committee of the Red Cross
IDA	International Development Association
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IFI	International Finance Institutions
ILS	Insurance-linked security
IMF	International Monetary Fund
InnoFin	Innovative (development) finance mechanism
JICA	Japan International Cooperation Agency
LCY	Local currency
LDC	Least Developed Countries
LIC	Low Income Countries
LSE	London Stock Exchange
MCPP	Managed Co-lending Portfolio Programme
MDB	Multilateral Development Banks
MIC	Middle Income Countries
MIGA	Multilateral Investment Guarantee Agency
MoU	Memorandum of Understanding
MSME	Micro, Small, and Medium Enterprises
NGO	Non-Governmental Organisation
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development

PBG	Policy based guarantees
PBL	Policy based loans
PONT	Prespa Ohrid Trust Fund
PPP	Public Private Partnership
PRI	Political risk insurance
PSW	Private Sector Window
RBF	Result based finance
REDD+	Reducing emissions from deforestation and forest degradation
REM	REDD Early Movers
SDC	Swiss Agency for Development and Cooperation
SDG	Sustainable Development Goals
Sida	Swedish International Development Cooperation Agency
SIINC	Social Impact Incentives
SLL	Sustainability linked loans
SME	Small and Medium Enterprises
SPV	Special purpose vehicle
SRL	Shock Resistant Loans
TA	Technical Assistance
TCX	The Currency Exchange
UNDP	United Nations Development Programme
UNFCCC	United Nations Framework Convention on Climate Change
WB	World Bank
WEF	World Economic Forum

Part I: Background & Purpose

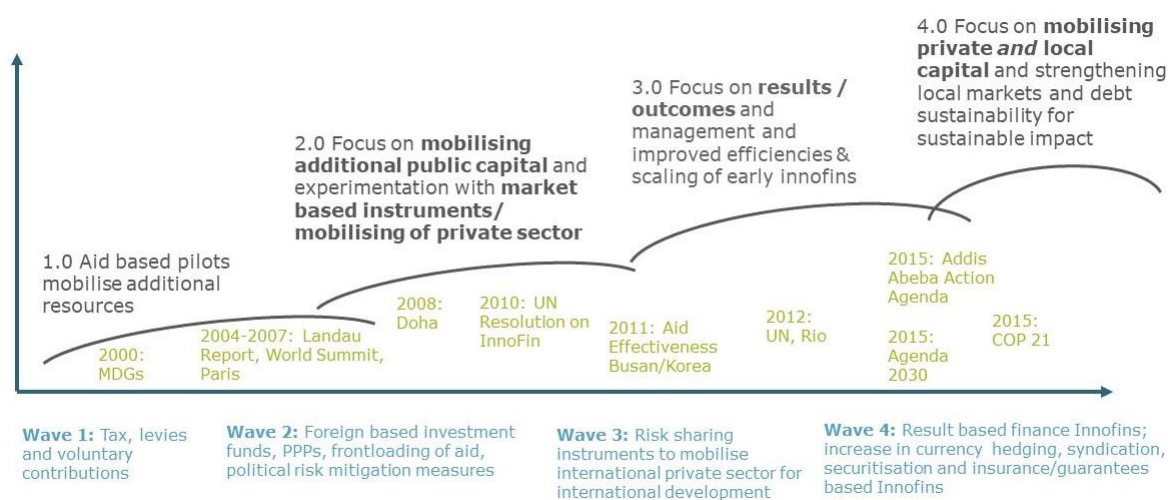
Background

The need for innovative development finance (IDF) is evident in view of the challenges ahead. Despite overall progress in achieving the Sustainable Development Goals (SDGs), 767 million people remain in extreme poverty and billions lack access to basic services, infrastructure, financial services and decent jobs. Without accelerating efforts, resources and innovation to address these challenges, the gains of the past decades could be lost, with poverty and fragility becoming more chronic in low income countries (LIC), and the ambitions of the Paris Agreement in addressing climate change being compromised.¹

Estimates for investment needs required to achieve the SDGs in developing countries range from USD 3.3 trillion to USD 4.5 trillion per year resulting in an SDG investment gap of approximately USD 2.5 trillion for developing countries.² About 30 % may be bridged by public resources, leaving at least 70 % of the gap that would need to be covered by private capital. At the same time, there is a consensus the challenge is not only about the quantity of capital required but also about ensuring that the capital raised is deployed effectively and efficiently to lead to sustainable development impact and achievement of the SDGs.

Mobilising additional finance and deploying capital more effectively and efficiently requires the deployment of innovative financing solutions to specific challenges which traditional development interventions have failed to address adequately. The success of IDF requires both new mechanisms and approaches, and replication and upscaling of existing successful innovations.

Figure 1: Innovative development finance waves



Source: Koenig, Anja et al. (2020): Innovative Development Finance – Stocktaking Report, based on Dahlberg (2014).

The field of IDF is not new. In March 2002, the Monterrey Consensus recognised “the value of exploring innovative sources of finance” and sparked a broad effort to pilot and implement a variety of new financing mechanisms, catalyzing developing countries to pursue the Millennium Development Goals.³ Since then, there have been various “waves” in development finance that have influenced the emergence of innovative finance mechanisms (“InnoFins” hereafter). The first important wave was the transition from a focus on mobilising additional public sector finance towards mobilising international private capital to invest in developing countries. In more recent years, attention has been expanded to (i) strengthen local (capital) markets, (ii) mobilise local

¹ IFC EM Compass (2019): Closing the SDG financing gap – trends and data.

² IFC EM Compass (2019): Closing the SDG financing gap – trends and data.

³ UN (2002): Report of the International Conference on Financing for Development.

capital and (iii) promote debt sustainability. Another theme through the past 18 years has been a focus on aid effectiveness: how development funds can be deployed more effectively and efficiently. Lastly, in recent years there have been increased efforts to improve, replicate and scale successful pilots of InnoFins to new geographies, sectors or contexts rather than developing radically new mechanisms.

There are high expectations in the development finance community about identifying the most suitable blueprints amongst a variety of Innovative Development Finance mechanism (referred to as InnoFins in this document) to address development challenges. The discussion around the best possible ways to respond to the COVID-19 crisis in the most effective way is one contemporary example. IDF is not a silver bullet for reaching the SDGs and the Paris Climate Agreement goals, and these cannot be achieved without working with well-established development tools and practices. In addition, any challenge is unique and its causes are deeply rooted in the specific (eco-) system as well as the local and international eco-context.

With one-third of the SDG period now completed, and with Covid-19 creating new challenges for developing countries, it is important for the development community to (i) identify and develop the most suitable InnoFins that match their (ii) focus on financial resources, (iii) standardise approaches and (iv) move to scale – four critical components for InnoFins to contribute meaningfully to development.

Toolbox Purpose

Definitions and terminologies in innovative development finance often lack clarity, compounded by different views on what is considered “innovative development finance”. In addition, there are few case studies, stocktakings and evaluations, and limited guidance on specific InnoFins. Even “experienced financiers from (...) development finance institutions and private investors are feeling their way into an unfamiliar territory”.⁴ The purpose of this toolbox is – therefore – to support development finance practitioners, policy makers and other stakeholders within the field of IDF by providing an introduction into key concepts as well as further details on selected InnoFins.

The present Toolbox provides an overview of terminology and concepts in innovative development finance (Part II) as well as a categorisation of InnoFins according to their respective objectives and their use in different sectors (Part III). Part IV includes twelve factsheets which offer detailed information on InnoFin families that were selected based on priorities in German Financial Cooperation. The fact sheets provide key facts, outline basic structures, variations and identifies success factors and trends. They also provide an opinion with regard to the effect each InnoFin Family may have on key impact areas of the Addis Ababa Action Agenda, namely on mobilising additional private capital, strengthening local capital markets and promoting debt sustainability.

The toolbox has been developed as part of a broader assignment to take stock of international and German experiences in IDF and to identify priorities for German Development Cooperation in IDF.⁵

⁴ Paddy Carter (2016): Maximising bang for the buck: Risks, returns, and what it really means to use ODA to leverage private funds, OECD Development Matters Blog.

⁵ The objective of stage 1 of this study programme was to take stock of international and German experience and to provide guidance on promising innovative financing mechanism that have a positive effect on the three priority impact areas identified in line with the Addis Ababa Action Agenda (AAAA): leverage private capital for sustainable development; promote partner countries debt sustainability and strengthen local (capital) markets. The work was conducted by a Consortium of Niras, LFS Advisory and Convergence and was documented in an unpublished stocktaking report: Koenig, A. et al (2020): Innovative development finance – stocktaking report. In a second stage selected InnoFins will be further explored, refined and developed.

Part II: Terminology & Key Concepts

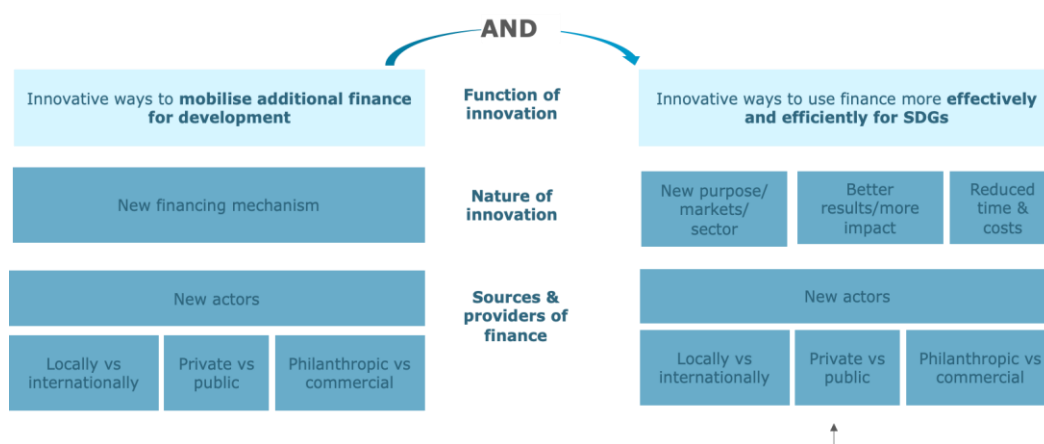
Terminology

There is no singular definition of innovative development finance (IDF) or Innovative Development Finance Mechanism (thereafter: InnoFins). The use of the term varies and the differences comprehend the following aspects:⁶

- **The function of IDF:** IDF may refer to the generation of additional financing for the achievement of development and/or the more effective and efficient use of existing funds.
- **The source of additional finance:** The generation of additional finance may refer to public finance (e.g. development finance provided by the private sector arm of development finance institutions) or private finance.
- **The definition of innovation:** Some organisations view IDF only in relation to new financing mechanisms, whereas others refer to IDF as the implementation of existing mechanisms in new sectors or markets, and/or using an existing mechanism with new sources of finance.
- **Capital provider location:** According to some sources, a defining aspect of IDF is a focus on international transactions and capital mobilisation (“increasing the pie”); whereas for others, it includes domestic resource mobilisation (“downstream mobilisation effects”).
- **Target sectors:** Some organisations see the health sector as the exclusive focus of innovative finance, although most of the current literature and practitioners take a broader view.

For the purpose of this toolbox we talk about **InnoFins** when **financial instruments and/or approaches are combined in a new way that help mobilise additional funds from existing and new sources for sustainable development AND utilise funds more effectively and efficiently in new sectors, geographies or for new purposes to contribute to sustainable development.**

Figure 2: Core elements of innovative development finance definitions



Source: Koenig, A. et al (2020): Innovative development finance – stocktaking report.

In this context it is also important to **distinguish blended finance and impact investing from IDF** as these terms are often used interchangeably.⁷ In our understanding that the focus of blended finance has been on the mobilisation of private capital for development purposes through the strategic use of (public and philanthropic) development capital (supply side). On the

⁶ Based on Donor Committee for Enterprise Development (2019): Donor engagement in innovative finance – opportunities and obstacles.

⁷ OECD (2019): Social Impact Investment 2019: The Impact Imperative in Financing Sustainable Development.

other hand, impact investing emphasises the deployment of capital with the intention of generating positive and measurable social and environmental impact alongside a financial return (demand side).⁸ In the recent discussion on IDF, attempts are made to bring both aspects together and in particular give more weight to how the additional capital raised is deployed.

It is also important to note that neither of these fields are uniquely new or innovative as such. Rather, within each of these approaches InnoFins emerged within existing instruments and approaches. They are either combined in new ways, or other elements of innovation are introduced to raise additional private capital and / or to deploy capital more effectively and efficiently. For example, in recent blended finance transactions:

- traditional grants and sovereign loans are increasingly being complemented or replaced by new types of financial instruments such as subordinated debt, equity, guarantees, securitisation, currency hedging and political risk insurance,
- new investors such as foundations, pension funds and corporate investors are mobilised; and
- existing blended finance approaches are being adjusted for new geographies such as Low-Income Countries.

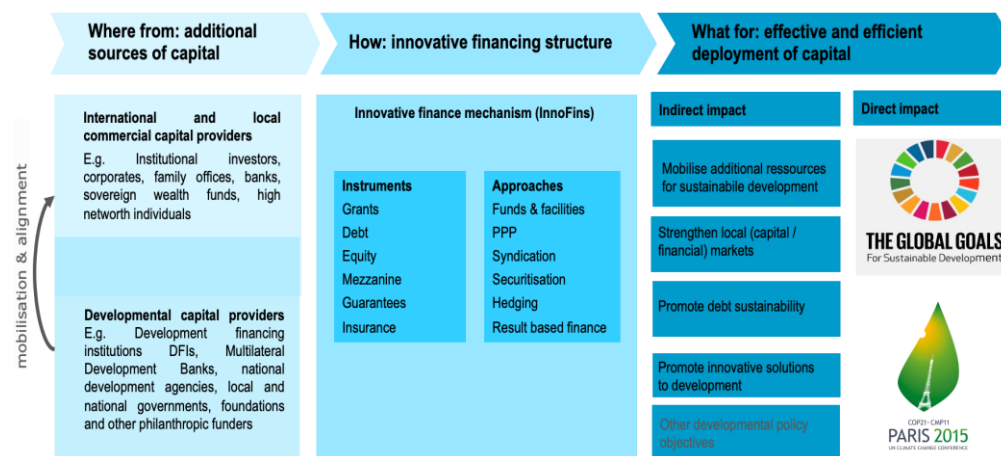
It is beneficial to think about InnoFins not as a limited number of clearly defined and distinguishable mechanisms, but rather as “InnoFin families”. They share similar features but cover a wider range of sub-categories and variations which emerged over time. They take account of lessons learned, and adjust and apply the original “innovation” to new purposes, sectors, markets or geographies.

InnoFins Impact Value Chain

In the past, the focus of the discussion in IDF has been on the mobilization of additional finance for sustainable development. It is important to stress the importance of the deployment of capital for the achievement of the SDGs and Paris Goals.

We use the concept of an “InnoFins Impact Value Chain” to visualise the pathway of how (additional) sources of finance (**where from?**) are transformed into impact (**what for?**) via the combination of financial instruments and approaches in new ways or for new purposes (**how?**).

Figure 2: InnoFins impact value chain



Source: Koenig, A et al (2020): Innovative development finance: stocktaking report.

Where from: additional sources of capital

Financing is typically sourced from a combination of public, philanthropic, social and private capital providers. In the past, the focus of attention in IDF has been on blended finance structures whereby (public or more recently philanthropic) development capital providers deploy their capital strategically to mobilise additional (private) capital (see Figure 2 above).

⁸ For a definition of the three financing methods see the glossary in Annex 1.

The discussion has been characterised by a strong dichotomy: It has been argued that on the one hand, developmental (public, philanthropic and social) capital providers primarily maximise developmental outcomes while on the other side, commercial (private) actors maximise profits. In today's practice, however, it is recognised that a spectrum of capital providers exists with a broad range of impact, return motivations. Indeed, an increasing number of actors from private sectors look for both commercial returns as well as developmental impact - or as corporate social investors focus mostly on investing for impact – while public investors while pursuing a developmental mandate and help mobilise private capital look for market rate returns. Table 1 lists common development capital providers that include (but are not limited to) government entities in developed and emerging countries, development (financing) agencies, banks, and philanthropists.

Table 1: Development capital providers

Organisation type	Examples	Financial objectives	Common instruments deployed in InnoFins	Primary partners or targets in developing countries
Governments (ministries) / development agencies	German BMZ, UK DFID, Swedish SIDA, Dutch Ministry for Economic Affairs, GIZ, USAID	Highly concessional – no/limited financial returns expectations	Technical Assistance, (Investment) grants Guarantees (SIDA, USAID)	Regional development agencies, national and local governments financial intermediaries and companies, academia, NGOs
Governments in emerging countries	India, Indonesia, Mexico, Columbia, Peru, Turkey	Highly concessional – no/limited financial returns expectations	Grants, guarantees, loans	Various
Multilateral and bilateral development Banks ⁹	KfW, African Development Bank, IBRD/World Bank, EBRD	Concessional and non-concessional finance	Grants, loans, equity and guarantees (EBRD)	Governments, financial institutions, special purpose vehicles
Development Finance institutions (private sector arms of development banks)	IFC, DEG, Proparco, FMO, CDC	Expected to earn positive / market rate returns for core financing activities, concessional for “special programmes” implemented on behalf of national governments or development agencies	Equity, loans, mezzanine and grants	Private sector companies, investment funds, financial institutions incl. commercial banks, national development banks, microfinance institutions, special purpose vehicles
National Development Banks in developing countries	Small Industries Development Bank of India; Development Bank of Nigeria Plc, Eastern and Southern African Trade Development Bank	Concessional and non concessional finance	Debt, equity and guarantees	Financial intermediaries, state owned enterprises, individuals (e.g. farmers), local governments
Philanthropic foundations	Bill and Melinda Gates Foundation, Rockefeller Foundation	Highly concessional – no/limited financial returns expectations	Grants	Governments, academia, (social) enterprises and NGOs

Public development capital providers increasingly seek to engage with private investors to mobilise additional capital for impact and access private sector expertise. In this case, development capital providers need to be clear about who they target as potential partners. Each have different risk-return-impact profiles and propensity for engaging in development, whilst they provide different quantity and quality of capital.¹⁰ As a result, certain InnoFins may be attractive to a certain type of capital provider and not to others due to the investor's strategy or constraints in terms of time horizon, deal size, risk considerations, return expectations and impact strategy. On the flip side, engaging with a certain type of private investors may lead to specific developmental benefits beyond the amount of capital provided.¹¹ Below are some of the alternatives to consider:

⁹ The boundaries between development banks and DFIs are not clearly cut, as some of the agencies listed here have private sector operations under the same roof.

¹⁰ For an overview of different investor profile, their motivations, risk and return profiles see Annex G in Koenig, A., Jackson, E. (2016): Private Capital for Sustainable Development.

¹¹ It is noteworthy, though that the most relevant actors referred to in this section are not German nor European. In fact, many relevant initiatives in the area of InnoFins are promoted through US based philanthropic organisations. They are encouraged by a legal and regulatory framework that is more conducive to using market based instruments for sustainable development such as mission investing and program related investing.

- **Local vs international investors:** International investors have been at the centre of attention of past efforts in mobilising private capital, whereas in consideration of foreign exchange rate risks there is a strong argument to promote InnoFins that raise awareness, build capacity and bring in local investors to finance in local currency. There is also the argument that local investors are better placed to manage and mitigate key risks given their local knowledge and social capital. Furthermore, there is a growing ecosystem of local investors which invest in other countries, regions or even continents that need to be better taken into account in international development finance.
- **Impact private capital vs commercial private capital providers:** Historically, the discussion about mobilising private investment capital was characterised by a strong polarity of interests between development agencies and private agencies, with only DFIs pursuing both commercial and developmental objectives. However – and whilst assets under management remain negligible in comparison to commercial assets under management – an increasing number of sustainable investors pay attention to not only managing their ESG risk carefully but also to reap growing economic opportunities through investing explicitly for social/environmental impact. In addition, providers of philanthropic private capital are playing an increasingly important role along the development finance ‘spectrum of capital’. For example, in innovative finance product development they act as promotor and provider of catalytic capital, guarantee and first loss tranches. They also play a role as grant funders in new InnoFins and even as investors.
- **Corporate vs financial institutional capital:** In 2016, transnational companies had more than USD 10 trillion invested or kept in cash holdings in developing countries. These organisations therefore offer a significant source of finance, investment capital, and opportunities for market access. In addition to that, they offer knowledge and scaling partnerships to local entrepreneurs and businesses as well as local communities. The SDG and sustainability concerns gain importance for both large multinational corporations as well as the local private sector beyond mere compliance and risk management. There are various examples of corporations which actively invest in sustainable development opportunities as part of their core business strategy. They also set up foundations, impact investing vehicles or inclusive business models that leverage company assets and support market based interventions for greater impact.¹²
- **Individual private capital vs institutional capital:** While much of the attention of the international development community is on mobilising institutional capital such as pension funds and insurers in areas where there is a need for large investment sizes and patient capital (e.g. insurers on climate investments), individuals and retail investors have also become providers of private capital for development. This includes developing country diasporas in Germany or Europe, crowd funders both internationally and locally, as well as small/retail investors who benefit from more and better financial products and services as offered by various financial service providers (e.g. GLS Bank, Triodos etc.).

The OECD argued that mobilization may not be enough as development finance has only been able to mobilise around USD 150 billion, while the SDG gap is estimated at around USD 2.5 trillion. It is unlikely that mobilisation will increase by a factor of 16 in the next decade to close the financing gap. The organisation therefore identified a possibly even greater challenge of closing the financing gap in **aligning the trillions invested daily in capital markets with the SDGs**, arguing that a significant proportion of financial flows were not aligned, and even incompatible, with the SDGs. In fact, according to OECD research, even Official Development Finance (ODF) continues to finance fossil fuel-based energy supply and generation, at an average volume of \$3.9bn annually for the 2016-2017 period.¹³

How: innovative financing mechanism (InnoFins)

How financial instruments and approaches are combined in innovative ways is at the core of most InnoFins. Commonly used **financial instruments** in IDF include convertible grants, bonds, guarantees, insurance and hedging in addition to traditional instruments such as concessionary loans and equity. Most common **approaches** used include (structured) funds and facilities, securitisation, result based finance or PPPs.¹⁴

More details on these InnoFins are provided in the fact sheets in Part IV of this Toolbox.

¹² E.g. see businesses community engaged with [Inclusive Business Action Network](#) set up and promoted by the German Government, the [Business Fights Poverty platform](#) supported by the British Government as well as corporate social investors that are members of the [Corporate Initiative](#) of the European Venture Philanthropy Association.

¹³ OECD, 2019, *Aligning Development Corporation and Climate Action*.

¹⁴ For a definition of the most important financing instruments and approaches methods see the glossary in Annex 1.

What for: Indirect and direct impact on SDGs and Paris Agreement goals

A core element of the definition of innovative finance is that the additional capital is to be used more efficiently and effectively. More efficient use of existing or additional funds means to add value by providing better value for money or by lowering the cost of achieving targeted development results (e.g. outcomes, outputs and impact). This can be achieved through the use of particular InnoFins. More effective use of impact of development funds on the SDGs and/or the Paris Climate Agreement objectives considers the extent to which the development intervention's objectives were achieved, or are expected to be achieved.

The ultimate objective is to contribute to sustainable development in line with the SDGs or Paris goals. However, different InnoFins can be effective in contributing to sustainable development in different ways. This depends on the underlying rationale and objective for which they were designed. As a result, the impact can be **direct or indirect**.

For InnoFins designed to achieve a **direct** impact on the SDGs or the Paris goals (such as many of the outcome or result based financing mechanism), there is often a direct link between the application of a specific InnoFin. Furthermore, there is a measurable improvement of the situation of a specific target group or end beneficiaries for example, in terms of job creation, increased income, reduced CO2 or access to water.

Other InnoFins only lead **indirectly** to a significant effect on the SDGs or Paris goals in the short run, but create the conditions for SDG impact to be achieved in the long term. Ideally this impact goes beyond the exit of development capital providers and donor agencies. Indeed, other InnoFins are intentionally designed in a way to fill a gap in the local (capital or financial) markets. They overcome a structural challenge at the level of policies, strategically invest in intermediary financing structures or aim to promote partner country's debt sustainability in line with Addis Ababa Action Agenda (AAAA). For such InnoFins, which include guarantee funds, local currency finance solutions or policy based finance interventions, a direct link to the SDGs or the Paris goals is more difficult to establish. More effort will have to be made preparing for, measuring and managing such interventions intending to create both indirect and direct impact.

Additionality, concessionality and leverage

Additionality is a central concept for public funders when it comes to understanding when and how to engage with the private sector. The simple premise of additionality – as formulated by a group of multilateral development banks – is that their interventions to support private sector operations should make a contribution beyond what is available in the market and should not crowd out the private sector.¹⁵ If poorly designed and implemented, public sector engagement with private investors or companies may result in:

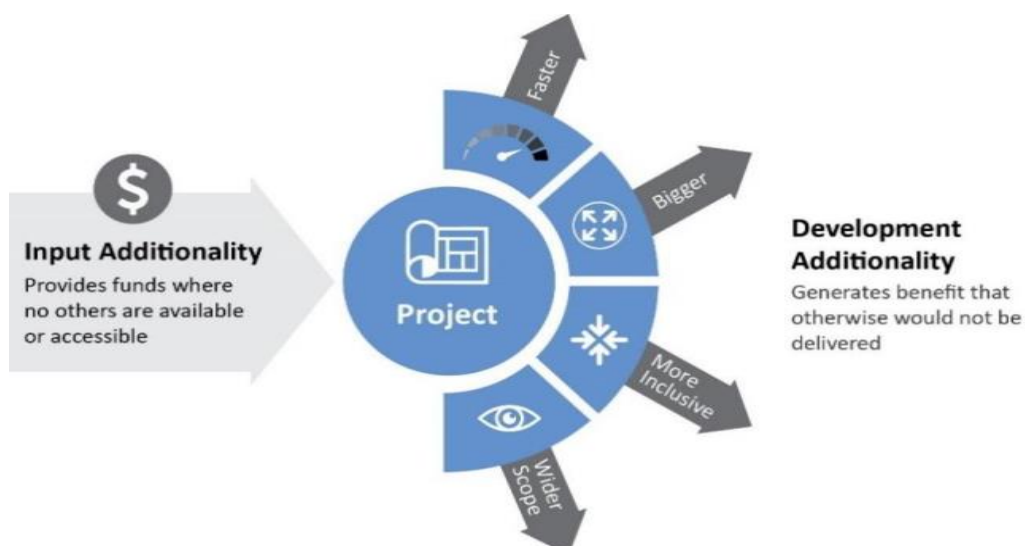
- Crowding out market players which otherwise could provide needed finance, financial or technical services more effectively and efficiently at prices reflecting the true market rates;
- Subsidising selected private investors or companies, resulting in an unfair competitive advantage for them vis-à-vis other investors or companies;
- Wasting public resources by supporting an activity that would have happened anyway or by providing concessions at a higher level than originally required to mobilise the private sector;
- Mission drift in favour of private sector objectives and away from development objectives.

It is therefore important to establish **minimum concessionality**, i.e. identifying the minimum amount of concessional capital needed to attract private capital and to operationalise the concept of additionality. Currently, even though progress has been made, there is still little guidance available about when and how to determine additionality, minimum concessionality as well as the development impact of many InnoFins.

A donor intervention is defined as additional if: Interventions are necessary to make the project happen, i.e. the private investor would not have engaged without public sector involvement (this is often defined as financial or input additionality); and/or interventions increase the development impact and sustainability of a project with positive implications for achieving the SDGs and climate goals (this is often defined as development or output additionality). It is important to note that financial additionality does not necessarily lead to developmental additionality but needs to be intentionally considered in the design of the respective InnoFins (Figure 3).

¹⁵ MDB (2018): MDB Harmonized Framework for Additionality in Private Sector Operations.

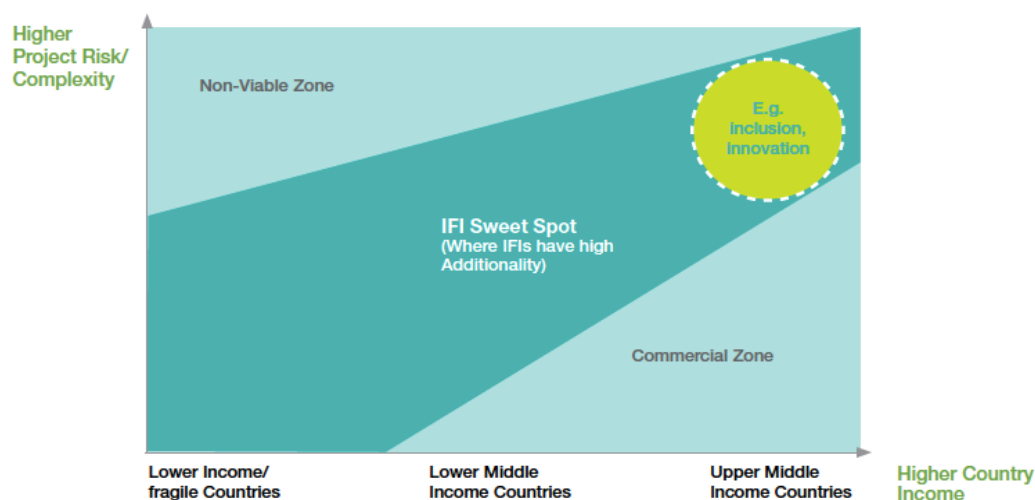
Figure 3: Financial (Input) and Development Additionality



Source: AECF (2017): AECF at 8 Impact Report 2016.

A clear understanding on additionality provides guidance on how to best leverage public sector financial and non-financial resources in the context of private-capital mobilisation. It has been argued for example, that development finance institutions achieve high additionality in complex, high risk and high impact projects, in fragile, low-income countries and regions (Figure 4).¹⁶

Figure 4: Where donors have high additionality



Source: International Finance Corporation (2011): International Finance Institutions and Development Through the Private Sector. A joint report of 31 multilateral and bilateral development finance institutions.

Additionality is achieved through the use of financial and non-financial instruments depending on the unique strength and instruments of a specific development capital provider, the context, and the specific project.

Table 2 provides an overview of the different ways how development capital providers may achieve additionality.

¹⁶ IFC (2011): International Finance Institutions and Development Through the Private Sector. A joint report of 31 multilateral and bilateral development finance institutions, p. 28.

Table 2: Types of additionality

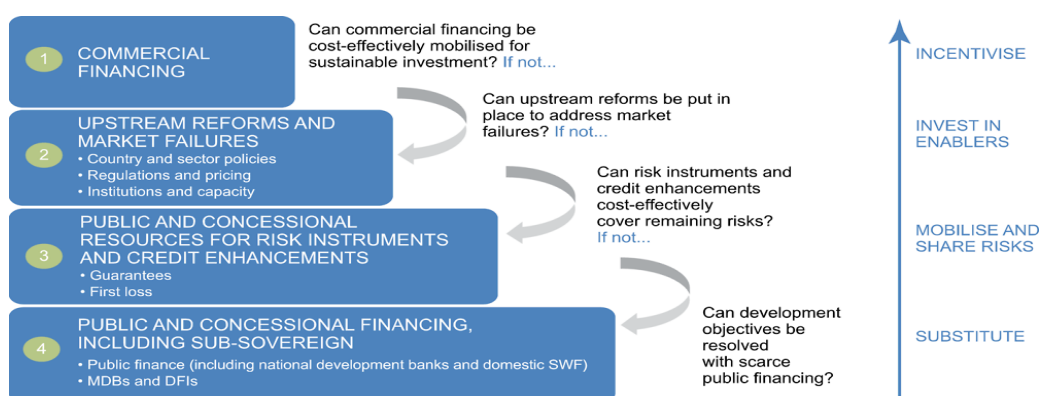
Types of additionality	Examples
Financial	Offering better terms, longer maturities, countercyclical finance, lower price, subordination, holding riskier portfolios, providing smart subsidies, guarantees and other to enhance returns and reduce risks.
Aggregation	Supporting projects at regional or global level for aggregation of opportunities, diversification of risk and cross boundary sharing of experience.
Signaling	Providing a stamp of approval, providing credibility, attracting other investors, acting as honest broker.
Knowledge	Strengthening the quality of the investment model and technology; sharing knowledge building the capacity of local partners, facilitate technology transfer, publicly share experiences and learning (beyond project boundaries).
Demonstration	Support innovative pacesetter to de-risk new business models; attracting capital in lower income, fragile countries and frontier markets that are not (yet) able to attract significant level of commercial capital.
Poverty	Influencing design to reach lower income market segments; reduce inequalities, improve local participation, generate employment of BoP.
Standards	Promoting high environmental, social and governance standards in investee companies, financial institutions, funds and at industry level.
Market building	Strengthening policy environment, build eco-systems and support market infrastructure, generate market data and support industry research.

Source: Based on König, A. Jackson, E. (2016): Mobilising private capital for sustainable development (DANIDA).

In 2012, a group at MDB defined the Five MDB Principles to Support Sustainable Private Sector Operations, which include (i) additionality (ii) crowding-in; (iii) commercial sustainability; (iv) reinforcing – and avoiding distorting – markets; and (v) promoting high standards. In 2018, a group of 8 MDB launched the *MDB Harmonized Framework for Additionality in Private Sector Operations* which sets out categories and definitions of additionality, a common approach to governance and operationalisation of additionality, as well as a set of examples and guidance on demonstrating ex-ante evidence on additionality.¹⁷

Further guidance on additionality is provided with the World Bank’s “Cascade Approach”. According to this concept, it is argued that only where market solutions are not possible through sector reform, investment in enablers and risk mitigation, public resources would be applied (Figure 5).¹⁸

Figure 5: The World Bank Cascade Approach



Source: Based on World Bank Group (2018): Approach Paper ‘Creating Markets for Sustainable Growth and Development’.

The World Bank’s Cascade approach is linked to the organisation’s recent “Creating Markets” strategy that emphasises the value of using concessional finance strategically to kick-start immature markets, and to gradually transform markets to achieve long-term financing on

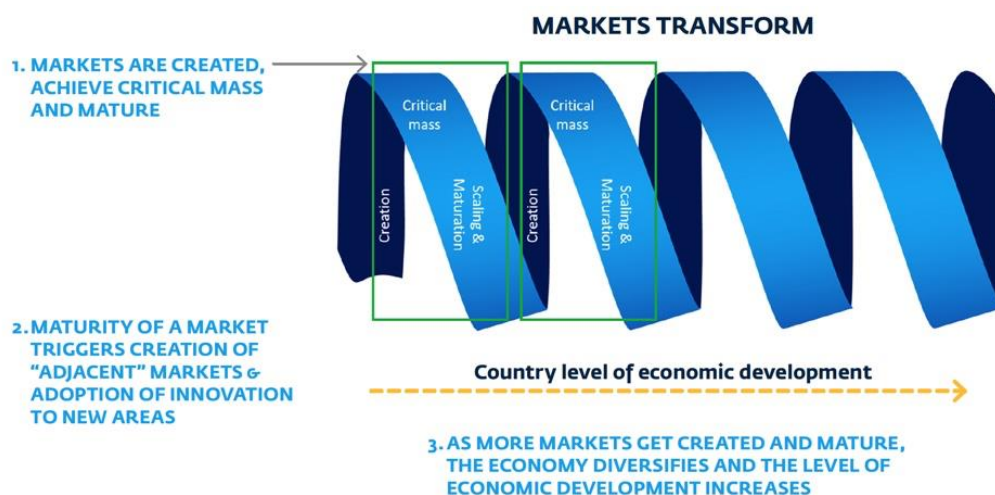
¹⁷ MDB (2018): MDB Harmonized Framework for Additionality in Private Sector Operations.

¹⁸ The World Bank (2017): Forward Look – A Vision for the World Bank Group in 2030 Progress and Challenges.

commercial terms where concessional finance can eventually be phased out.¹⁹ The “Creating Markets” strategy distinguishes three phases (Figure 6):

- In the **first phase**, the focus is on the triggers for market changes, such as pioneering investments, building market platforms, and adoption of new technologies and business models, where new products and services are introduced and producers and consumers are connected to form a market. This first phase requires InnoFins with substantial risk capital, combined with policy and technical assistance.
- In the **second phase** there would be further expansion and clustering of complementary investments and government action, which reinforces the change process and leads to better market infrastructure for more efficient and sustainable exchanges of goods or services. During this phase, it is argued, concessional (senior or subordinated) debt may be appropriate as well as revenue enhancement options to ensure that the ultimate beneficiary can still access services at an affordable price.
- And after reaching the **third phase**, business models are ideally scaled up and extended, new standards and market norms are established, new financing is mobilised as additional private players join. During this phase, financing on concessional terms would need to be phased out and financing on commercial terms would need to be phased in e.g. through tailored de-risking structures (such as embedded deferrals in a loan or a guarantee with specific triggers).

Figure 6: Creating and transforming markets



Source: IFC (2018): Blended Finance – a stepping stone to creating markets.

While guidance and frameworks on additionality have been strengthened recently, there is still limited evidence of additionality in practice. There are a number of explanations for this:²⁰

- **Lack of ex ante additionality assessment:** In many development organisations systematic ex ante additionality assessments are not a necessary condition for a development finance project to go ahead. Even ex-post evaluations of additionality have yet to become a common practice. For some funds it is simply too early for comprehensive evaluation.
- **Confidentiality:** more detailed evaluations are not often released to the public, with DFIs and development agencies arguing for confidentiality. This includes a ‘publication bias’ to report predominantly on successful figures.²¹
- **Methodological constraints:** applied to assess additionality is not sufficiently robust and ‘is often based on qualitative descriptions, often lacking objective supportive evidence.’

¹⁹ IFC (2018): Blended Finance – a stepping stone towards creating markets. We would note that in practice there are some markets with inherent market failures that will never be fundable a purely commercial basis.

²⁰ More on the concept on additionality, the evidence for financial and developmental additionality as of 2016 can be found in König, A., Jackson, E. (2016): Mobilising private capital for sustainable development (DANIDA).

²¹ Campos, F. et al. (2012): Learning from the experiments that never happened: Lessons from trying to conduct randomized evaluations of matching grant programs in Africa, World Bank.

- **Lack of guidance:** there is little practicable guidance available for staff of development financing agencies to assess and evaluate additionality in planning or evaluating projects with private investors.²²

Many development practitioners look at the **leverage ratio** that measures the amount of commercial capital mobilised by concessional capital as an indication for how successful they have been in mobilising private capital. However, the following aspects have been challenging in this regard:²³

- **How to treat DFI funding:** Whether to count as commercial contribution any of the DFI investment, which while mostly intervening at market conditions, do not provide new or additional funding for development purposes.
- **How to measure the leverage ratio:** Given there are still no agreed methodologies confusing headlines and reporting about leverage ratios are common. Some compare public, publicly backed or concessionary investments with the level of private investments (e.g. USD 1 of IFC investment leverages USD 3 in private investment). Others compare the grant element to the overall investment costs.²⁴
- **How to identify the direction of the leverage effect:** It is hoped that public sector grants contributed to the leveraging of additional private sector capital. However, it may well be possible, that in some cases, the private sector leveraged the public sector contribution and would have invested anyway without the public sector contribution.
- **How to interpret high financial leverage ratios:** At first glance, high leverage is desirable in view of public sector objective to mobilise a maximum of additional funding for development. A high leverage ratio, however, does not automatically mean high additionality of donor funding. It may not only be an indication that the investment did not need the donors' contribution, but it may also reduce the ability of the donor to influence the project design, investment strategy and implementation.

Where information on (financial) additionality is available the picture is mixed. In terms of percentage of projects that would not have happened without public sector contribution, one review identified a range of 30 % to 63 % of projects, another more negative evaluation identified little to no additionality.²⁵

²² Other than the 2018 guide developed by eight MDBs, the only orientation available is the DCED guide *Demonstrating Additionality in private Sector Development Initiatives*, published in 2014, which provides useful considerations and concepts but focuses on support to private companies rather than the mobilisation of private investors; the EBRD's DFI Guidance for Using Investment Concessional Finance in Private Sector Operations, developed in 2013, which was intended as a framework for developing detailed internal guidance and regulations as well as the IFC Additionality Primer that has been used by many DFIs for investment in private companies (updated version of 2013).

²³ Bretton Woods Project (2012): Leveraging private sector finance. How does it work and what are the risks.

²⁴ According to the WEF/OECD Survey on blended finance, private to public capital investment ratios varied between USD 0.29 and USD 20.40 for different market segments and instruments. WEF. OECD and World Economic Forum (2015): A How-To Guide for Blended Finance: A practical guide for Development Finance and Philanthropic Funders to integrate Blended Finance best practices into their organisations.

²⁵ UK Aid Network (2015): Leveraging Aid: A Literature Review on the additionality of using ODA to leverage private investments, p 13.

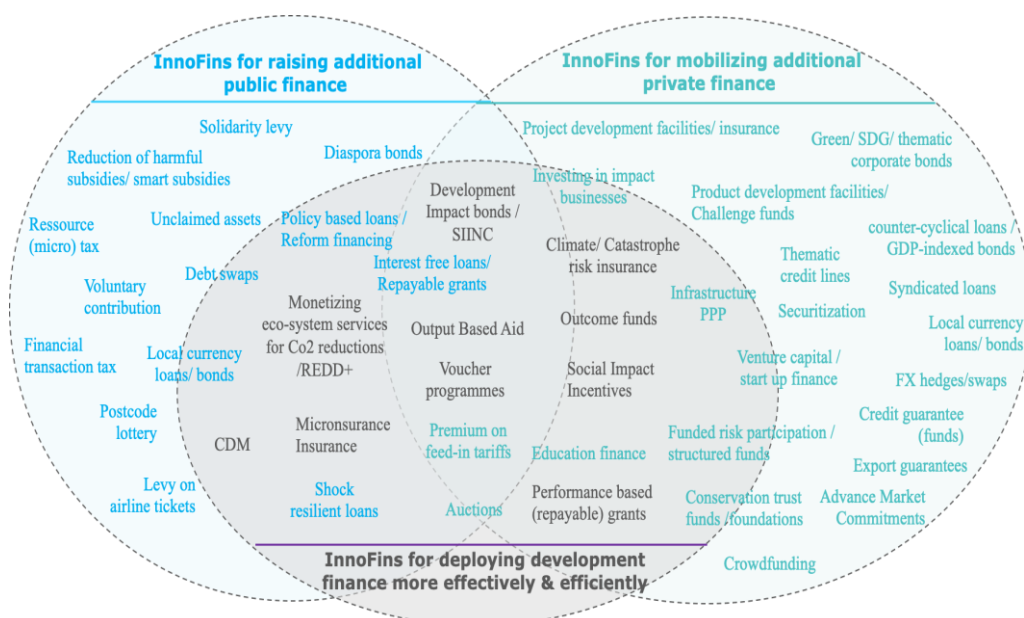
Part III: InnoFins Objectives & Sectors

There is a great variety of InnoFins and InnoFin families, some of which we cover in more detail in the factsheets in Part IV. InnoFins can be considered respective their priority **objective** namely raising public finance, raising private finance or deploying capital more effectively. In addition, InnoFins can be considered with regard to their ability to address **sector specific (financing) challenges**, which explains why some InnoFins are used more frequently in some sectors compared to others.

InnoFins Objectives

We identified a broad universe of InnoFins. Figure Figure 7 provides an overview of most common InnoFins and InnoFin families clustered according to whether their objective is 1) primarily to mobilise additional public capital (blue coloured InnoFins) 2) primarily to mobilise additional private capital (green coloured InnoFins) 3) deploy capital more effectively and efficiently (grey coloured InnoFins).²⁶

Figure 7: InnoFins according to objectives



Source: Koenig, A. et al (2020): Innovative development finance – stocktaking report.

InnoFins that have a potential **to mobilise public capital** include a range of taxes and levies, access to unclaimed assets²⁷ as well as policy based finance or shock resilient loans. InnoFins that have a **high potential to mobilise private capital** include (sustainability and thematic) bonds, structured funds as well InnoFins related to guarantees and risk mitigation measures. To a less extent this also included some facilities such as the establishment of endowment foundation, challenges (matching) funds, development/social impact bonds or outcome funds or any other mechanism that have the ability to monetise impact (e.g. SIINCs).

²⁶ Such an illustration has its limits, as in practice the InnoFins designs vary greatly which in turn influences their actual effectiveness in reaching the respective objectives.

²⁷ Accessing unclaimed assets for social impact is attracting a lot of attention globally following the example of Big Society Capital, the British wholesale bank set up by the British government in 2011. Unclaimed assets are assets that are lying dormant in bank accounts or are invested in government bonds without their owner coming forward and the claim deadline passes. The funds could instead be used for social purposes. According to the current proposal discussed in Germany deployment of these funds would not directly contribute to international development finance, however but focus on German Social Enterprise that may or may not engage outside Germany. See SEND, 2019: Nachrichtenlose Konten. <https://www.send-ev.de/>

InnoFins which tend to **deploy capital more effectively (and efficiently)** typically include impact investments that have impact at the core of their investment strategies, InnoFins with in-built result orientation such as REDD+, development impact bonds, SIINC, but also voucher programmes. Efficiency indeed is a constraint with all these results based finance mechanisms as many suffer from small sizes and high monitoring and external validation costs.

Sector Use of InnoFins

InnoFins should not be considered, assessed or even compared in isolation but in relation to their potential capacity to address a specific finance development challenge for which traditional financing mechanisms are insufficient or ineffective. Many financing challenges relate to market gaps in the financial services sector and capital markets. For example, many local financial (capital market) systems do not provide long term, local currency or venture capital.

In addition to financial sector and local capital markets gaps, however, there are financing challenges that are **specific to sectors** and / or affect some sectors more severely than others. Table 3 list typical financing challenges in selected sector and the most relevant InnoFins.

Table 3: Sector specific financing challenges and Examples of InnoFins and/or financiers²⁸

Sector	Typical financing challenges in sector	InnoFins	Examples
SME & Social entrepreneurs	High transaction cost; lack of collateral and lack of collateral free financial products; high early stage risk before proof of concept and lack of early stage finance providers; lack of exit opportunities; limited capacity and financial literacy; High local interest rates limited capital available from banks without collateral; Financial products not available for specific entrepreneurship/enterprise segments	Structured funds – Improves risk-return for private investors to invest SME Thematic Fund – Aggregates capital from diffuse investors RBF – Creates additional revenues to incentivise SME of financier Securitisation: Debt products securitised against loans and receivables sometimes in a bond-like structure Various to overcome financing barriers for different entrepreneurship segments: Royalty based lending; (fintech) working capital loans; trade finance, platform based lending models; PAYGO; Peer to peer lending	EFSE, SANAD, Eco Business Fund etc. AfricaGrow; SIINC; Global Innovation Fund; Adobe Capital (Royalty based lending); Lendable (Securitisation/Bonds): A55; Konfio, Sempli (working capital loans); Amarthia (peer to peer lending model)
Energy & climate	Access to energy by low income communities; transition financing; large upfront investment costs and long term capital; regulatory risk; lack of funding for technological and business model innovation	RBF/OBF ²⁹ : Creates revenue to make project viable Guarantees/credit enhancements: Makes risk acceptable for private investors Project preparation facilities: Increases universe of bankable projects	GET FIT (RBF); Green for Growth Fund; Geothermal Project Development Facility; African Energy Guarantee Facility Advance Market Commitments Global Fund (Guarantees); Climate risk insurance / InsuResilience
Natural resources, biodiversity, forestry	Lack of financial viability of ecosystem services; public goods character; need for cooperation with multiple partners	RBF / REDD+: Creates revenue to make project viable Thematic bonds: Mobilises investment for project Debt for nature swap: Frees up debt service funds for conservation Conversation Trust Fund	Athelia Impact funds; Green outcome fund; Forest Resilience Bond; Tropical Landscape Finance Facility; Seychelles blue bonds; Aqua Spark; Coral reef insurance; Water funds; Cofco SLL Caucasus Nature Fund (CNF)
Agriculture	High sector specific risks such as natural disasters, price volatility, pests and disease; smallholder farmers size and capacity constraints; bulky, seasonal and long-term financing requirements	Thematic and structured funds; Aggregates private investment monies from multiple sources into pooled vehicles	African Agriculture Capital Fund; Micro-leasing Kenya; Syngenta / UAP Insurance; Voucher grant schemes; Omnivore

²⁸ Abbreviations: RBF Result Based Finance, OBF Output-Based Finance, AMC Advanced Market Commitments

Sector	Typical financing challenges in sector	InnoFins	Examples
	for food products; lack of agrifinance capacity in financial sector	Micro- insurance: Reduces risk of investment and increases invested capital Local Currency Finance: Matches project revenues to debt service reducing risk	
Education	Lack of financial viability & affordability concerns	RBF (Challenge funds, Prizes, Voucher schemes): Creates financial incentive to achieve results RBF (Impact Bonds or Outcome funds): Outcome funder attracts investors Structured Funds: Concessional capital improves risk-return for investors	GSG Education outcome fund; Regional Education Financing Fund Africa
Health	Lack of financial viability & affordability concerns	Advance Market Commitment: Increases financial reward and reduces uncertainty catalyzing investment Insurance: Reduces impact of extreme events RBF (Challenge funds/Prizes/Voucher schemes): Increases financial incentives to produce identified results	GAVI AMC; International Finance Facility for Immunisation IFFM; WB pandemic risk insurance
Humanitarian Sector	Financial viability; funding insufficient or short term; arrives too late; ineffective; insurance premiums too expensive for LIC; High R&D costs	Insurance (disaster, climate, pandemic risk): Generates cash to reduce impact of extreme event RBF (impact bonds): Creates predictable cash flow to incentive impact activities Facility: Aggregates donor funds to achieve scale	Diaspora bonds; Refugee Bond; ICRC Impact Bond; Global Displacement Fund; Africa Risk Capacity
Public sector	Funding needed for non-commercial sectors; debt sustainability concerns; inefficiencies and capacity constraints	RBF (Policy based finance): Creates financial incentives to achieve reforms Loan buy downs: Incentives for reforms Debt swaps: Increases public cash flows for SDG activity	PBL Indonesia, Reform financing Tunisia, Performance based grants Ghana, shock resilient loans BOAD

Source: Koenig, A. et al. (2020): Innovative development finance – stocktaking report.

Part IV: Factsheets

Overview

Part I-III of the toolbox aimed at providing a short introduction into the background, the terminology and key concepts that are most relevant in IDF as well as a categorisation of various InnoFins by objectives and applications in different sectors. Part IV provides twelve fact sheets on InnoFins commonly deployed by development finance providers. The twelve fact sheets in this part of the toolbox provide more details.

The InnoFins were selected based on German Development Cooperation priorities and international interest.

Table 4 shows an overview of the fact sheets as well as selected case studies. On the one hand, the identified InnoFins show the spectrum of KfW's long term experiences in IDF, e.g. such as with funds and facilities, foundations and result based finance. On the other hand, they also include InnoFins in which others have spearheaded innovation in development finance, e.g. outcome based finance and guarantees.

Table 4: Factsheet overview

InnoFin Cluster / Family	Factsheet	Case Studies
Funds & Facilities	1. Facilities	African Enterprise Challenge Fund (AECF), InsuResilience Solution Fund, Geothermal Development Facility, International Finance Facility for Immunisation
	2. Endowments	Caucasus Nature Fund (CNF), Prespa Ohrid Nature Trust (PONT), Blue Action Fund, Crop Diversity Endowment Fund, The Foundation Tri-National Sangha (FTNS), Endowment Fund for Global Research Institute
	3. Structured Funds	SEE – Green for Growth Fund (GGF), InsuResilience investment Fund, ECO Business Fund, The European Fund for South East Europe (EFSE), AfricaGrow
	4. Flat (unstructured) Funds	Invera Private Equity Fund (Balkans), Emerging Capital Partners Africa Fund IV, Partech Africa Fund, Africainvest FIVE
Results- and Policy-Based Finance	5. Results-based Finance	Global Energy Transfer Feed-in Tariffs Programme (GET FiT), Pilot Auction Facility for Methan and Climate Change (PAF), Ghana – Output based Aid, REDD Early Movers (REM)
	6. Outcome-based Finance	Outcome funds with GSG Outcome fund, Mexico – Clínicas del Azúcar SIINC, Westbank & Gaza – Youth unemployment Impact Bond (DIB), Uganda – Yunus Social Success Note
	7. Policy-based Finance	Ghana – Performance based grants, Tunisia – Policy-based lending in the water sector, Benin – WB Policy-based guarantee, Montenegro – WB Policy-based guarantee
Risk participation	8. Guarantees	Nigeria – Azura Edo PPP, ACRE Africa, African Energy Guarantee Facility (AEGF), Managed Co-Lending Portfolio Programme (MCPP)
	9. Bonds	Tamil Urban Development Fund, City USD Green Bond Issue, Enel SDG-cooperate bond, Women's Livelihood Bond™ (WLB™), Latin American Green Bond Fund – LAGREEN
	10. Insurance	African Risk Capacity (ARC), R4 Rural Resilience Initiative – Ethiopia, Shock resilient loans (SRL), Health Insurance in Pakistan

InnoFin Cluster / Family	Factsheet	Case Studies
	10. Local Currency Finance	African Local Currency Bond (ALCB), GuarantCo, Fund EBRD SME Local Currency Programme, TCX Lift Program – Subsidy
	12. Securitisation	AfDB – Room2Run, Bayfront Infrastructure Management

The InnoFins were selected regarding their capacity to advance the field of innovative finance consistent with international development objectives articulated in the 2030 Agenda for Sustainable Development (SDGs), the Paris Climate Agreement and the Addis Ababa Action Agenda (AAAA). The AAAA was adopted by the international development community and endorsed by the UN General Assembly in 2015. It establishes a strong foundation to support the implementation of the SDGs and provides a global framework for financing sustainable development by aligning financial flows to developing countries with economic, social and environmental policies.

The InnoFins were assessed on a scale of 1 to 10 (with 10 the best to achieve and 1 the lowest) according to hypothetical benefits of each InnoFin family to contribute to three impact areas:

Mobilise additional private capital: This refers to InnoFin's capacity to mobilise additional private capital to narrow the USD 2.5 trillion annual SDG investment gap. InnoFins that have a **high potential to mobilise private capital** include bonds, structured funds as well InnoFins related to guarantees and other risk mitigation measures. Furthermore, endowments have the capacity to generate additional capital from return of investments in international capital markets as well as – to a lesser extent - development/social impact bonds funds. Other mechanism with some positive impact include investment grants in challenges (matching) funds, or mechanism that (temporarily) monetise impact or enhance revenues (e.g. SIINCs).

Strengthen local capital markets: Development finance is at its best when generating systemic impacts beyond direct impact. An InnoFin should therefore be assessed not only in terms of its direct impact on beneficiaries but also on strengthening local capital markets, ultimately leading to better economic outcomes in the long term through e.g. lower foreign currency risk, increased productivity, access to suitable capital and flexible funding. Conversely, harmful development finance crowds-out and distorts local financial and capital markets. InnoFin families that have a strong positive impact on strengthening local capital markets include Local Currency Finance InnoFins but also Structured Fund InnoFins as well as, depending on the respective design insurance, bonds and securitization. **Promote debt sustainability:** Private and government debt sustainability is critical for achieving the SDGs in the long term. If the SDG investment gap is narrowed by cross-border FX debt beyond the debt service capacities of a private investment or a government institution and country, then the core sustainability goal is sacrificed. For example, if the income generated to repay the debt is in local currency, local currency debt and equity finance decrease the risk of overindebtedness compared to hard currency debt finance. Other risks to be considered in sustainable development finance are related to external shocks and climate change. InnoFins that are suitable for promoting debt sustainability include all InnoFins mechanisms that lower risks related to debt structure, have built-in debt relief options in certain external debt distress situations or during periods of low fiscal revenues or those where good impact performance lowers repayment requirements. This includes shock resilient loans, local currency finance, counter cyclical loans/bonds, policy based loans, performance based grants or debt swaps. We considered both private and public debt in our assessment.

Furthermore, each fact sheet introduces the reader into key facts which illustrate the basic structure, provide the scope and common application in sectors and countries as well as other important criteria. The fact sheets further explain the main mechanism and roles, discuss comparison and success factors, as well as trends before providing more details on some case studies. Each fact sheet summarises KfW experience in this field and provides a list of key references.

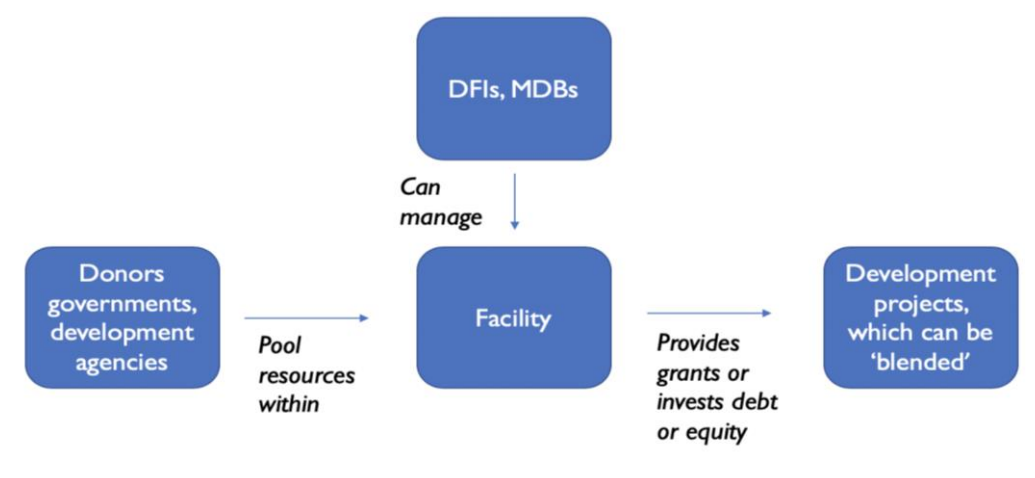
Facilities

KEY FACTS

- A facility is an aggregated pool of grant funds from development capital providers to be allocated to development projects with the aim of aligning donors behind a specific development challenge, encouraging innovation and/ or mobilising additional funding.
- Due to their concessional funding and mandate, facilities often target the earlier stages of project exploration and development, investment in innovation, start ups or small enterprises that commercial investors (still) find unattractive or provide funding for technical assistance.³⁰ Facilities allow donors to operate where their own presence or activities are limited, raise the profile of under-targeted development issues, and boost alignment, coordination and knowledge exchange between various donors.
- By definition, facilities only pool grants provided by donors and other providers of development capital whereas flat and structured funds are also funded by commercial investors. Capital deployed is often in the forms of grants but also loans and in rare cases equity participation.

Basic structure

Facility basic structure



Source: Authors' compilation.

Scope

Facilities encompass a wide field for different use cases:

- Facilities are often constituted as “**multi-donor trust funds**” managed by MDBs. Monies from the facility are allocated to complement MDB traditional financing activities.
- Facilities often fill a gap in the early stage of project exploration and development, which commercial investors may find less attractive, given the greater costs and associated risks and help to develop bankable development projects (e.g. **project development facilities**).
- Facilities can directly target private enterprises, provide grants and technical assistance to early stage start ups, inclusive businesses or SMEs and thereby ultimately bring them to a level of scale and sophistication in their operations and projects that would enable them to access financing from local banks or investors (e.g. **start up or acceleration facilities**).

³⁰ OECD (2019): Blended Finance Funds and Facilities – 2018 Survey Results Part I: Investment Strategy.

- Some facilities support innovation not only in the enterprise sector but also in government, civil society or academia (e.g. **innovation funds**).
- Facilities can also allocate funds to a variety of actors to address developmental challenges in an innovative way using competition as a main principle (e.g. **challenge funds**).
- Facilities can directly finance development projects with equity or debt (and thereby provide a demonstration effect to private investors) or engage in risk mitigation finance (e.g. **guarantee facilities**).
- Some donors and other developmental capital providers pool their funding in **multidonor trust funds** or in endowments that invest funding in capital markets and use income generated for funding of projects in line with their mission (see Factsheet on **endowments** – see Factsheet on “endowments”).

Facilities are often used to pool funding for technical assistance either in combination with other approaches and financing mechanism such structured funds or as stand alone **TA-Facilities**.

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Grant, debt and equity	Target Group: Governments, projects and financial institutions, private enterprise Investors: Do not contribute funds to facilities, but often benefit from the grants, TA and concessional investment allocated by Facilities.	Development Stage: ☐ Concept ☐ Pilot ☒ Proven ODA eligibility: Yes
Approach: Funds & Facilities	Applicability Type of Countries: ☒ LDC/LIC ☒ LMIC ☒ UMIC	KfW experience: Yes
Product for end beneficiaries/local market: Risk capital, grants and TA, and increasingly debt or equity	Relevance for SDGs: In principle, all SDGs and particularly important for Paris Goals	Peer Experience: World Bank and other MDBs for multidonor trust funds; DFID, SIDA, USAID, Global Affairs Canada for Challenge and Innovation Funds

Addis Ababa Action Agenda Impact Areas

Criteria	Assessment	Explanation
Mobilise additional private capital	7 out of 10	A frequent (and increasing) objective of a facility is to reduce risks or make projects and ventures bankable or investable increasing pipeline of investable opportunities.
Strengthen local capital markets	5 out of 10	Most facilities have no / limited impact on local capital markets. But facilities are being deployed more frequently with local currency, capital and financial market development as an objective.
Debt Sustainability	9 out of 10	Facilities usually disburse grants, therefore not encumbering national debt sustainability. In some cases, it might be considered an investment in future productivity and innovation.

MECHANICS & ROLES

How does it work? Public development funds (and increasingly philanthropic) are pooled and allocated for specified development projects, enterprises as well as – in some cases – NGOs, academic institutions and public sector entities.

Facilities generally have the following characteristics: (i) development objective with focus on underfunded development challenge (e.g. women empowerment, start up finance and (agriculture) SME development or project development in renewable energy and energy efficiency, post conflict and fragile geographies, (ii) approved instruments (e.g. grants and TA), (iii) a facility manager (e.g. an MDB, a professional service firm or an asset manager), (iv) a governance process and (v) a strong focus on impact measurement and reporting for accountability to donors and effective impact management. Facilities typically provide grants but increasingly also debt and equity (e.g. capital into blended finance vehicles),

What are the key differentiating factors?

Funders: Large majority have been governments, with philanthropic foundations and DFIs also active. Development objective: Broad range, with climate mitigation, WASH, financial services, SMEs and health predominant.

Instrument deployed: Mostly grants and TA, increasingly concessional investment in blended finance vehicles.

Financial mandate: Range from fully concessional to preservation of capital – in blended finance higher capacity of capital preservation.

Manager: Majority of facilities has been managed by DFIs to date, with governments and private sector such as professional service firms next prevalent.

Term: Fixed life or permanent (including how capital is treated at the end of its life).

Selection of grantees/Investees: Competitive process or strategic allocation of pre-identified grantees/investees.

Role of donors in mechanism? Donors typically collaborate to establish development objectives of a facility, allocate funding and preside over governance. By launching and funding facilities, donors can raise the profile of favoured development issues and encourage MDBs and DFIs to scale-up their participation. Facilities can sometimes be managed by donor governments.

Role of development finance institutions in mechanism?

Generally, DFIs do not capitalise facilities, but facilities are sometimes managed by DFIs (or rather MDB such as the World Bank). Facility resources are often disbursed in grants and TA in parallel to DFI commercial financing in a linked financing intervention.

Role of investors in mechanism? Investors do not fund facilities, but often benefit indirectly from the allocations from

facilities, e.g. in forms of a matching grant to their investees, a stronger pipeline, better data or a stronger eco-system.

COMPARISON CRITERIA

Impact: High coordinated development impact. Facilities are effective to achieve coordinated development impact by a group of likeminded donors because they can be focused on one objective/tailor made to achieve/address a certain target. Facilities range from narrow to broad development objectives. Facilities often channel resources into development projects that are currently under-targeted by market actors. Publicly funded facilities must demonstrate strong development impact, additionality and minimum concessionality.

Scalability: Highly scalable. Structure allows for many organisations with similar development objectives to partner in a facility.

Efficiency: High effectiveness and efficiency. The OECD reports 96 % of capital in facilities comes from concessional development finance providers (e.g., donors), with governments owning 86 % and non-governments (e.g., philanthropies) the other 10 %.³¹ Facilities can potentially be 'evergreen' in structure, with development resources being continuously reinvested into new projects, providing long-term financing for donors' favoured (and potentially under-targeted) development issues.

Feasibility: Proven and mature. Use of debt or equity instruments is less developed.

Mobilisation: Many facilities ultimately aim at mobilising private capital. Combining facilities with other InnoFins can mobilise additional private commercial capital towards specific development issues.

Flexibility: High flexibility. Facilities can adopt a variety of structures, using a broad range of instruments (such as grants, loans, equity, guarantees, and technical assistance) to invest in (and potentially mobilise private commercial investment for) development projects. Facilities can therefore be a way for donors to test out new financing approaches that differ from traditional bilateral and multilateral programmes, but also invest in eco-system strengthening.

SUCCESS FACTORS

Facilities are most effective when donor objectives are aligned internally amongst themselves (and with the organisation managing the facility) and externally **with the recipient country or countries** and partners, if applicable, and where there are clear mechanisms in place to ensure effective and accountable decision-making. In fact, facilities sometimes suffer from low levels of engagement with and representation from recipient countries actors and may not be aligned to the recipient countries' strategies. This lack of representation can be worsened by weaknesses in complaint mechanisms and a lack of transparency on projects funded by facilities. Also, having development partners manage facilities

³¹ OECD (2019): Blended Finance Funds and Facilities 2018 Report.

can create tension between them and the expectations and policies of donors.³²

Supporting programmatic approaches can be more efficient, price competitive and scalable than supporting multiple standalone risk-sharing facilities. For example, the Small Loans Guarantee Programme, supported by first-loss capital from the Ireland Development Agency Private Sector Window, looks to increase access to finance for SMEs, pooling together a portfolio of IFC risk-sharing facilities and providing partial guarantees to reduce risks for participating banks' SME lending. Thereby the programme is encouraging banks to increase the size of their lending to SMEs.

Given the high level of concessionality in both the funding of facilities and deployment of funds, **ensuring that funding to projects or companies is truly additional** is one of the critical success factors.

TRENDS TO-DATE

- In its 2019 Blended Finance Funds and Facilities Report, the OECD reports on 180 funds and facilities that took part in its 2018 survey. Facilities represent a relatively small, but growing part of the development finance markets with USD 41.5 billion of Assets under Management in facilities, with 87% managed by multilateral and bilateral DFIs, and 13% by Governments and others.
- Around 40% of facilities anchor their investment strategies to the Paris Agreement on Climate Action. Newer facilities are more aligned with the Sustainable Development Goals (SDGs). Notably, the OECD found facilities dealing with health, education, and gender equality experienced a relative rise in interest since the last OECD survey in 2017.
- Facilities increasingly allocate concessional capital to blended finance projects seeking to mobilise private (co) investment. However, only 27% of the surveyed facilities reported having some portion of their portfolio in local currency and only a minority successfully mobilise local investors and funders.
- Many facilities support local small- and medium-sized enterprises (SMEs) and increasingly use (concessional) loans and equity funding rather than grants.

CASE STUDIES

African Enterprise Challenge Fund (AECF)

The AECF supports innovative commercial businesses in the agribusiness, renewable energy and adaptation to climate change technology sectors in Africa. AECF is financed by Sida, Australia, Canada, CGAP, Denmark, IFAD, the Netherlands, Global Affairs and the UK. Similar to most other challenge funds it uses competition between applicants to identify the best solution to a pre-defined development problem. It provides both grants and loans to successful applicants to implement their ideas. While applicants have to adhere to certain criteria, they are given freedom in designing, testing and scaling their solutions. AECF also connects investees to other investors. It offers a gender lens investing product of USD 50 million and has a clear value proposition in terms of its additionality measuring its own contribution and that of its investees on system change. Since 2008, it has mobilised over USD 356 million, leveraging more than USD 658 million in matching capital.

Read more here: <https://www.aecfafrica.org/>

Geothermal Development Facilities

The Geothermal Development Facility for Latin America, launched in 2014, looks to encourage public and private investment in geothermal power development in the region, providing financial support to help mitigating geothermal exploration risk. It was jointly launched by the BMZ, the EU and KfW, CAF, CABI, WB, ESMAP, IDB, AfD, EIB, JICA, NDF, BGR and GIZ. As the first multi-donor climate initiative to promote geothermal energy within Latin America, the facility aims at catalyzing the development of a minimum of seven geothermal plants with a cumulative capacity of at least 350 MW.

The Geothermal Risk Mitigation Facility for Eastern Africa (GRMF) was established in 2012 to fund, facilitate, and accelerate geothermal development in eleven partner countries in the Eastern African Rift Valley region. With funding provided by the BMZ, the EU-Africa Infrastructure Trust Fund (EU Africa ITF) via KfW, and the UK Department for International Development (DFID), the GRMF's financial support aims at mitigating the early-stage exploration risk associated with geothermal power projects, thereby increasing project bankability and securing external financing.

Read more here:
<https://gdfilac.com/about/objectives/>
<https://grmf-east africa.org/>

³² Oxfam (2017): Private Finance Blending for Development: Risks and Opportunities.

InsuResilience Solutions Fund (ISF)

The InsuResilience Solutions Fund (ISF) is one of the implementing programmes of the InsuResilience Global Partnership. A project development facility established by KfW on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ), the ISF looks to support innovative solutions to mitigate the negative impacts of extreme weather events linked to climate change (such as floods, storms and droughts), which undermine sustainable development and threaten lives and livelihoods.

The ISF provides grant-based co-funding to partnerships consisting of public and/or private organisations, thereby supporting the development of innovative, needs-based, and financially sustainable climate risk insurance products in developing countries, and thereby increasing local populations' resilience against extreme weather events.

Read more here:

<https://www.insuresilience-solutions-fund.org/>

The International Finance Facility for Immunisation

The International Finance Facility for Immunisation (IFFIm) was launched in 2006. It supports the work of the Global Alliance for Vaccines and Immunization (GAVI), which looks to develop affordable vaccines against pneumococcal diseases in the world's poorest countries.

The IFFIm supports GAVI by using long-term pledges from donor governments to sell 'vaccine bonds' in the international capital markets, making large amounts of capital immediately available for GAVI projects. Its donors include the governments of Australia, France, Italy, the Netherlands, Norway, South Africa, Sweden, Brazil, and the United Kingdom.

Read more here: <https://www.gavi.org/>

OVERVIEW OF KfW PORTFOLIO

KfW has a large amount of experience in supporting facilities for development purposes in addition to examples highlighted above. Examples include the various TA Facilities set up as part of German FC initiated or funded structured funds; the FC facility "Investments for Employment" established to support jobs and improve working conditions across partner countries in Africa; the Facility for Energy Inclusion's Off-Grid Energy Access Fund which looks to support innovative, climate-friendly off-grid energy access solutions in Africa; the Geothermal Project Development Fund. Other examples include KfW participation in multidonor trust funds in fragile countries such as the Afghanistan Reconstruction Trust Fund or its investment in biodiversity and natural resources trust funds and endowments. More recently German Financial Cooperation set up and funded the Regional Challenge Fund (RCF) which aims to improve vocational education and training (VET), and thus employability of VET graduates in the Western Balkans six CEE Economies.

MOST RELEVANT ADDITIONAL RESOURCES

Gyimah, A. & Agyeman, A. (2019): A Study on How Development Finance Institutions Support SMES: A Case Study of International Finance Corporation. Accessed at: https://www.researchgate.net/publication/331170678_A_Study_on_How_Development_Finance_Institutions_Support_SMEs_A_Case_Study_of_International_Finance_Corporation.

IDA (2018): IDA18 IFC-MIGA Private Sector Window (PSW) IDA18 Mid-Term Review. Accessed at: <http://documents1.worldbank.org/curated/en/157801542813052758/pdf/psw-mtr-version-final-published-10252018-636762750312547314.pdf>.

Ipsos MORI, SQ Consult & EY (2017): GCPF MID-TERM EVALUATION REPORT, BMU.

OECD (2018): Making Blended Finance Work for the Sustainable Development Goals. Accessed at: https://assets.ctfassets.net/4cgg1wde6gy0/77K8quUYEwekiealWmiSqm/8a2472bac649afc93e8558200c994ec/OECD_Making_Blended_Finance_Work_2018.pdf.

OECD (2019): Blended Finance Funds and Facilities 2018 Report. Accessed at: https://www.oecd-ilibrary.org/development/blended-finance-funds-and-facilities_806991a2-en.

Oxfam (2017): Private Finance Blending for Development: Risks and Opportunities. Accessed at: <https://www-cdn.oxfam.org/s3fs-public/bp-private-finance-blending-for-development-130217-en.pdf>.

Sida (2018): Evaluation of Sida's Global Challenge Funds.

Weru, J., et al. (2018): The Akiba Mashinani Trust, Kenya: a local fund's role in urban development, Environment and Urbanization.

Endowments

KEY FACTS

- Endowments are pools of money capitalised by one or multiple donors. They are invested in high-quality assets to generate ongoing financial revenues to fund an organization's operations, and/or for specific long-term development purposes defined by the endowment's founders and donors. The legal structure to administer endowments are typically trust funds, (private) foundations or private limited companies.
- Endowments are suitable to support and fund social sector organizations, projects or programmes that: (i) would not generate sufficient cash flow by their own means; and (ii) require long-term funding.
- Endowments are an important innovative finance mechanism. This given their ability to generate financial resources for organisations and projects with high development impact but no or limited revenue-generating potential. They are a way to ensure long-term financial sustainability for projects and development impact after the exit of the main donor. However, beside nature/biodiversity conservation finance where endowments are well established they are under-deployed.

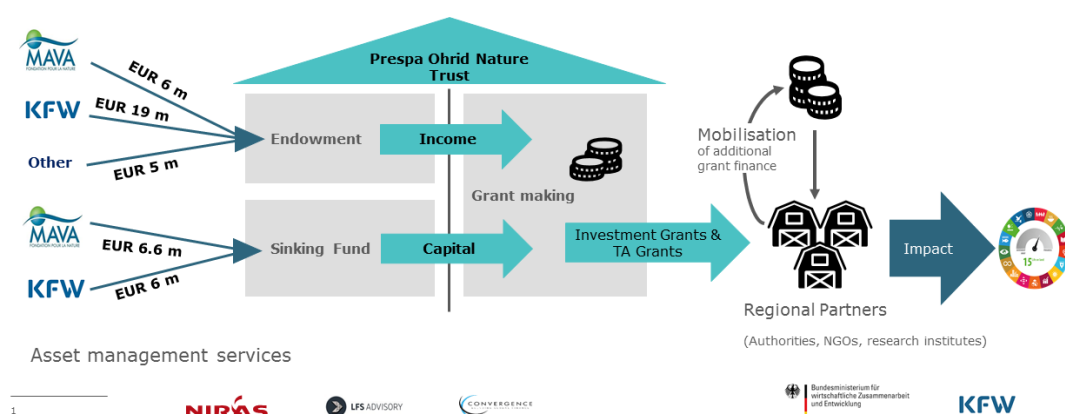
Basic Structure

Example of an endowment foundation in development finance

The PONT Endowment Foundation

Innofin: Trusts / foundations to pool finance (public and private philanthropic) for additional mobilisation & greater impact

Prespa Ohrid Nature Trust PONT



Source: own based on website: <https://www.pont.org/> and <http://mava-foundation.org/heroes/prespa-ohrid-nature-trust/>.

Scope

- Endowments are structured, deployed and managed in many different ways. They can be structured as permanent endowments, sinking funds, revolving funds, or a hybrid combination.
- A **permanent endowment** is designed to last in perpetuity, preserving its capital and using only the interest or returns to fund operations.

- A **sinking fund** endowment is designed to disburse its interest/returns and a proportion of its capital each year over a defined period.
- Sometimes a **revolving fund** is replenished or augmented on a regular basis, usually through fees, taxes or levies collected by a government, and the revenues may be disbursed or a proportion set aside to create a new endowment fund.
- In development finance, endowments have mostly been used in conservation, biodiversity and natural resources (e.g. Conservation Trust Funds). Sometimes endowment funding is deployed cross-country as their scope follows natural resource boundaries rather than geographical borders.

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Grants for capitalisation of endowment capital Debt and equity for deployment of endowment capital Grants for funding of NGOs on the deployment of capital side	Target Group: Organizations (e.g. NGOs, protected area management authorities) and persons	Development Stage: ☐ Concept ☒ Pilot ☒ Proven ODA eligibility: Yes
Approach: Funds & Facilities	Applicability Type of Countries: ☒ LDC/LIC ☒ LMIC ☒ UMIC	KfW experience: Yes.
Product for beneficiaries / local market: (catalytic) and long-term grants in underfunded, cross-boundary development projects	Relevance for SDGs: Mostly in natural resources sectors like conservation and biodiversity. Possible but largely untested for social sectors, such as health, education and gender.	Peer Experience: USAID, Global Environmental Facility/World Bank, AFD and Global Affairs Canada

Addis Ababa Action Agenda Impact Areas

Criteria	Assessment	Explanation
Mobilise additional private capital	7 out of 10	Endowment foundations have not mobilised additional commercial capital as such additional capital in endowment foundations has been mostly philanthropic so far. However the investment income earned can be considered additional capital from private sources depending on capital market performance. On the recipient side, in some cases grantees found it easier to mobilise additional public and philanthropic grants for their cause, given the guaranteed long-term support and funding provided by the endowment funding.
Strengthen local capital markets	3 out of 10	It is unusual for an endowment fund to target funding local capital markets. However, the endowment capital could be invested in local capital market instrument(s) that are linked to the mission of the foundation, such as local currency green bonds.
Debt Sustainability	10 out of 10	Endowment funds usually disburse grants with no obligation for repayment.

MECHANICS & ROLES

How does it work? Endowments are capitalised by grants and donations from international donor agencies, governments, (venture) philanthropists, or high net worth individuals. Endowments are often open funds in order to allow for the mobilisation of additional short term and long term resources. Endowment Capital is invested in capital markets to produce an income stream that funds pre-specified grant-making activities in accordance with the objectives of the donors.

The legal structure to own and administer endowments include **trust funds, (private) foundations, associations or private limited companies**. The endowment capital is mostly invested by an external **asset manager** contracted by the endowment. Commonly, endowment mechanisms have been established for the capital to last in perpetuity. The value of the endowment capital (the principal) is therefore kept intact and only the investment income is deployed for developmental purposes. Alternatively, endowment capital can be drawn down over a long-term timeframe (e.g. minimum 10 years for term-limited foundations under German law). Increasingly, hybrid structures are used where resources from sinking funds complement investment income from endowment capital that remains intact in perpetuity.

The **deployment of investment income** is often designed in a way to leverage additional resources from governments or other donors, for example through co-financing requirements. These can provide an incentive for governments in partner developing countries to increase budgets for a specific development topic, to generate new revenues to benefit the sector and/or for supported projects to develop income generating activities. Indeed, in many programmes funded through investment income from endowment capital, market development opportunities are sought to improve project viability (e.g. tourism services, agro-forestry, community enterprise models, access to carbon markets etc.).

In the **conservation sector**, conservation trust funds are also often used as the financial and institutional mechanisms for disbursing user fees, REDD+ payments, climate adaptation funding, biodiversity offset payments, and environmental compensation. The endowment administrator is generally not an implementation organisation, but some institutions are more engaged in implementation activities than others which may act simply as conduits for funding. Technical assistance (TA) to grantees is often provided often alongside the provision of grant-making with the aim to strengthen local partner organisations' institutional capacity and to enhance the revenue generating potential of grantee projects.

The **country-specific legal and regulatory environment** where endowments are set up have great influence on how endowments are designed in practice. Endowments vary with regard to the following aspects:

- **Time horizon:** Whether endowments are set up in perpetuity or time-bound (e.g., sunset foundations)³³
- **Use of principal:** How and when principal can be used (restricted, unrestricted, term or quasi-endowment).

³³ Under German law foundation endowments are generally set up in perpetuity ("Ewigkeitsstiftungen"), since 2013 some German states allowed for time bound foundations ("Verbrauchsstiftungen") and even hybrid structures that combine

- **Legal vehicles:** In international development finance endowments are mostly governed and managed as **trusts**. This is a legal arrangement whereby a trustee (individual, group, company or organisation) legally owns and manages financial resources or property that has been donated exclusively for a designated developmental purpose. Alternatively, (private) **foundations, civil associations or private limited companies** are often used to the same end.
- **Number of donors:** Endowment capital can be provided by a single-donor (often the case for foundations that limit the donors to the founder or family e.g. under German law) or multi-donors (often the case for trusts that are better suited to mobilise additional funders).
- **Governance and management:** The type of institutions that manage endowment capital and decide on the deployment of investment income. In the case of trust funds, these commonly include academic/cultural organisations, non-profits, development agencies or specialised trust fund managers.
- **Regulatory oversight:** The extent to which endowment structures are subject to oversight by public authorities or are outside of public sector authorities.
- **Tax regulations:** The legal structure (e.g. whether it is a permanent or sinking fund endowment or a trust) and the jurisdiction (see below) have significant impact on donors' tax benefits, as well as level of taxes on investment income. Most common law countries provide tax exemptions for income earned by trusts, whereas civil law countries apply taxes.
- **Location:** Endowments can be set up in the main donor's country of origin, the beneficiary countries where investment income is to be deployed, or in an off-shore location. Off-shore is beneficial when there is a lack of legal basis or transparency in the donors' or partners' country, or as an intentional measure to gain access to specific donors outside the lead donor's national boundaries and/or to benefit from tax exemptions.

Role of donors in the mechanism? In international development finance, it is mostly public donors who have initiated and capitalised endowment mechanisms (e.g. KfW, USAID or UNDP), as well as large environmental non-profit organisations (e.g. WWF, The Nature Conservancy, Conservation International). A common source of funding for Conservation Trust Funds has been bilateral debt-for-nature swaps, whereby debt owed by a developing nation is forgiven in exchange for local conservation measures. Donor governments can use endowments to target particular regions or favored development issues. While donors may not manage the deployment of funds directly they can exercise control and provide direction indirectly by ensuring the fund's activities remain true to its founding legal documents and agreements, and by joining the fund's governing board.

Role of development finance institutions in mechanism? DFI's can be contracted as asset managers by the endowment administration to manage endowment capital investment and capital allocation, depending on their internal capacities.

elements of both ("Hybridstiftungen"). An even leaner way are trust structures ("Treuhandstiftungen") which contrary to the other structures are not subject to regulatory oversight by public authorities.

Role of investors in mechanism? Asset managers are contracted by the endowment administration to invest the endowment capital. Sustainable, impact or conservation investment vehicles are ideal investment targets to align investment and grant-making strategies.

COMPARISON CRITERIA

Impact: Endowment mechanisms have been beneficial for development projects that require a stream of funding over the long term or in perpetuity, including many conservation projects.

While few evaluations of endowment funds exist, projects funded by endowment investment income are understood to have enhanced local community buy-in, create trust and strengthen collective impact structures as support is provided over a long period of time.

Grants from endowments are often performance-based, where specific targets must be achieved to trigger subsequent grants.

Scalability: Scalability depends on (i) legal structure and ability to mobilise additional donors; (ii) the performance of the endowment investment portfolio, (iii) whether the grant funding to be provided to the beneficiary organisation needs to be matched by additional capital and (iv) the extent to which supported projects generate their own revenues (e.g. tourism or agro-forestry).

Efficiency: There are significant costs involved in establishing and managing endowments depending on the country-specific legal and regulatory framework, the quality of professionals hired, and grant-making and fundraising strategy. The strong value proposition compared to traditional facilities is that endowment mechanisms make a significant contribution to financial sustainability, with grant-making funded mostly by the investment returns achieved. Multi-donor endowments (e.g. conservation trust funds) often combine various donors and streams of funding. The Nature Trust Alliance is an example of an innovative structure aiming to provide operational support to a variety of endowment mechanisms – creating significant efficiencies and reductions of operational costs (see case study).

Feasibility: Endowments have existed for centuries and are a common financing instrument in many countries (e.g. university endowments in the US). In international development finance, conservation trust funds have been common since the early 1990s and some development (financing) organisations, including KfW, have gained considerable experience in the past decade setting up and managing different types of endowments. In international development finance, however, there is limited experience beyond conservation.

Mobilisation: Endowment mechanisms can directly mobilise private (philanthropic) donors and indirectly mobilise additional sources from investment income generated in the deployment of endowments in international capital markets. ecipient countries.

Flexibility: Without additional grant funding or capital sinking funds, deployment of funds is restricted to the returns achieved

by the endowment's investment. Poor or negative returns can lead to a suspension of grant-making activities.

SUCCESS FACTORS

Capital market performance: An endowment's investment activities need to generate sufficient income. A low-yield environment in global capital markets and any financial crisis can impede good returns in the short-run. Endowments that suffer significant investment losses may have to suspend their grant-making activities if they are unable to draw down on their principal or (temporarily) access additional funding.

Investment strategy and management: Asset managers must balance a prudential investment strategy and the need to generate sufficient returns to invest for developmental purposes. Endowment asset managers often prioritise investing in lower-yielding, lower-risk financial instruments like government bonds, rather than stocks or other investment opportunities.

Use of the potential of investing across the spectrum of capital: Rather than generating returns from investment activities that may or may not be related to the endowment's purpose, endowment capital can be (partially) invested in alignment with the desired developmental purpose of the endowment. For example., an endowment seeking to generate income for social sector organisations supporting biodiversity might invest its capital into conservation investment opportunities, such as carbon markets, forest bonds or structured eco-business investment vehicles. In these cases investments do not need to generate market-rate return if the targeted impact can be realised through capital investment itself.

Tax and other regulations: The amount of funding available for impact activities depends on the tax legislation, both in the country of origin and grant destination. Similarly the ability to invest endowment capital for sustainability or intentional positive impact, depend on the country-specific regulations on endowment vehicles' investment strategies.

Long-term perspective: Donors must take a long-term view when endowments are set up for perpetuity or an extended period. Depending on the legislation of the country where the endowment vehicle is established, they can remain involved by lengthening their supervision periods; becoming a permanent or long-term member of the foundation board; keeping a permanent right to nominate board member who can represent its interests; and including a provision in donor grant agreements requiring their approval for changes in the endowment purposes, structure, operations, or investment activity.

Size: Small endowments tend to have relatively high administrative costs relative to incomes. Large endowment funds can benefit from economies of scale. High administrative costs reduce endowment funds' grant-making budgets. Similarly, small grants made to local enterprises and NGOs (rather than larger organisations with a national or international presence) tend to have higher per-unit administrative costs.

Reputation: The reputation of the founding donor and selection of board members and partnerships are essential to attract new capital to increase the size of the endowment.

Grantee / Investee performance: The achievement of development objectives depends on the selection of grantees or investees, and ultimately their performance. A transparent and active performance measurement and management regime, strong and open collaboration between funder and grantees over time, and investment into the grantees organisational capacity to deliver are key to the success of endowments.³⁴

TRENDS TO-DATE

- Funding has come mainly from donor agencies and governments in partner countries (through debt swaps). Philanthropy has begun to play an increasingly important role in recent years. Large endowment funds (e.g. Colombia's Fondo Acción) have been exploring the concept of 'citizen philanthropy' through innovative approaches such as crowd funding, where contributions are leveraged directly from the public and local communities. Partnerships with the corporate sector are also becoming more common.
- According to the analysis of the Conservation Finance Alliance, over 100 conservation trust funds have been established since 1990. Conservation trust funds, the most common vehicle for administering endowment capital in international development, exist in Africa, Latin America and the Caribbean, Asia and the Pacific, and Eastern Europe. Recent years have seen growth in the number of regional Trust Funds, established to support protected areas or conservation goals across national boundaries.³⁵
- According to the Conservation Finance Alliance investment survey, when asked about their investment strategy, organisations listed "maintaining real value of endowment" as the first investment priority, when asked to rank investment goals. Other investment priorities included growing the real value of the endowment, maintaining the nominal value of the endowment, interest and dividend income, and capital gains. Achieving social or environmental impact with investments (impact investing), or avoiding investment in specific companies (negative screening) was not a priority for most respondents.³⁶
- Nature conservation has concentrated more on "charismatic ecosystems" on land, such as rainforests and savannahs. Increasing attention is being paid to "blue" development challenges such as coral reefs, mangrove forests and the high and deep sea, reflected in the establishment of marine conservation funds such as the Blue Action Fund, a sinking fund co-funded by the German, Swedish and French government.

CASE STUDIES

The Foundation Tri-National Sangha (FTNS)

The Sangha Tri-National Trust Fund is an endowment set up under British law as a private limited company. It has the aim to contribute to the long-term financing of conservation, eco-development and cross-border cooperation within the forest complex called the Sangha Tri-National (TNS) in the Central African region (ZAR, Kameron, Rep. Congo). At its creation the FTNS capitalisation objective was set at EUR 100 million. In 2019 FTNS had managed to mobilise an endowment of more than EUR 50 million (including EUR 45.5 million from KfW and EUR 3 million from AFD). The FTNS capital is invested in international financial markets by an internationally recognised investment manager Crédit Agricole Indosuez (Switzerland). The investment follows the policy guidelines defined by FTNS to generate a perpetual stream of stable income to finance targeted activities in the TNS. Income from funds provided by KfW and AFD complement grant from the German *Regenwald Stiftung (Rainforest Foundation)*, which had mobilised nearly EUR 4 million through the "Krombacher Rainforest Campaign", an advertising campaign conducted jointly with WWF Germany, who's former Director General is FTNS' founding member.

Read more here: <https://www.fondationtns.org/>

Crop Diversity Endowment Fund

The Crop Diversity Endowment Fund is a permanent, self-sustaining vehicle that looks to preserve crop diversity in order to protect global food security. It does so by targeting the conservation of crop diversity in gene banks, ensuring that scientists can breed more resilient, nutritious, and productive crops.

The fund operates by providing long-term grants, funded by the income from its investment portfolio, to safeguard collections of crop diversity held in gene banks globally, prioritising the eleven gene bank collections of CGIAR (the Consultative Group for International Agricultural Research). It is targeting a final size of USD 850 million and has received commitments from investors such as KfW Development Bank.

Read more here: <https://www.croptrust.org/>

³⁴ EVPA (2018): A practical guide to venture philanthropy and social impact investment.

³⁵ More information on Conservation Finance Alliance can be found at Conservation Finance Alliance (2020): "CTIS Publications".

³⁶ Conservation Finance Alliance (2018): Conservation Trust Investment Survey, p. 6.

Endowment fund for global research institute

The Centre for International Governance Innovation (CIGI) supports world-leading research in global governance, particularly global economic and financial governance, international security and international law. The Fund was created with initial private donations from CIGI founder Jim Balsillie (approximately USD 20 million) and other private donors, matched in 2003 by the federal government of Canada (USD 30 million), and subsequently added to by other public and private donors. The Centre continues to be funded by the proceeds of this endowment.

Read more here: <https://www.cigionline.org/>

The Nature Trust Alliance

The **Nature Trust Alliance** is a unique collaboration between three of Europe's leading conservation trust funds: the Caucasus Nature Fund (CNF) and Prespa Ohrid Nature Trust (PONT) and the newly established Blue Action Fund. Established in 2016 in Frankfurt am Main, Germany, NTA provides operational support services (financial management, administration, communications, reporting, etc.), so that funds can focus on their core missions of employing innovative and sustainable financing mechanisms for nature conservation. The NTA shared services initiative is a first of its kind.

Read more here: <https://www.naturetrustalliance.org/>.

PONT is a transboundary conservation trust fund established in 2015 with funding from the MAVA Foundation and the German Ministry for Economic Cooperation and Development (BMZ), working through KfW Development Bank. It provides financing for conservation and sustainable management initiatives to conserve the unique biodiversity of the Prespa lakes basin in Albania, Greece and North Macedonia. Raising over

EUR 20 million in endowment and sinking funds within the first few months of its existence, PONT combines investment income from its endowment with other available capital and annual donations to generate grant-making resources for protected areas and environmental actors in the region. PONT is one of only eight transboundary conservation trust funds world-wide and the first of its kind in the Balkans.

Read more here: <https://www.pont.org/>

CNF is a regional conservation trust fund created to protect the unique biodiversity of Armenia, Azerbaijan, and Georgia through co-financing protected areas. Starting with only EUR 7 million in endowment capital, CNF now has a total capital (including endowment and sinking fund) of over EUR 55 million. Established in 2007, CNF gave its first grant in 2010 and has built its grant programme steadily over the last fifteen years; CNF's current annual programmatic budget is more than EUR 2 million.

Read more here: <https://www.caucasus-naturefund.org/>

The **Blue Action Fund** is an independent conservation foundation that was initiated by the German Federal Ministry for Economic Cooperation and Development (BMZ) and KfW in 2016. With the later involvement of Sweden in 2017, through SIDA, and France in 2018, through AFD, the fund provides grants to NGOs working in ODA countries to conserve marine biodiversity and to improve the lives of local people. It primarily works as a sinking fund in addition to EUR 2 million endowment capital, which is invested to provide grants (in addition to substantial grants financed from the sinking fund portion) to projects resulting in measurable outcomes. These include the conservation of biodiversity and the recovery of fish stocks, enhanced livelihood conditions and food security, and newly established or better managed Marine Protected Areas (MPAs) of regional importance. Total commitments amount to around EUR 93 million.

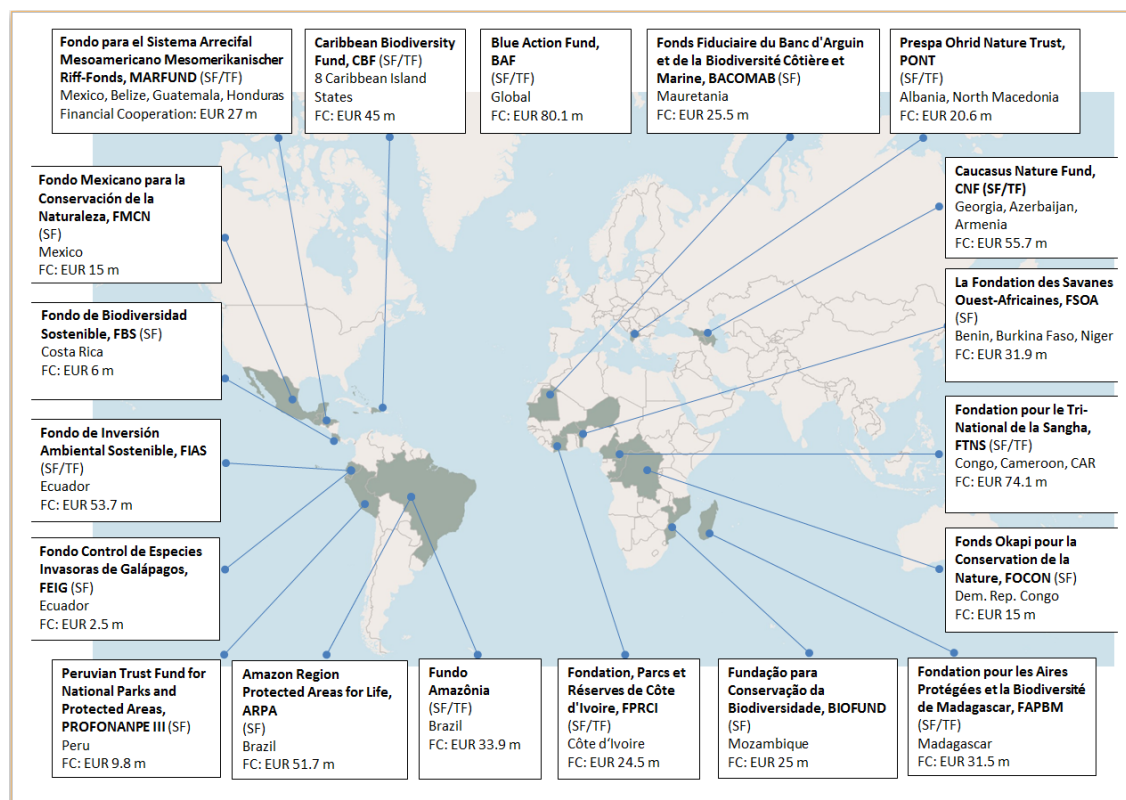
Read more here: <https://www.blueactionfund.org/>

OVERVIEW OF KfW PORTFOLIO

Through the work of KfW Development Bank, Germany has become one of the largest donors for conservation and biodiversity.³⁷ KfW's first commitment to an endowment was in 1995 to the Peruvian PROFONANPE (a mix of endowment and sinking fund) with counterpart funds from debt relief. KfW has established and funded many conservation trust funds together with more than 19 development and philanthropic partners such as the World Bank (usually with funds from the Global Environment Facility – GEF), USAID (with funds from debt conversions) and major environmental organisations WWF, Conservation International (CI) and The Nature Conservancy (TNC). A large portion of the funds invested in biodiversity sector benefits Latin America, while almost one third is used in Africa.

³⁷ In 2018 KfW promoted 94 conservation projects in 59 countries, whereby all of the projects have the primary goal of protecting biodiversity. The total volume of

all projects that have biodiversity as either a primary or a secondary goal, amounts to some EUR 2.2 billion.



Source: KfW (2020): Materialien zur Entwicklungsfinanzierung (in the process of publication).

MOST RELEVANT ADDITIONAL RESOURCES

Conservation Finance Alliance (2008): Rapid Review of Conservation Trust Funds. Accessed at: <https://www.cbd.int/financial/trustfunds/g-rapidassess.pdf>.

Conservation Finance Alliance, 2014: Practice Standards for Conservation Trust Funds. Accessed here: <https://www.conservationfinancealliance.org/practice-standards-for-ctfs>.

Conservation Finance Alliance (2018): Conservation Trust Investment Survey. Accessed at: <https://www.conservationfinancealliance.org/webinars-1/2019/2/11/conservation-trust-fund-investment-survey-2017?rq=Survey> and other publications <https://www.conservationfinancealliance.org/ctis-publications>.

Credit Suisse & WWF (2014): Conservation Finance Moving beyond donor funding towards an investor-driven approach.

Credit Suisse & McKinsey (2016): Conservation Finance. From Niche to Mainstream: The Building of an Institutional Asset Class.

EVPA (2018): A practical guide to venture philanthropy and social impact investment and additional resources on venture philanthropy. Accessed at: <https://evpa.eu.com/knowledge-centre>.

Global Environment Facility (1998): Evaluation of Experience with Conservation Trust Funds. Accessed at: <https://www.cbd.int/financial/trustfunds/g-gefevaluation.pdf>.

KfW (2020): Materialien zur Entwicklungsfinanzierung (in the process of publication). On impact investing research see, for example, the Global Impact Investing Network website <https://thegiin.org/research>.

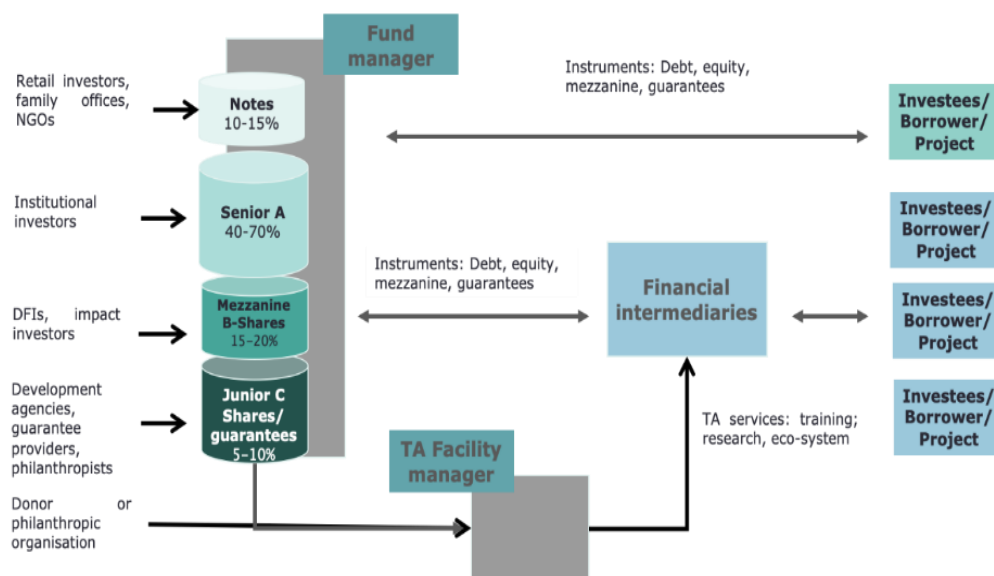
Structured Funds

KEY FACTS

- Structured funds are investment vehicles capitalised by multiple tiers of capital in order to mobilise additional (international and local) private capital providers with differentiated risk-return-impact profiles for sustainable development.
- Structured funds usually make debt or equity investments either to financial intermediaries or directly to projects or enterprises aligned with pre-defined development objectives.
- Structured funds are often combined with a Technical Assistance (TA) facility where the TA is directed to support financial intermediaries, achieve positive development results at end-beneficiary or strengthen the local eco-system.

Basic Structure

A four tiers structured fund model



Source: König, A., Jackson, E. (2016): Private Capital for Sustainable Development.

Scope

- Structured funds are well suited for SDGs areas, sectors and projects that (while potentially being high risk) can generate sufficient revenues to remunerate private investors.
- They target investments in middle income countries (MICs) and low-income countries (LICs) and mobilise private capital from both developed and developing countries.
- Structured funds aim at supporting and complementing local financial markets by filling in financing gaps with respect to products, conditions or borrower segment.
- Structured Funds invest in a granular portfolio generating economies of scale and achieve risk mitigation via diversification.

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Debt, Equity, Guarantee or Grant	Target Group: Bottom of pyramid, microenterprises, SMEs and others	Development Stage: ☐ Concept ☐ Pilot ☒ Proven ODA eligibility: Mixed
Approach: Funds & Facilities	Applicability Type of Countries: ☐ LDC/LIC ☒ LMIC ☒ UMIC	KfW experience: Pioneer
Product for beneficiaries (market): Finance to underserved beneficiaries such as SMEs, agriculture finance, women led business renewable energy and energy efficiency finance as well as local currency solutions, insurance or guarantee products.	Relevance for SDGs: Target SDGs that can generate commercial revenues.	Peer Experience: Multiple, including DFID, USAID, Sida

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Criteria	Assessment	Explanation
Mobilise additional private capital	8 out of 10	The primary intent of a structured fund is to aggregate various sources of finance and to mobilise additional private capital. Structured funds are the most frequent mechanism in innovative finance and blended finance to mobilise commercial capital, even though much of the investment capital in structured funds is still provided by public sector funders and DFIs.
Strengthen local capital markets	8 out of 10	Most structured funds have a positive impact on local capital markets as they introduce new products and services to underserved market segments and fill gaps in the local capital markets through the provision of local currency solutions, long term capital, green bonds or guarantees and insurance products.
Debt Sustainability	6 out of 10	Structured funds that invest equity and/or extend local currency debt or provide loans for lending for improved productivity and innovation have positive impact on national debt sustainability. Many structured funds still deploy their funding in credit lines in hard currency.

MECHANICS & ROLES

How does it work? The core of the structured fund mechanism is altering the fund's risk-return profile to mobilise private, commercial investors to investment(s) they would otherwise not invest in.

A structured fund has multiple tiers of capital. The highest-risk tier, typically subscribed by donors and development agencies, is structured to improve the risk-return of other tiers of capital to a "market-equivalent" investment risk-return profile that mobilises commercial investors to invest. Generally, 'senior' tier investors are repaid first and do not bear losses suffered by the fund until the 'junior' capital has been exhausted. When and how fund proceeds are distributed to different tiers depends on the type of distribution waterfall that the fund establishes to mobilise commercial investors. These are the following characteristics:

- First, commercial investors usually rank senior to donors and sometimes development organisations.
- Second, senior investors usually have preference in the distribution of proceeds.
- Third, senior investors can have shorter maturities than donors and development organisations leading to a faster pay-back and lower risk.

Structured funds invest debt or equity, and can provide guarantees and enter risk participation agreements. Fund investments are usually made directly into projects or companies (e.g. renewable energy projects), or indirectly to those projects/companies through financial intermediaries.

Structured funds are often supported by technical assistance facilities, which improve the development impact of the fund's beneficiaries, e.g., helping them to tackle capacity-related risks and facilitating compliance with donor requirements, such as financial reporting.

Fund investment decisions are made by professional asset managers and investment committees, while good governance of the fund is ensured through board members nominated by different capital providers

Structured funds make the SDGs investible for private investors, thereby mobilising much higher amounts to the SDGs than otherwise possible. The following examples illustrate the approach.

Risk mitigation in a fund making debt investments: The combination of diversification and subordination in a structured fund can improve the risk profile to create a lower-risk investment that can compete successfully with market investments. This type of diversification and subordination is used frequently for debt structured funds.

Enhancing risk-return in a fund making equity investments: The combination of diversification and asymmetrical returns (e.g. subordination) in a structured fund can improve the risk-return profile to create an investment that competes with market investments. Assume a fund will make equity investments in 8-12 medium-sized companies in developing

countries with an expected internal rate of return (IRR) of 10 % – below the industry benchmark of 12.5 %. If the fund is capitalised 80 % by commercial investors that will earn 100 % of the fund's positive IRR and donors/ development organisations that will only earn back its initial investment, the fund's 10 % IRR can be paid to the commercial tier of capital to realise the 12.5 % benchmark. This asymmetrical distribution of proceeds "waterfall" is used almost always in development finance for equity structured funds.

Role of donors in mechanism? Donors typically act as investors into the most junior tier of capital on below-market (concessional) terms. In addition, they provide grants for TA support.

Role of development finance institutions in mechanism? DFIs typically invest in (i) the senior tier of a two-tier fund or (ii) the senior and/or mezzanine tier of a three-tier fund. Their presence within the fund can provide comfort to private investors, assuaging their concerns about investing in a particular fund targeting a specific sector, region or investment theme that would be considered by private investors as high risk. DFIs as part of the investment committees and boards play an important role in (co-) deciding of the investments as well as in supervising the work and the management of the funds.

Role of private investors mechanism? Private investors invest in senior tranches of structured funds. Local private investors are increasingly co-investors in structured funds and their intermediaries' investment deals.

COMPARISON CRITERIA

Impact: Internal evaluations of structured funds identify a strong contribution of structured funds to strengthen and stabilise the financial sector, therefore creating a strong indirect impact to the SDGs and Paris goals.³⁸ More specifically, such benefits include:

- Provision of medium and long-term finance to developing countries – a type of capital which is systemically under-supplied.
- Building up local capacity with local financial institutions and investing in eco-system services help to introduce new financing products and strengthen local markets.
- Structured funds have the capacity to channel capital to hard to reach sectors/investees that would have been unattainable for individual due to size, risk and institutional constraints.

Scalability: The aggregation of funding, the regional and sometimes global scope and the potential to mobilise additional capital from the private sector makes structured funds potentially highly scalable.

Structured funds are usually larger than flat funds and allow for expansion of operations to new regions or countries, portfolio growth and product development in line with market demand as well quick disbursement procedures to investees.

³⁸ PwC (2014): Studie zur Durchführung der Finanziellen Zusammenarbeit mit Regionen (FZR) im Auftrag des BMZ.

Typical funds are of regional coverage (compared to many traditional development finance interventions that are based on bilateral cooperation agreements with individual partner countries), which opens the possibility of addressing regional/cross-country problem and/or problems that are similar in several countries.

As regional vehicles they typically serve as a coordination platform promoting sector dialogue and contribute to harmonising standards throughout the whole region.

Efficiency: Highly efficient as pooled investment vehicle, such funds increase coordination and alignment across various development actors, countries and beyond resulting in significant efficiency gains.

Feasibility: Proven and mature.

Mobilisation: In some areas where markets are underdeveloped, structured funds can mobilise higher amounts of private investment to the SDGs compared to for example, flat funds by creating investment assets comparable to market investments. The funds evaluated have successfully mobilised more than USD 700 million private capital until end 2018.³⁹ The potential to mobilise private capital is a major advantage of structured funds, and has to be assessed for each fund individually. However, the mobilised amount depends very much on the region, sector, age, track record and other factors. Barriers to mobilisation identified include the complexity of structure, selected structural issues, e.g. fully used risk buffers, as well as impact reporting requirements.

Flexibility: High flexibility to mobilise debt or equity investment to impact projects that would otherwise not receive commercial finance.

SUCCESS FACTORS

Identifying relevant investments: As such the “sweet spot” of structured funds lies at the frontier of investments that are not (yet) attractive to private investors due to perceived risk, while in fact being financially viable for structured fund financing using donor support.

Balancing investor objectives: A core challenge of successful structured funds is balancing the different objectives and requirements of the fund itself and its different investors’ general financial and development objectives. Commercial debt investors are focused on risk: they seek to maximise the likelihood of payment of original capital and contracted interest. Commercial equity investors, on the other hand, are return-focused, interested to earn the market-benchmark return with a good possibility of “upside” – further excess returns when investments work well. Donors allocating capital to junior tiers often primarily target development impact objectives, while willing to accept high risk and low returns. Such different objectives of stakeholders in structured funds require clear ex-ante agreement e.g. in shareholder or lending documentation and investment guidelines.

Optimizing additionality, concessionality and leverage:

Structured funds with donor support should only happen when market investment, e.g. via flat funds would not happen.

A considerable challenge is determining minimum concessionality: How to calculate the minimum concessionality required to mobilise private, commercial investments in a structured fund so that scarce developmental capital is not wasted on investment that would have happened anyway?

This requires dialogue with a broad set of (potential) investors to determine which investors could be prepared to invest under different conditions. It also requires attentive fund governance and management entities to avoid seeking more donor funds than required or on more concessional terms than required.

Best practices: Given the success of structured funds over the past 15 years, it is crucial to draw on lessons learned. For example, different governance models and success factors in balancing interests of donors and commercial investors. Where possible, existing structured funds could be used and expanded to or replicated in additional geographies rather than creating new ones. Deploying funds in development and development finance also requires critical analysis on domiciliation of funds (e.g. low-tax jurisdictions).

Donor exit strategy: The development hypothesis is that donor funds are required in a structured fund to bridge the gap between perceived risk and actual risk and mobilise private investment when a flat fund cannot fill a gap in local capital markets as well as available products and services. Good practice should target a (gradual) exit of donor funding once gaps have been narrowed and structured fund has demonstrated viability without donor funding.

Overall: Combining these factors, a successful structured fund must build on best practices to unite the different interests of parties. This requires investment professionals who are close to targeted markets, well aware of private investor criteria while fully aligned with development objectives. It also requires careful balancing of shareholder objectives in the governance entities of each fund, particularly by dedicated representatives of development finance institutions with close donor relations.

TRENDS TO-DATE

- The OECD Blended Finance Funds and Facilities Report summarises USD 18.7 billion of Assets Under Management in funds (around USD 13.5 billion structured and USD 5.2 billion flat funds), with 72 % managed by commercial fund managers. 42 % is concessional development finance, 32 % non-concessional development finance and 26 % commercial finance. Governments own 34 % of the funds.
- With the establishment of the European Fund for Southern Europe (EFSE) in 2005, which has become one of the largest funds in development finance with EUR 1 billion Assets Under Management, German FC has been instrumental in developing the blueprint for the design of layered structured funds that now form the basis of most structured funds set up by German Development Cooperation as well as by development agencies and impact investors internationally.

³⁹ OECD (2019): Blended Finance Funds and Facilities 2018 Report.

- While the fundamental structure, set up and processes remain similar, there have been many innovations since the establishment of the first funds in 2005:

New investors: In the early days structured funds investors included mostly DFIs, impact investors and value-based banks, whereas the most recent investors include institutional investors as well as corporate investors (e.g. Bertelsmann, L'Oréal, Orange and others in REFFA fund). Furthermore, some funds have been set up with a matching fund of funds provision to mobilise local investors, leading to a double leverage effect in the development finance value chain (e.g. AfricaGrow).

FX risk hedging: A L-Share in structured funds that provides for a dedicated share class and enables funds to provide lending in local currency, thus safeguarding borrowers against the vagaries of exchange rate fluctuations.

Deployment: Traditionally, structured funds deployed the capital through credit to local financial institutions that on-lend to end customers (e.g. households, small companies or projects). Increasingly structured funds support direct equity investments (e.g. SANAD Equity Fund, AfricaGrow, Partech) or the deployment for special financing solutions (e.g. African Guarantee Fund (AGF) and African Local Currency Bond Fund ALCBF).

Replicability to new sectors and geographies: Originally much of the funding was provided to the financial services industry and energy sector whereas more recent funds focused on other sectors including health such as the Global Health investment Fund, education finance such as REFFA and conservation finance, e.g. the BMZ/KfW supported eco-business fund or the US based Athelia Climate Fund. The eco-business fund is also an example for a mechanism that is being replicated across continents (from LATAM to Africa).

CASE STUDIES

AfricaGrow

AfricaGrow is a fund of funds that looks to have a catalytic effect on SMEs and start-ups that operate primarily in countries associated with the G20 Compact with Africa (CwA), thereby supporting jobs and incomes across the region. As an anchor investor, the fund looks to allow partnering Venture Capital and Private Equity funds to raise capital more easily, and has therefore been established as a structured fund, with KfW providing a first-loss tranche on the fund-of-fund level, so as to leverage additional funding from other investors for the emerging African Venture Capital and Private Equity financing sector.

Read more here: <https://abidjan.diplo.de/>

ECO Business Fund

The ECO Business Fund, initiated by KfW Development Bank, Conservation International, and Finance in Motion in 2014, looks to promote business and consumption practices supporting biodiversity conservation and sustainable natural resource use by providing financing to intermediaries or by directly investing in businesses, targeting Latin America and replicated in Sub-Saharan Africa.

It has a layered capital structure, in which public investors and donors provide a concessionary risk cushion that facilitates the participation of private institutional investors.

Read more here: <https://www.ecobusiness.fund/en/>

InsuResilience Investment Fund

The InsuResilience Investment Fund, formerly known as the Climate Insurance Fund, is an initiative created by KfW on behalf of the German Ministry for Economic Cooperation and Development (BMZ). The fund looks to promote climate change adaptation by improving access to and the use of insurance in developing countries, reducing the vulnerability of MSMEs and low-income households to extreme weather events.

It operates as a public-private partnership. Since July 2017, private investors have been able to commit to two separately investible sub-funds making Private Debt and Private Equity investments. The fund is also accompanied by a technical assistance component, funded by BMZ.

Read more here: <https://www.insuresilienceinvestment.fund/>

Green for Growth Fund

The Green for Growth Fund (GGF), initiated by the European Investment Bank and KfW Development Bank in 2009, looks to promote energy efficiency and renewable energy in Southeast Europe, the Caucasus, the Middle East and North Africa, by providing financing to businesses and households through partnerships with financial institutions and through direct financing.

It is structured as a public-private partnership with a layered risk-return structure, allowing investors with different risk return profiles to invest in different share and note tiers within the fund.

Read more here:

<https://www.ggf.lu/about-green-for-growth-fund>

The European Fund for Southeast Europe

The European Fund for Southeast Europe, initiated by KfW with the support of the German Ministry for Economic Cooperation and Development (BMZ) and the European Commission, looks to sustainably provide additional development finance to MSMEs and private households via qualified financial institutions.

Its public-private partnership approach enables it to mobilise funding from private institutional investors in order to supplement international public donor funding for development finance, multiplying the impact of budget funds in promoting responsible financial sector development and financial inclusion in its target countries.

Read more here: <https://www.efse.lu/>

OVERVIEW OF KfW PORTFOLIO

KfW is a pioneer in structured funds and has an extensive history of participating in structured funds through equity participation, funded with budget and own funds. Examples range from the European Fund for Southeast Europe (EFSE), the Green for Growth Fund (GGF), initiated by the European Investment Bank and KfW in 2009, the SANAD Fund for MSME, the InsuResilience Investment Fund, an initiative originally launched by KfW in 2015, the Climate Insurance Fund as well as the Eco-business fund. Much of the investments have been in the microfinance, SME as well renewable energy and energy efficiency sectors. The Regional Education Finance Fund for Africa (REFFA) is another pioneering structured debt fund as it provides loans for education finance.

MOST RELEVANT ADDITIONAL RESOURCES

Bandura, R. & Ramanujam, S. (2019): Innovations in Guarantees for Development.

Convergence (2019): The State of Blended Finance 2019 Report. Accessed at: <https://www.convergence.finance/resource/13VZmRUtiK96hgAvUPk4rt/view>.

Fabozzi, F. et al. (2006): Introduction to Structured Finance Market. New Jersey.

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OECD (2018): Making Blended Finance Work for the Sustainable Development Goals. Accessed at: https://assets.ctfassets.net/4cgqlwde6gy0/77K8guUYEwekiealWmiSqm/8a2472bac649afc93e8558200c994ec/OECD_Making_Blended_Finance_Work_2018.pdf.

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PwC (2014): Studie zur Durchführung der Finanziellen Zusammenarbeit mit Regionen (FZR) im Auftrag des BMZ.

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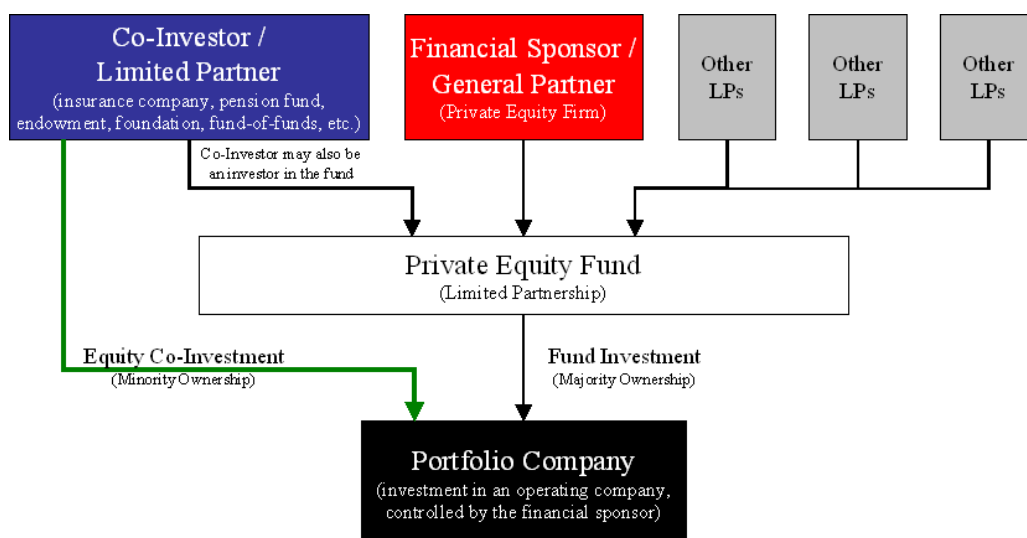
Flat (unstructured) Funds

KEY FACTS

- Flat funds are pools of developmental and commercial capital that provides financing to commercial projects, companies and financial institutions, with the expectation of earning a target internal rate of return for its investors. Capital is subscribed concurrently by all funders, invested pro rata and repaid pro rata. This stands in contrast to structured funds with differentiated capital tiers offering different risk-returns to funders.
- Flat funds are used to provide equity, which is systemically under-supplied in developing countries but particularly important in Upper Middle-Income Countries (with BBB and BB sovereign ratings) than Low-Income Countries (with B and CCC ratings) with an emerging start up scene.⁴⁰
- Flat funds usually invest in either debt or equity investments, and can also issue guarantees or enter risk sharing agreements.
- Flat funds are deployed in development finance when private investors can be mobilised on market terms with no need for concessionality but where engagement by DFI and development banks means a strong signal and provides comfort to co-investors. When full mobilisation at market terms is not achievable, development finance deploys structured funds.

Basic Structure

Typical Flat Fund Structure to Invest in Development Projects



Source: Somil Bhargava (2014): Fund Structure of Private Equity and Venture Capitalists.

Scope

- Flat funds focus on revenue-generating, lower-risk SDGs, sectors and projects. They typically target MICs and mobilise private capital from developed and developing countries. LICs and LDCs can benefit in general through a small portion of a fund allocation as opposed to a fund being dedicated to them.

⁴⁰ For example, around 95 % of MDB and DFI investment in flat funds are in Middle-Income Countries.

- Flat funds cater different investment strategies, e.g. infrastructure, growth equity and venture capital, typically providing long-term financing in illiquid assets not available from banks.
- Some flat funds include DFIs and development banks whereas others consist only of commercial investors.

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Debt, Equity, Grants and Guarantees	Target Group: High quality projects, companies and financing institutions Investors: Equity investors into private equity funds and debt investors into private credit funds	Development Stage: ☐ Concept ☐ Pilot ☒ Proven ODA eligibility: Mixed
Approach: Funds & Facilities	Applicability Type of Countries: ☒ LDC/LIC ☒ LMIC ☒ UMIC	KfW experience: Yes
Product for beneficiaries / local market: Venture capital finance	Relevance for SDGs: In particular (but not exclusively), SDGs 1, 8, 9, 10, and 13	Peer Experience: Multiple, including MDBs, DFIs, e.g. DFID/CDC

Addis Ababa Action Agenda Impact Areas

Criteria	Assessment	Explanation
Mobilise additional private capital	7 out of 10	Flat funds are deployed in innovative finance to pool and mobilise local commercial capital.
Strengthen local capital markets	3 out of 10	Most flat funds have no / limited impact on local capital markets. But a flat fund can be designed with the aim of improving local capital markets, such as by providing local currency financing and/or risk sharing with local financial institutions or if set up as a funds of fund providing matching funds or co-investing in local (VC) funds.
Debt Sustainability	8 out of 10	Flat funds that invest equity (or extend local currency debt) have a positive impact on public debt sustainability since they displace FX debt funding of the projects. As of April 2020, most flat funds make equity investments,

MECHANICS & ROLES

How does it work? Almost all flat funds have a finite life of 10-12 years – permanent, perpetual funds are rare. Investors subscribe capital to the fund, the fund manager invests the capital for a typical 5-year investment period and then the fund manager converts those investments to cash in the remaining period and aims to return all capital (plus returns) to the investor by the end of the fund's life.

A flat fund has a single class (tier) of capital. Capital is subscribed and distributions (e.g. repayments) are allocated equally to all funders.

Flat funds benefit from (i) portfolio risk diversification, (ii) economies of scale achieved by lower transaction costs and (iii) the expertise of professional fund managers.

Flat funds are almost always capitalised by the same financial instrument that is deployed on the asset side – i.e. equity capital to fund equity investments; debt capital for debt investments.

What are the distinguishing factors? The main differences are (i) form or capitalisation, (ii) type of investments and (iii) investment strategy. Flat funds can be funded by debt or equity and can make debt or equity investments (and sometimes guarantees). Flat funds invest on commercial terms. Investors target market or above-market returns. Flat funds have the ability to attract commercial investors by taking relatively low-risk investment strategies in developing countries. Returns vary depending on factors like investment type (e.g. debt or equity), investment strategy and development impact objectives.

Flat funds typically have an investment strategy aligned to a sector: for example infrastructure, SMEs, tech entrepreneurship, financial institutions or venture capital.

Role of donors in mechanism? Donors often participate outside the capital structure of a flat fund, for example providing grants, technical assistance, or concessional loans to the projects invested in by the fund or strengthening the local eco-system.

Role of development finance institutions in this mechanism? DFIs are frequent investors in flat funds. DFIs can provide a demonstration effect to private investors, assuaging their concerns about investing in a fund targeting a specific investment strategy, sector region that could be considered by private investors to be high risk. When DFIs subscribe to a flat fund, they usually serve on investment committees and boards.

Role of private investors in this mechanism? Private investors manage flat funds (i.e., as fund managers or general partners) and invest in (i.e., as limited partners) flat funds.

COMPARISON CRITERIA

Impact: Flat funds deliver impact to SDGs and sectors that are financeable by the private sector with usually no need for concessionality. However, Flat funds can include DFIs as investors (limited partners), typically when DFI investment is required to send a positive signal to mobilise market co-investment, or when private investor commitments are not enough to achieve critical mass for successful first close. When full mobilization at market terms is not achievable, development finance deploys structured funds.

A strong benefit of funds is their long-term investment horizon, typically 10-12 years. Flat funds can channel long-term risk capital to sectors/investees regarded as illiquid assets, like infrastructure and industrial capacity investment, where public capital market flows are not present or insufficient.

Scalability: Highly scalable in relatively low risk sectors/investments and developing countries. Equity flat funds generally invest in countries with low country risk (e.g. Upper Middle Income Countries – rarely in Low Income Countries). Investors also prefer countries with large economies where investment exit risk is lessened. Flat funds are usually smaller than structured funds.

Efficiency: The flat fund model can be highly efficient for development organisations that can catalyze the model to leverage economies of scale to target multiple small-scale development projects or financing deals at once. For example, funds usually typically invest in 8-30 projects or enterprise.

Development organisations, through the fund model, gain access to private sector tools, incentive mechanisms to achieve desired development outcomes, private sector co-financing, a greater range of managerial talent for the implementation of development programmes, and a long-term focus on financial and development sustainability.⁴¹

Feasibility: Proven and mature.

Mobilisation: Flat funds should be preferred over structured funds, when possible, since the financing is a more market oriented solution. Flat funds can mobilise private commercial investors if they have commensurate high expected rates of return – matching or exceeding market benchmarks.

Flexibility: High flexibility to mobilise debt or equity investment to impact projects that would otherwise not receive commercial finance.

SUCCESS FACTORS

Identifying relevant investments: Flat funds are intended for investment strategies that can attract commercial, private investors into risk-return opportunities that match or exceed what's available in developed countries – which limits the breadth of countries, sectors and SDGs. This is easier to achieve in middle-income countries, large economies and

⁴¹ Lion's Head Global Partners (2013): Low Carbon Study Fund 203134-101. Fund Management/Administrator Impacts on Investment and Challenge Funds' Value for Money, Efficiency and Results.

conventional investments (e.g. investing in large companies versus SMEs).

Consensus on investor objectives: Flat funds require a fund manager and investors to align on a fund's investment strategy and objectives. Infrastructure, financial institutions and mid-caps are frequent targets.

Critical mass of “investible” investments: Flat funds can struggle to demonstrate a pipeline and portfolio of investments in developing countries that will generate a gross and net return to investors that meet or exceed market benchmarks. Technical assistance can help to identify more investible projects.

Flat funds making debt investments face high risk and are attractive only to a sub-set of investors. The 145 developing countries have a median sovereign rating of S&P-equivalent “B”. With private borrowers having higher risk implied ratings than sovereign borrowers, most debt funds would model high probabilities of default and expected losses. This risk profile will discourage most investors and will limit prospective investors to those with a high appetite for alternative assets, especially illiquid credit.

Flat funds making equity investments usually have a finite and limited universe of prospective investments.

Developing countries have high levels of economic informality, which limits conventional equity investments. Also, exit risk is significantly higher in developing countries compared to developed countries. The universe of viable and feasible equity investments in developing countries can be very limited.

Currency risk is high in developing countries. Commercial private investors are usually interested in expected returns in hard currencies. This often leads funds to make debt investments in hard currency – exposing the borrower to high currency risk and the fund to high credit risk. Similarly, equity investment in local currency exposes investors to high currency risk. Given that funds can have lives of 10-12 years, a typical fund can expect to experience 1-2 episodes of high local currency depreciation and general high volatility.

Fund management experience can be limited. Many investors are reluctant to invest in first-time fund managers and seek top-name fund managers. Given the complexities of investing in developing countries relative to developed countries, it can be difficult for first-time fund managers to compete when fundraising in an increasingly competitive environment. All brand-name fund managers are much less present in developing countries.

TRENDS TO-DATE

– Many independently-managed flat funds focused on developing countries have emerged over the course of the last decade, enabling development organisations to tap into the private sector to help deliver development outcomes more efficiently, and providing private investors with access to rapidly growing economies in an era of sluggish growth in developed markets.⁴²

– Two types of flat funds have been raised to date: (i) those including DFIs and (ii) those not including DFIs.

The funds that include DFI capital almost always provide equity investments. The 2019 DFI Mobilisation Report identifies total mobilisation of USD 70 billion to MICs and LICs. A reasonable estimate is that 4 % of this amount would be in flat funds – around USD 2.8 billion of mobilisation.

– The funds that do not include DFIs have also mostly been equity funds, but increasingly also private debt funds.

– Emerging Markets Private Equity Association reports that, within emerging markets, around 40 equity funds (raising around USD 7 billion) and 50 debt funds (raising around USD 9 billion) closed in 2018-19.

– The OECD Blended Finance Funds and Facilities Report summarises USD 18.7 billion in funds (around USD 5.2 billion in flat funds and USD 13.5 billion in structured funds), with 72 % managed by commercial fund managers.

– **Focus on impact of investees:** While much of the focus of flat fund investments are in tech focused companies, increasingly funds explicitly target enterprises and start ups that are sustainable, offer inclusive or social business models that – beyond generating employment and contributing to tax income and economic growth – have sustainable business models, offer product and services that specifically address the needs of disadvantaged communities or operate in rural areas, include the Base of the Pyramid in their value chains (inclusive or social enterprises).

⁴² Lion's Head Global Partners (2013).

CASE STUDIES

Invera Private Equity Fund

Invera Equity Partners is a private equity fund manager that will focus on developing private companies in Croatia, Slovenia, Bosnia and Herzegovina, Serbia, and Montenegro with equity and equity-related investments, taking a broad sectoral focus, including food and beverages, manufacturing and industrials, and information and communication technologies. It looks to mobilise local institutional investors and has received equity commitments from investors such as the European Bank for Reconstruction & Development (EBRD).

Read more here: <https://www.ebrd.com/>

Emerging Capital Partners Africa Fund IV

ECP Africa Fund IV is a Mauritius-domiciled private equity fund focused on Africa, which announced its final close in November 2018, having received commitments of over USD 640 million from a broad range of investors based in Africa, Europe, and North America, amongst whom African pension funds and insurance companies were well represented. The fund targets investments in Africa that meet basic consumer needs or vital business requirements, focusing on financial services, consumer goods, telecommunications & ICT, and infrastructure and logistics.

Read more here: <https://www.ecpinvestments.com/>

Africinvest FIVE

FIVE stands for Financial Inclusion Vehicle. The number five represents the aspiration of AfricInvest and FIVE's investors to contribute to achieving universal access to financial services in Africa. As the current level of banking penetration on the continent is a mere 20%, achieving universal access will require a fivefold increase. Digital transformation is one of the key drivers toward the universal access and as such, FIVE seeks to enhance the digital strategies of its portfolio companies. FIVE has been designed to fully align the interests of investors and the manager. Its evergreen structure enables it to support its portfolio companies in achieving meaningful strategic transformations. Moreover, its permanent capital structure provides regulators and partners with the assurance that the fund has the capacity to make longer-term commitments. Appropriate liquidity provisions have been incorporated to allow investors to adjust their exposure to FIVE.

Read more here: <https://www.africinvest.com/>

Partech Africa Fund

Partech Africa Fund, which announced a final close at EUR 125 million (USD 143 million) in 2019, is the largest VC fund dedicated to technology start-ups in Africa, having been backed by a range of financial institutions (including KfW), corporate partners, and entrepreneurs. It is positioned to participate in series A and B financing rounds in innovative start-ups altering how technology is being used in a range of sectors, including education, finance, and energy.

Read more here: <https://partechpartners.com/>

OVERVIEW OF KfW PORTFOLIO

KfW is increasingly engaging in flat (venture capital) funds or fund of funds including as anchor investor. Other examples include the Omnivore (India) funds, Partech. Some fund investments in equity flat funds are made by the Germany's private sector development finance institution (DEG) which has a portfolio of more than 130 fund investments (www.deginvest.de).

MOST RELEVANT ADDITIONAL RESOURCES

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Emerging Markets Private Equity Association (2019): Private Credit Solutions: A Closer Look at the Opportunity in Emerging Markets. Accessed at:

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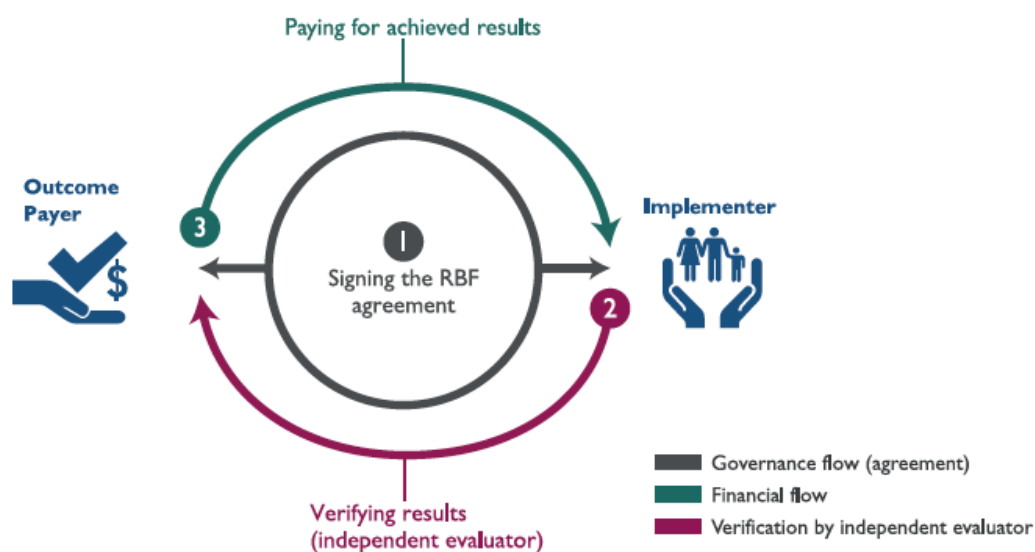
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Results-Based Finance

KEY FACTS

- Results-Based Finance (RBF) mechanisms are defined as financing arrangements where payments by the payer or principal (e.g. donor, outcome funder or commissioner) to the payee or agent (e.g. implementer, service provider or incentivised agent) are contingent upon the achievement of pre-defined and/or verified results (i.e. outputs, outcome or impact) rather than payments for activities or inputs.
- RBF mechanisms can be used to align the goals of the principal with those of the agent by setting a monetary incentive for the agent to pursue the developmental goal. RBF can also be used as a “lean” financing instrument with low transaction costs for more mature country contexts with strong institutional capacities.
- RBF is suitable for technically simple measures that can be carried out in a fairly standardised way. The recipient should be familiar with the implementation of this type of measure and have a positive track record in implementing similar measures on its own.
- RBF is a modern funding mechanism. They encourage a relationship between funder and agent and overcome a traditional “recipient mentality”. RBFs have the benefit for donors that payments are only made if the results are achieved and verified. Most RBFs require pre-financing – agents must have the capacity to bear some or all of the risk.
- Outcome-based finance structures (OBF) (see separate fact sheet) differ from many traditional RBFs as donors place a value to the impact generated, and focus on outcomes rather than outputs.
- Policy Based Finance (PBF) (see separate fact sheet) often use similar financing mechanisms to RBFs, e.g. (budget) finance linked to performance. However, contrary to most RBFs, PBFs seek to improve the framework conditions and work at the policy level (e.g. water sector reform program) thus resulting in an indirect impact on the SDGs or Paris Goals.

Basic RBF mechanism



Source: Instiglio (2017): A practitioner guide to RBF.

Scope

- RBFs are used mostly in sectors or activities that are not yet commercially viable and **require concessional financing to make them attractive to commercial investors** (e.g. eco-system services in natural resources and biodiversity, project development, innovations proposed by early stage social start-ups or policy reforms).
- RBFs are mostly used in the **social sectors** (e.g. health and education), natural resources, conservation and climate sectors.
- **They are appropriate for LICs and MICs**, although they are easier to implement in MICs where the capacity of agents and access to independent institutions are available to identify and measure consistently and sustainably the achievement of contracted results, sometimes relative to a benchmark.
- **RBF mechanisms encompass a wide field** and can be distinguished by a number of factors including the agent they seek to incentivise as shown in the table below:

RBF mechanism according to incentivised agent

Who is incentivised?	RBF categorisation	Description	Examples
Performance based aid & transfers			
National Government	Performance-based grants or loan	Tranches are disbursed upon achievement of predefined results on government services or sector reforms.	World Bank Programme for Results
National Government	Performance based debt buy down	A third-party donor (such as a private foundation) pays down part of a loan (by softening the terms of the loan or reducing the principal outstanding) for the borrowing country on behalf of the lending organisation if the country meets certain development targets. The loan buy down creates fiscal room-for-manoeuver which the borrower can (or is mandated to) use to fund domestic development projects.	Various buy downs by Bill & Melinda Gates Foundation, DFID and others mostly in health and education sector
Local or Regional Government	Performance based transfers / disbursements	Payment from donors or national governments to local governments are at least partly based on performance including in the efficiency of a services, system or government activity.	E.g. local government RBFs such as Plan Nacer, Argentina/some of the REDD+ mechanism
Performance based contracts & incentives			
Service Provider (NGO, private or public agencies)	Output-Based Aid	A service delivery is contracted out to a public or private provider which receives a subsidy to complement or replace required user contribution if certain results are achieved. Used to enhance access to and delivery of basic infrastructure and social services for the poor.	E.g. subsidy for additional connection
Service Provider (NGO, private or public agencies)	Performance based financing	A fee-for-quality-service payment to public or private provider.	E.g. supply side of voucher programmes
Service Provider (NGO, private or public agencies)	Do no harm incentives	A service provider is paid if he can prevent others from harmful behaviour.	E.g. deforestation programmes REDD / Forest bonds
(Corporate) private sector	Prizes / Challenges	An arrangement where prizes (financial rewards) are awarded, usually through an open and competitive process, to one or more competitors that are successful at accomplishing a pre-specified desired result such as an innovative approach to addressing a persistent development challenge.	E.g. AgResults

Who is incentivised?	RBF categorisation	Description	Examples
Outcome based finance			
Investor (foundation, impact investor) / implementer	Development impact bond / Pay for success schemes	An investor provides upfront working capital to a service provider and is paid (plus a return) by the outcome funder (e.g. donor agency) if or to the extent outcomes have been achieved.	E.g. Educate Girls, West Bank & Gaza DIB
Impact enterprise/Investor	Social Impact Incentives	Financial solutions for impact enterprises that directly link financial rewards that is paid by an outcome funder on the achievement of positive social outcomes.	E.g. Roots of Impact/SDC
Social business / investor	Social success note	A social business accesses investment capital upfront from an investor, who receives a return on investment by an outcome funder if impact is achieved, and who is paid back the principal by the social business.	E.g. Rockefeller / Yunus Social success note in Uganda
End beneficiary finance			
Households and individuals	Conditional cash transfer	CCT make financial support conditional upon the receivers' actions and money is only transferred if person meets certain criteria (e.g. enrolling children into public schools, getting regular check-ups at the doctor's office, receiving vaccination).	E.g. Bolsa Familia Brazil / demand side of voucher programmes
Households and individuals	Performance-Based Scholarships	PBS provide incentives for good academic performance while reducing the financial burden on low income students.	E.g. Education finance facility

Source: Based on Instiglio (2018): A guide for effective results-based financing strategies, Global Partnership on Output Based Aid at the World Bank.

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Grant	Applicability Target Group: Governments, projects and financial institutions Investors: Private investors can be mobilised by additional revenues from achieving results.	Development Stage: ☐ Concept ☐ Pilot ☒ Proven
Approach. Result-based finance	Applicability Type of Countries: ☒ LDC/LIC ☒ LMIC ☒ UMIC	ODA eligibility: Yes
Product for beneficiaries (market): Result based finance grants and innoFins mechanism	Relevance for SDGs: Social sectors, like SDG 3, 4, 5, 12, 14, 15 and 16	KfW experience: Considerable experience in parts of RBF (see 'Overview of KfW Portfolio' section)
KfW experience: Yes – see 'Overview of KfW Portfolio' section		Peer Experience: World Bank Global Partnership for Results-Based Approaches is a global leader operating for 15 years. UK Government in developed countries.

Addis Ababa Action Agenda Impact Areas

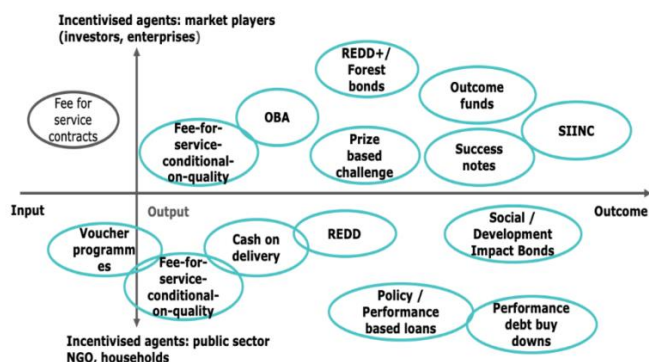
Criteria	Assessment	Explanation
Mobilise additional private capital	5 out of 10	RBFs generally do not directly target the mobilisation of private capital, although they can be designed to bring in private investors through revenue enhancement methods (e.g. Social Impact Incentives SIINCs). See Outcome Based Finance Factsheet for deeper discussion.
Strengthen local capital markets	3 out of 10	RBFs are generally not used to strengthen local capital markets (unless in some cases of carbon credits, although they can be designed to achieve this result).
Debt Sustainability	7 out of 10	RBFs are grants, and therefore provide funding for development that is not repayable.

MECHANICS & ROLES

How does it work? Payments from outcome funders to implementers and/or incentivised agents are contingent upon the achievement of pre-defined and verified results i.e. outputs, outcomes or impacts. RBFs are broader than Outcomes-Based Finance mechanisms – see figure below.

Results-based finance is a potential way to improve the efficiency and effectiveness of development finance, but also has the ability to mobilise private capital providers through revenue enhancement rather than risk mitigation methods.

RBF mechanisms according to incentivised agent and outcome orientation



Source: Koenig, A. et al, 2019: Innovative Development Finance – stocktaking report (internal).

What are the distinguishing factors? There are many forms of RBFs, differing by key design aspects listed below:

- **Outcome orientation:** Most RBF mechanisms focus on outputs (e.g. additional number of connections established under output-based aid RBFs, or the rainforest area that was protected from deforestation), whereas some focus on outcomes aimed at target group (e.g. improved service delivery of water and electricity services in low income communities). Payment triggers often include a combination of outputs (e.g. the number of vaccinations performed, or schools built) and outcome indicators (e.g. the number of qualified graduates or tons of CO2 avoided from “reduced emissions from deforestation and forest degradation” in REDD+).
- **Incentivised agent:** Performance-based aid mechanisms such as policy-based loans or grants or debt buy-downs mostly target national, regional or local government agencies. With performance contracts, the incentivised agent can be a public agency, a local community-based organisation or international NGO, a private service provider, a public or private water or electricity company (e.g. in some output-based aid contracts). Social Impact Incentive mechanisms (SIINCs) and Social Success Notes target social enterprises or social businesses and investors (see earlier table).
- **Timing of funding provided:** Traditional RBF contracts provide only ex-post funding upon verified delivery of results, sometimes leaving implementers without necessary capital to invest in measures and reducing their capacity to achieve results. Funders therefore increasingly allow for advance payments, or the provision of non-performance-based grants

or separate funding from additional donors that focuses on strengthening implementers’ operational capacity.

- **Spread of performance and financial risk:** Early forms of RBF had a 100% allocation of risk to either the service provider or the investors (e.g. the first social impact bonds). Recently, risks have been allocated more evenly across all parties and incentivised agents can partly cover their costs or principal. They can even generate additional returns if they outperform.
- **Mobilisation of private sector capital:** RBFs can be set up to mobilise additional private capital. Alternately, investors may find investment in a social enterprise more attractive as their impact has been monetised. Furthermore, some RBF structures incentivise private organisations to provide good quality services to low income communities that would otherwise not be served (e.g. voucher schemes, output-based aid structures).
- **Pricing in RBF:** RBF contracts size payments based on a number of factors including: the estimated cost of delivering an intervention at the required quality and quantity (which could be identified after a competitive process); the payments that are required to close a financial viability gap for a private service provider or investor (e.g. OBA); the negative impact that is prevented (e.g. carbon emission prevented). Some outcome-based financing structures only price the positive impact / outcome that is generated, rather than paying for the full cost of service provision, where income can be earned through market-based interventions (e.g. SIINC payments).

Role of donors in mechanism? Donors are usually the payers or outcome funders of RBFs.

Role of development finance institutions in mechanism?

Under some RBFs, private sector DFIs can come in as the investor. DFIs can also issue and/or promote innovative financing mechanisms that are linked to RBFs (e.g. forest bonds).

Role of private investors in mechanism? Investors can invest in impact bonds and finance social enterprises in SIINCs and SSNs.

COMPARISON CRITERIA

Impact: RBF mechanisms align interests (and thus the targeted development results) between funders, implementers and beneficiaries. This financially incentivises the implementer for improving the welfare of the beneficiary rather than for providing inputs that may or may not lead to better development outcomes.

Scalability: RBF mechanisms are potentially scalable, depending on the ability of the funded operation to effectively scale their operations and replicate impact/results.

Effectiveness/Efficiency: RBF requires investing in results measurement and management data systems and regularly tracking results. This data-driven insight is important for evidence-based funding and result-based adaptive implementation management.

Feasibility: Proven and mature.

Flexibility: Implementers have more flexibility to react to changing external circumstances and to experiment with new delivery strategies, leading to increased innovation.

SUCCESS FACTORS

Size: Although RBFs have demonstrated the benefit of donor funds paying for results as opposed to inputs, many RBF projects remain small. In view of the high design, monitoring and verification costs, a minimum project size is applicable for RBFs to be cost effective.

Choice of design features: The success of RBF relies heavily on the decisions on RBF design features to optimise the use of incentives, in particular the setting of payment triggers, pricing of performance, the spread of financial and performance risk.

Need for upfront working capital: The agent often requires upfront working capital to invest/execute well prior to the verification of results.

TRENDS TO-DATE

- The **amount of funding allocated** to result based financing (RBF) has increased significantly in the last decade. This is in line with the growing attention of the international development finance community to demonstrate

effectiveness, and the need to use scarce funding resources more efficiently and effectively for greater outcomes.

- **Donor attention has shifted from project outputs to outcomes** in recent outcome-based or impact-linked structures.
- Important **milestones** include the start of the Global Partnership on Output-Based Aid (GPOBA) in 2001, the launch of the World Bank's Programme for Results in 2011, and the launch of the first Development Impact Bond in 2015.
- RBF mechanisms are applied in a **variety of sectors** depending on the RBF category applied. For example, most of the World Bank Programmes for Results are in the education sector and in public administration, whereas Output-Based Aid has been applied most commonly in energy and the water and sanitation sector. Performance based financing has been almost exclusively applied to the health sector
- **World Bank GPRBA** is establishing a multi-donor "Outcomes Fund" trust fund to aggregate donors' contributions into a single fund, and thereby overcome challenges to success.
- UK DFID has led the **Impact Bond Working Group**, which is currently evaluating the benefit of a club of outcome funders that would collaborate to scale and increase the efficiency of RBF.

CASE STUDIES

Global Energy Transfer Feed-in Tariffs Programme (GET FiT)

GET FiT started in Uganda with financing and support by the German government and is now being upscaled to other countries in the region and beyond. The programme is designed to address the investment barriers in small renewable energy independent power projects by providing project owners additional cash flow during the early debt repayment periods as a top up to the existing regulated feed in tariffs. Half of the GET FiT premium is paid out at start on the Commercial Operations Date (COD) and the other 50 % is disbursed during the first 5 years of operation according to actual amounts of energy provided. In addition, the programme has a Partial Risk Guarantee (PRG) Facility which is deployed in three complementary risk-mitigating components.

Read more here:

<https://www.kfw-entwicklungsbank.de/>

Ghana – Output-based Aid

Alongside the Greater Accra Metropolitan Area Water and Sanitation Project, launched by the Government of Ghana and the World Bank in 2013 to improve the water distribution network and waste collection and treatment services, output-based aid (OBA) was deployed in the form of a USD 4.85 million grant to improve the affordability of household sanitation in low-income communities.

The grant provided a partial subsidy to private toilet suppliers to cover 50 % of the total cost for a standalone toilet with a digester. The grant was only paid after toilet installations had been inspected and verified. The subsidy was later raised to 70 % in low-income communities, by-laws requiring households to have toilets were more strictly enforced so as to raise demand and supply for financing toilets. As of June 2018, 7,685 toilets had been installed in low-income communities as a result of this project.

Read more here: <https://www.gprba.org/>

Pilot Auction Facility for Methane and Climate Change Mitigation (PAF)

The World Bank's Pilot Auction Facility for Methane and Climate Change Mitigation (PAF), with contributions from Germany, Sweden, Switzerland and the US, disburses results-based funds in the form of put options for carbon credits to reduce the risk associated with investing in mitigation. These options provide holders with the right, but not the obligation, to sell carbon credits to the PAF at a predetermined price. Option holders do not receive upfront financing from the PAF. The PAF requires option holders to pay an upfront premium, thereby ensuring that the latter are serious participants capable of delivering results.

Read more here:

<https://www.pilotauctionfacility.org/>

REDD Early Movers (REM)

The REDD Early Movers (REM) funded and supported by the German government, grant financed by KfW and implemented with technical assistance from GIZ rewards pioneers of forest protection and climate change mitigation. The programme targets countries or regions that have already taken measures to protect forests. It provides performance-based payments for verified emission reductions from deforestation prevention, thereby managing REDD+ in line with the decisions agreed to in the context of the United Nations Framework Convention on Climate Change (UNFCCC). So far, the REM programme has been implemented in three countries: in the Brazilian states of Acre and Mato Grosso, in Colombia and in Ecuador.

Read more:

<https://www.kfw-entwicklungsbank.de/>

OVERVIEW OF KFW PORTFOLIO

In German financial cooperation, RBF has increased significantly since 2016. KfW Development Bank is currently supporting 40 ongoing RBF projects on behalf of the German federal government, 13 of which are purely results-based, with 27 containing one or more results-based components. These projects are worth EUR 916 million in value, EUR 735 million of which is disbursed based on results. Most of these RBF projects are in Asia, followed by Sub-Saharan Africa, and in the energy sector, followed by education and health.

KfW has a strong reputation for its engagement in result-based climate finance (including several projects under the UNFCCC REDD mechanism such as the REDD Early Movers Programme), the Brazilian Amazon Fund as well as Get FIT) as well as voucher programmes in particular in the health sector (e.g. Yemen, Kenya, Tanzania, Cambodia, Pakistan).

MOST RELEVANT ADDITIONAL RESOURCES

Angelsen, A. et al. (2018): Transforming REDD+ – lessons and new directions, Center for International Forestry Research (CIFOR). Accessed at: <https://www.cifor.org/knowledge/publication/7045>.

Credit Suisse & WWF (2014): Conservation Finance Moving beyond donor funding towards an investor-driven approach.

Forest Resilience Bond (2017): Forest Resilience Bond. Accessed at: <https://www.forestresiliencebond.com/roadmap-report/forest-resilience-bond>.

Grittner, A. (2013). Results-based Financing: Evidence from performance-based financing in the health sector. Accessed at: <https://www.oecd.org/development/peer-reviews/Results-based-financing.pdf>.

Instiglio (2017): A practitioner's guide to RBF. Accessed at: <https://www.instiglio.org/en/publications-and-resources/>.

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- USAID, Palladium (2017): Pay for results in development: a primer for practitioners. Accessed at: <https://www.usaid.gov/documents/1865/pay-results-development>.
- World Bank, Frankfurt School of Finance and Management (2017): Results-Based Climate Finance in Practice : Delivering Climate Finance for Low-Carbon Development. Accessed at: <https://openknowledge.worldbank.org/handle/10986/26644>.
- World Bank Global Partnership on Output-Based Aid (2018): A Guide for Effective Results Based Financing Strategies. Accessed at: <https://www.gprba.org/knowledge/publications/guide-effective-results-based-strategies>.

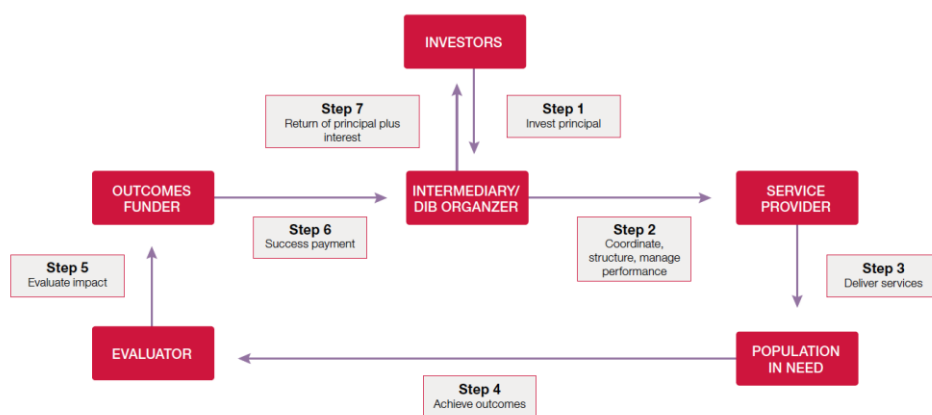
Outcomes-Based Finance

KEY FACTS

- Outcomes-Based Finance (OBF) mechanisms involve one or several outcomes payor(s) making payments conditional on the achievement of pre-agreed, measurable outcomes, thus monetizing the impact generated.
- Compared to many traditional Results-Based Finance (RBF) mechanisms that focus on outputs, OBF focuses on outcomes. OBF payments are often made to private investors who take over delivery risk and prefinance activities, or to impact enterprises or NGOs to increase their attractiveness to potential investors.
- OBFs are useful when impact baselines can be observed, measured, and established, with payments triggered by measurable, verified improvements.

Basic Structure

Development Impact Bond Mechanism



Source: USAID, Palladium (2017): Pay for results in development: a primer for practitioners.

Scope

- OBFs are usually applied in the **health, employment, education and environmental sectors**. OBFs are appropriate for LICs and MICs, although mostly concentrated in MICs where countries have systems in place to identify and measure the achievement of targeted outcomes consistently (which is more complicated than measuring outputs typical in RBF mechanisms).
- OBFs come in different forms:
 - With an **impact bond**⁴³, an investor provides upfront working capital to a service provider. The service provider engages in activities to achieve the outcomes, and the investor is repaid principal plus a return by the payer / outcomes funder (e.g. a donor agency) only if

⁴³ In a Social Impact Bond (SIB) the payor is the domestic government, while in a Development Impact Bond (DIB) the payor is a donor. In developing countries to date, DIBs have been deployed more often than SIBs – motivated by donors' targeting specific interventions.

the pre-specified outcomes are achieved (compared to traditional sustainability bonds that are usually fixed income instruments).

- **Social Impact incentives (SIINCs)** tie payments (paid by payers / outcomes funders) to the achievement of social outcomes, with payments usually being made to a social enterprise that has achieved the outcome. The payments make the enterprise more attractive for investors, thereby increasing its ability to raise capital, its potential for scale and/or further amplifying impact. For example, if an SME achieves a 6 % rate of return and an extra 4 % is paid by payers, the total return increases to 10 %, thus attracting investors unsatisfied with only a 6 % return.
- **Social Success Notes** are mechanisms through which a social business accesses capital upfront from a debt investor and the investor is subsequently paid a return from an outcomes funder if pre-specified impact outcomes are achieved, and repaid its principal by the social business.
- **Outcomes funds** or programmatic approaches pool resources and/or provide funding to a pool of selected service providers or entrepreneurs. There are programmatic approaches based on impact bonds mechanism and proposals for SIINCs based outcomes funds (see case studies).

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Grant (as outcomes payors), debt and equity (as investors)	Applicability Target Group: Governments, projects and financial institutions Investors: Private investors can be mobilised by additional revenues from achieving outcomes.	Development Stage: ☒ Concept ☒ Pilot ☐ Proven ODA eligibility: Yes
Approach: Results-Based Finance	Applicability Type of Countries: ☐ LDC/LIC ☒ LMIC ☒ UMIC	KfW experience: Limited
Product for beneficiaries (market): OBF	Relevance for SDGs: Usually social, employment & entrepreneurship and environment sectors, like SDGs 3, 4, 7, 8 and 13	Peer Experience: DFID, SDC/SECO, USAID

Addis Ababa Action Agenda Impact Areas

Criteria	Assessment	Explanation
Mobilise additional private capital	5 out of 10	Compared to traditional RBFs, OBFs seek to involve (social) investors and DFIs to take some of the risk and prefinance and support the work of the service provider.
Strengthen local capital markets	2 out of 10	SIINCs strengthen local financial markets, but not capital markets. They make social enterprises more creditworthy for banks to finance. SSNs increase the feasibility of issuing a note/bond/security to investors.
Debt Sustainability	7 out of 10	OBFs include grants, and therefore provide funding for development that is not repayable. SIINCs contribute to debt sustainability by increasing the ability of a social enterprise to raise equity (possibly displacing debt). If a note in a SIINC or debt in an impact bond is issued in local currency, this increases debt sustainability.

MECHANICS & ROLES

How does it work? Within OBF mechanisms payments are disbursed when observable and measurable development ‘outcomes’ are achieved, as opposed to paying for inputs, activities or outputs. For example, in education projects, outputs could include the number of schools refurbished, the number of children enrolled/educated or the number of hours of training delivered by teachers, while outcomes could include the greater educational achievement of students, greater motivation of teachers, or student lifetime earnings.

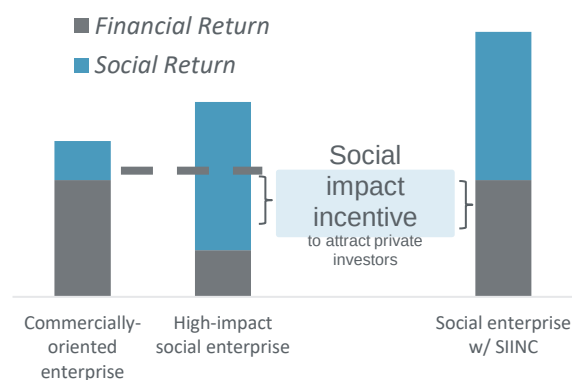
Payments are typically made by development organisations – e.g. a development agency, a philanthropic funder or a developing country government – when the outcome is verified. The outcome payment flows to the entity that achieved the outcome, such as a social enterprise or a non-profit service provider, or the investor or fund manager.

With **impact bonds**, there are many actors initiating, designing, and implementing the programme. Often, development agencies or philanthropic agencies identify a development challenge and then, together with an intermediary and an implementer and/or an investor, structure an impact bond. An independent agency validates the results of the services and reports them to the outcomes funder(s), who in turn makes success payments to the impact bond intermediary, which then pays the investor.

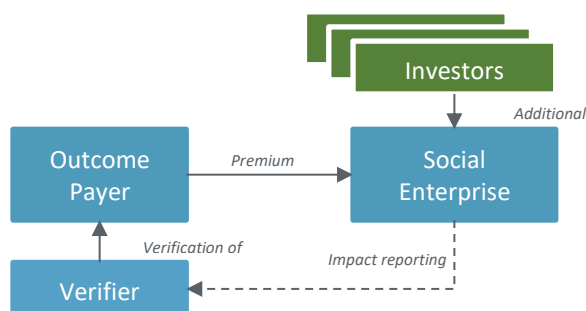
SIINCs are contracts between outcomes payer(s) and a social enterprise(s). SIINC has been implemented typically on a direct two-party contract basis (i.e. with a social enterprise), but to achieve greater scale and mobilisation a development organisation can channel finance through a fund or vehicle that makes payments to multiple enterprises or directly incentivises the fund manager or lender. Differing from the impact bond model, SIINC is applied in sectors with underlying activities generate commercial revenues, since a SIINC only compensates for the impact achieved, and not the full cost of operation. Additionally, a SIINC mechanism only requires a performance contract between an outcomes payer and the enterprise; attracting investment capital remains the responsibility of the enterprise. SSNs operate similar to SIINC.

Illustration of a Social Impact Incentive

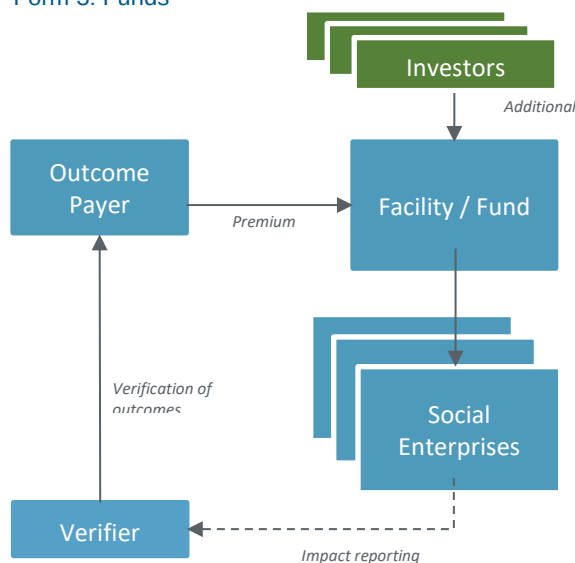
Form 1: Single Social Enterprise SIINC



Form 2: Multiple Social Enterprises SIINC



Form 3: Funds



What are the distinguishing factors? Outcomes-based finance structures differ mainly as to whether:

- the service provider is an entrepreneur with a revenue model or a social purpose organisation;
- payments cover the full cost of operations of the service provider (e.g. NGOs in DIBs) or just monetise the impact generated;
- investors are directly part of the incentive structure (Success Notes) or outside and incentives are targeted towards the entrepreneurs (e.g. SIINC).

Role of donors in this mechanism? Development organisations typically act as outcomes payers in OBFs – paying for positive social, development and environment outcomes with no (or limited) expectation of financial returns. Without donors, OBFs would not be possible.

Role of development finance institutions in this mechanism? DFIs can identify a development challenge and collaborate with traditional donors to structure an OBF mechanism. DFIs can (i) subscribe to an impact bond and (ii) finance social enterprises (e.g. equity, debt or guarantee) participating in SIINC and SSNs. SSNs and SIINC are high-impact development finance tools that enable DFIs to increase the impact-focus of their existing/core investments, with minimal additional internal capacity required.

Role of private investors in mechanism? Similar to DFIs, investors can invest in impact bonds and finance social enterprises in SIINCs and SSNs. In practice, while they seek a certain level of financial return, investors in OBFs have so far been mostly impact first investors.

COMPARISON CRITERIA

Impact: OBF mechanisms are good development tools when the development impact target can be achieved more effectively than a traditional input or activity-based mechanism. They are similarly effective when development funds can be deployed to support a social enterprise to raise financing, thereby allowing it to undertake and scale up commercial activities which also have social benefit. Social and development impact bonds (SIBs and DIBs) are usually deployed to achieve a development outcome more effectively than the current approach, such as providing a health care service differently from the status quo. SIINCs and SSNs are deployed to finance social enterprises that can produce outcomes aligned to development organisations' objectives, while concurrently supporting market-based solutions.

Scalability: Somewhat scalable. Ultimately, the scalability of OBF mechanisms depends on the ability of the funded social enterprise or service providers to scale their operations and demonstrate outcomes (beyond outputs) as well as the extent to which investment opportunities are pooled.

Efficiency: With OBFs, donors only pay when a targeted outcome has been achieved and independently verified. There is minimal project implementation risk, as is commonly associated with traditional input and activity-based ODA. A negative challenge for OBFs has been development costs (that is, the very high costs incurred until the OBF programme is launched). Therefore, OBFs are only beneficial if the development costs are less than the efficiencies gained during implementation.

With impact bonds, service providers can immediately deploy the funds raised for impact purposes, and outcomes funders can shift more resources towards prevention, potentially resulting in costs savings in the long term.

SIINCs and SSNs are efficient since the donor payments are typically only a small portion of the enterprise's revenues – with donor revenues tactically deployed to achieve a social, development or environment outcome on top of underlying commercial activity. The mechanism also helps social enterprises that pursue/achieve development outcomes to raise capital by improving performance and scale, thereby allowing the development funder to effectively monetise development outcomes and overcome theoretical market failures.

Feasibility: Initial evidence from the first DIBs and SIINCs, outcomes fund and programmatic structures remain limited since the majority are still at conceptual stage.

Mobilisation: OBF mechanisms are deployed both to increase the effectiveness of ODA and domestic budget funds, and to mobilise private investment. The latter is most beneficial for projects and sectors with underlying revenues that can

mobilise investors. An impact bond typically mobilises private sector expertise to implement the service in a superior way, while also mobilising private capital to provide the working capital / liquidity financing until the outcome has been verified and the development payment has been made. Social enterprises benefit from SIINCs and SSNs to bolster revenues, allowing them to attract finance and investment.

Flexibility: High flexibility in tailoring financial payments to the exact type of development outcome targeted and in mobilising private financing.

SUCCESS FACTORS

The real challenge of DIBs is **whether they demonstrate to developing country governments the benefit of delivering public goods more effectively and efficiently at scale beyond the pilot impact bond**. To exploit the full potential of SIINCs and SSNs based OBF the conditions of the incentive payments must be ambitious yet fair. The metrics should align the net income and impact of a social enterprise. Ideally, SIINCs and SSNs should be made available on a competitive basis to fund outcomes efficiently.

Other challenges for OBFs include (i) limited supply of outcomes funding, (ii) institutional preference for legacy development solutions (e.g. input based grants), (iii) limited quality data sets on which to base outcomes funding, (iv) limited understanding of good practice and (v) small scale of projects to date.

Other challenges for impact bonds include (i) insufficient evidence that they are truly innovative since investors have concentrated on known and proven programmes and methodologies; (ii) limited scalability and replicability to date; (iii) too expensive per beneficiary; (iv) small transaction sizes leading to high financial costs for outcomes payments and high transaction costs in relation to beneficiaries reached; and (v) service providers often being small social enterprises with limited ability to scale operations.

TRENDS TO-DATE

- The **World Bank-led Global Partnership for Results-Based Approaches** is the best data source for OBF mechanisms. It aggregates and reports on a breadth of mechanisms that fall under the OBF and RBF classifications, with aggregate financing volumes of around USD 127 billion across 350 projects since 1999. The sub-set of impact bonds (SIINCs and SSNs) is much smaller. Reasonable estimates would be around USD 200 million in the past decade.
- The **Brookings Institution and the World Bank Group are active researchers and publishers** of knowledge documents on OBF. The Brookings Institution has now accumulated six years of data and information.
- The **Impact Bond Working Group**, led by DFID, is a leading multi-stakeholder group involved in OBFs. The Group started in 2018 with a focus on impact bonds, and currently covers the territory of RBF and OBF approaches. The Working Group endeavours to create a club of outcomes payers to accelerate the implementation of OBFs, specifically impact bonds.

- **Impact bonds:** Brookings and IB-WG report a total of 17 impact bonds contracted in developing countries for around USD 50 million in 2019.
- **Two benchmark SIINC transactions** were finalised in a project led by Roots of Impact in partnership with the Swiss Agency for Development & Cooperation (SDC), the Inter-American Development Bank (IDB), New Ventures and Ashoka. The first SIINC payments were made to Clinicas d'Acucar in Mexico (with USD 275.000 over 2.5 years), contributing to attracting investment from private investors of USD 1.5 million.
- There is currently a **pipeline of new impact-linked finance transactions** seeking outcomes funders and investors.
- To date, a **sector or SDG-specific approach has held the largest potential** to drive down transaction costs and create synergies. There is strong potential to create multi-party outcomes funds where "donors" – and potentially investors – pool their resources and target pre-defined impact objectives along the SDGs.
- **Technology** also holds the potential to reduce costs and increase transaction speed, with remote sensors, impact data generation, and even machine learning being used for outcomes identification and pricing. In the interim, existing best practices for impact measurement and verification (e.g. Acumen's Lean Data) are an important foundation.

CASE STUDIES

Outcomes Funds

Outcome funds are emerging as a solution to the problem of scalability in single-intervention, single-geography projects within OBF. They take a longer-term programmatic approach, wherein donors make ongoing commitments to a series of investments, typically adopting a sector or thematic focus.

Examples that are at different stages of development include the GSG Education Outcome Funds, a thematic outcome fund of fund that would invests in other regional or country outcome funds; Green outcome fund South Africa, an outcome fund that incentivises traditional SME fund managers to invest in SME with a green impact or help them become more sustainable; outcome funds using SIINC payment in different sectors e.g. in agriculture or off grid energy or structured funds (including a first loss tranche) that would invest in several DIBs (recent proposal by UBS Optimus foundation).

Read more here:

GSG Education Outcome Funds:
<https://www.educationoutcomesfund.org/>

Green outcome fund South Africa:
<https://www.infodev.org/>

SIINC payment: <https://www.icwa.org/>

Off grid energy: <https://www.roots-of-impact.org/>

West Bank & Gaza Youth Unemployment Development Impact Bond

The West Bank & Gaza Youth Unemployment DIB is a programmatic outcomes-based finance approach. They are applied to a cohort of service providers in a certain industry that are recruited in a competitive process rather than to one single service provider identified by the impact bond developer. Service providers include several vocational/professional trainings institutions and other service providers and they are requested to form a partnership with other entities e.g. job placement agencies and private sector industry associations to ensure that trained youth do find a job rather than stopping services at the delivery of training. The World Bank acts as an outcomes funder by providing funding to the Palestinian Authorities. Investors are the Dutch DFI FMO, the European Bank for Reconstruction and Development, Invest Palestine, and the Palestine Investment Fund.

Read more here: <https://www.worldbank.org/>

Mexico – Clínicas del Azúcar SIINC

Clínicas del Azúcar (CdA) operates 'one-stop-shops' that offer high-quality, cost-effective healthcare services to treat diabetes in Mexico.

The SIINC programme set up by the Swiss Agency for Development Cooperation (SDC) in cooperation with the Inter-American Development Bank (IDB) incentivises CdA to increase diabetes services to the Base of the Pyramid (BoP) while maintaining quality services. With USD 1.5 million of investment and up to USD 275,000 in SIINC payments over 2.5 years, CdA plans to scale nationwide.

Investment in similar organisations is on-going.

Read more here:

<https://nextbillion.net/social-impact-incentives-a-new-solution-for-blended-finance/>

Uganda – Yunus Social Success Note

The Yunus Social Success Note (SSN) looks to expand access to clean water and sanitation in Uganda by funding Impact Water, which installs water filtration systems in the country.

The UBS Optimus Foundation provided a USD 500,000 5-year loan to Impact Water. If Impact Water's targets are met, the Rockefeller Foundation will pay up to USD 200,000 to pay off some of their interest and pay UBS a performance-based return.

Outcome funder(s): The Rockefeller Foundation, Yunus Social Business.

Read more here:

<https://assets.rockefellerfoundation.org/app/uploads/20170706180703/Social-Success-Note.pdf>

OVERVIEW OF KfW PORTFOLIO

KfW is new to Outcomes-Based Finance, similar to most development banks and donor organisations.

MOST RELEVANT ADDITIONAL RESOURCES

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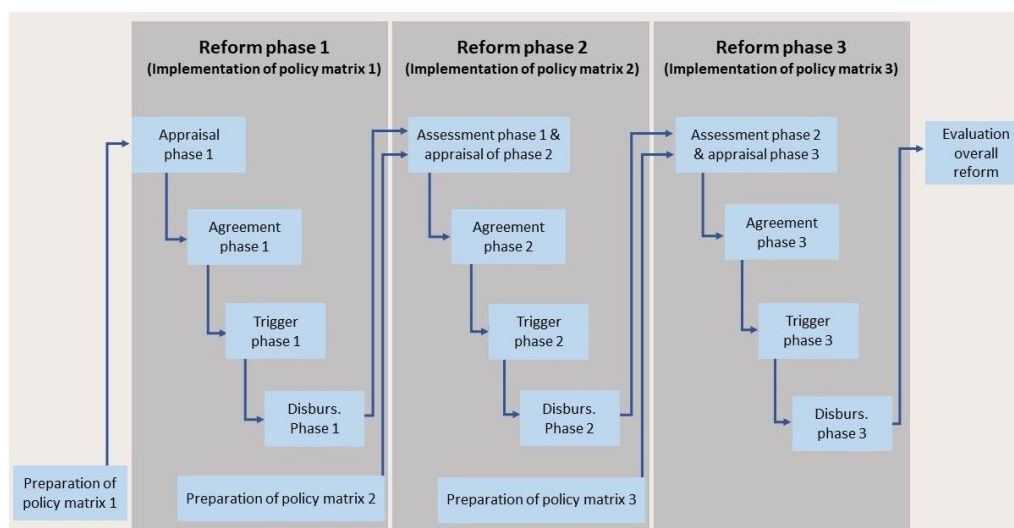
Policy-Based Finance

KEY FACTS

- Policy-based finance (PBF) incentivises governments to pursue policy reforms by linking payments to the successful implementation of reforms by governments. Policy-based finance is seen as an evolution from straight budget support – it is generally tied to specific reforms compared to the general funding of developing country governments. Unlike most Results-Based Finance that only work if there are clearly measurable outputs at the project level, PBFs encourage and support comprehensive reform programs.
- Funding instruments typically consist of loans, but can include grants, guarantees and debt service subsidies. Technical assistance facilities often accompany PBF interventions.
- PBF has also sometimes been used to encourage governments to borrow for social sectors like education.

Basic Structure

A longer-term (multi-phase) reform project structure



Source: KfW (2018): What is "policy-based lending"?

Scope

- PBF is usually deployed not to finance individual projects, but to accelerate reforms in key public policy areas linked to economic development, such as macroeconomic stability, public financial management, tax reforms, reforms to the business environment or investment climate, and reforms to the financial sector and social sectors. PBF is mostly concentrated in MICs where countries are seen to have higher capacity to implement reforms and is appropriate for LICs in exceptional cases.
- Policy-based finance covers the following main mechanisms:
 - **Policy-Based Loans (PBL):** Usually disbursement is conditional on pre-agreed policy actions, often with the entire loan amount disbursed in a 'single shot' once conditions are met so that reforms can be implemented quickly. PBLs' flexibility – they have fewer eligibility assessments, reporting requirements, and performance conditions than typical budget-support grants – makes them more suited to more advanced partner countries.

- **Policy-Based Guarantees (PBGs):** Usually risk mitigation / credit enhancement for governments to borrow from private sector lenders. The debt proceeds provide governments budgetary support for a specific program of policy and institutional actions.
- **Performance-based grants:** local governments obtain transfers from the central government on the basis of whether they meet specific basic or minimum conditions (measuring their capacity to perform their functions).
- **Loan buy-downs:** Donor pays all of or part of a loan's principal amount or the interest incurred, on behalf of a borrowing country if progress is achieved in reforms of sectors that have a high development impact (e.g. education, health etc.).

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Debt instruments and guarantees, grants in exceptional cases	Applicability Target Group: Overall populations through general policy or institutional reforms Investors: Not Applicable	Development Stage: ☐ Concept ☐ Pilot ☒ Proven ODA eligibility: Yes
Approach: Policy-based Finance	Applicability Type of Countries: ☐ LDC/LIC ☒ LMIC ☐ UMIC	KfW experience: Yes
Product for beneficiaries (market): Not Applicable	Relevance for SDGs: All SDGs	Peer Experience: World Bank, Asian Development Bank, AFD

Addis Ababa Action Agenda Impact Areas

Criteria	Assessment	Explanation
Mobilise additional private capital	5 out of 10	Policy based guarantees contribute to mobilisation of private capital. Most policy-based finance though does not directly mobilise private investment but the reforms pursued typically create a better economic and business environment and investment climate in the medium-term, thereby attracting private investment.
Strengthen local capital markets	4 out of 10	Policy-based finance only strengthens local capital markets if the reforms are targeted for this purpose or in a related area such as macroeconomic and fiscal or banking sector reforms.
Debt Sustainability	6 out of 10	Loans linked to broader reform policies or offering of shock resilient loans as well as loan buy-downs contribute to greater debt sustainability compared to traditional loan.

MECHANICS & ROLES

How does it work? PBF mechanisms link payments to a government's implementation of policy reforms to key development sectors or to the overall business environment.

PBF mechanisms usually involve (sectoral) policy reform programs, which are launched on the partner governments' own initiative and carried out with donor support and technical assistance, like reforms to the energy sector or the business environment.

PBFs can be (i) disbursed in advance with policy objectives to be achieved later, (ii) disbursed subject to the achievement of milestones or (iii) disbursed upon the completion of policy milestones. Disbursements are most frequent ex post, being tied to several phases of reforms. In a loan buy-down (subsidy), a third party (e.g. donor) buys down part or all of the interest and principal of a loan between a sovereign and a lender, giving the country fiscal room to fund development projects.

How can the mechanism be distinguished? PBF mechanisms can broadly be distinguished by the financial instruments used, e.g. **loans, grants or guarantees** or with regard to disbursements. These classifications can be further subdivided depending on the disbursement mechanism. For example, within PBL, there are:

(i) **multi-tranche policy-based loans**, which are disbursed in several tranches upon the pre-defined policy conditions tied to each tranche being completed and verified;

(ii) **programmatic policy-based loans**, which are disbursed in a series of linked, sequential tranches over the medium-term (three to five years) to support medium-term policy reforms, with specified triggers for moving onto the next operation, improving predictability, reducing transaction costs and improving flexibility; and

(iii) **deferred drawdowns**, which can be used with both multi-tranche and programmatic PBLs – they enable PBL resources to be drawn down over several years after pre-specified policy conditions have been met, allowing governments to access the resources in the amounts and at the times most needed.

Role of donors in mechanism? Donors and development banks like the World Bank are typical funders of PBF, agreeing the policy objectives to be pursued by the government and then providing the funds. PBL projects are often designed as multi-donor programs and can be tied to other financing instruments.

Role of development finance institutions in mechanism? PBF financing mechanisms are often offered by MDBs in their sovereign operations as well as by bilateral development banks such as KfW.

Role of private investors mechanism? No direct role, other than in projects where they are mobilised through guarantees.

COMPARISON CRITERIA

Impact: PBF mechanisms improve structural conditions in recipient countries, removing barriers to development and improving the investment climate. With PBLs for example, recipient governments can access funds on better terms and conditions than what would be available on the capital markets, aiding domestic consensus-building on reforms and making governments more willing to implement reforms more quickly and comprehensively.

Scalability: PBF mechanisms as such as not scalable – as policy reforms are only financed once – but allow for pooling of resources by different financing agencies and funders. However, they lead to better scalability of financing supports reforming governments' policy agendas overall.

Effectiveness/Efficiency: PBF mechanisms are efficient given that multiple lenders can be aligned behind a reform agenda led by governments. With PBLs, exiting from non-performing reforms is made easier by their generally shorter duration; eligibility assessments are simple – typically determining if a country is committed to reform, with reporting requirements minimised to reduce recipients' transaction costs; and disbursement is conditioned upon pre-agreed policy actions, typically occurring in one go such that reforms can be quickly implemented.

Partner countries, particularly those that have transitioned to middle-income status, are increasingly able to finance their public spending by borrowing from international markets, often at low interest rates. This looks likely to reduce demand for EU budget support grants, which offer governments smaller amounts of funding with more conditions than what they can receive from capital markets.

Feasibility: Proven and mature.

Mobilisation: PBFs have mobilisation potential since they create conducive framework conditions that – depending on their design – are likely to make investments in a country or sector more attractive. Policy-based guarantees cover political risks that the market is unwilling to take, thereby mobilising private lenders to fund reforming governments' policy agendas. More generally, improvements in the domestic business environment or reforms made to specific sectors can also encourage private actors to invest in the future.

Flexibility: PBF mechanisms are highly flexible. Recipient governments keep control over the design and execution of reforms, using national systems. Lenders can work with governments to find consensus on the details of each reform phase, and can exit after each reform phase.

SUCCESS FACTORS

Basic prerequisites for PBL include a strong commitment on the part of the partner government to make reforms ("ownership and commitment") and an overarching national policy framework (development strategy) as the base of support for the PBL measures. There must also be a strong commitment on the part of the recipient government to its

reform agenda, which should form a part of a well-defined, overarching development strategy.

Performance-based grants rely on there being strong policy support for the incentives put in place, as well as the political will to withstand pressure from poorly performing local governments. The operations, measures, and outcomes of PBG systems also having to be transparent and publicly disclosed.

The connection between proposed reforms and longer-term development outcomes should also be clear. This so that lenders can be sure that the policy reforms selected for support are actually pressing concerns, directly conducive toward development. SMART objectives provide clarity.

PBF mechanisms are generally better suited to more advanced developing economies, where a strong reform agenda has been conceptualised, and recipient governments have the will and capacity to undertake reforms.

However, loan buy-downs have the most potential for “missing middle” countries – i.e. for those countries transitioning from low to middle-income. At this transitional point, concessional aid is falling off faster than non-concessional financing and domestic public resources are rising, and private investment tends to focus on sectors with clear cash flows.

Using policy-based guarantees for debt obligations that are too large can disincentivise governments from making good fiscal choices, reducing the focus on tackling fiscal and macroeconomic risks head-on. This highlights the importance of a national reform agenda and macroeconomic policy framework.

PBF should be designed in way to make an even stronger contribution to mobilising private capital, strengthening local capital markets and improving debt sustainability, and tackling the foreign currency risks of the engagement. Even climate risks can be taken into account, when insurance elements are included e.g. a shock resilient loan is used for funding a climate reform agenda.

TRENDS TO-DATE

- In recent years, **several development agencies have come out strongly in support of PBL** including the World Bank, ADB, AFD and KfW (see figure below).
- PBLs are **expected to become a permanent fixture** in financing for advanced developing countries and emerging economies.
- PBLs are primarily **offered by multilateral and bilateral development banks**.
- In practice, PBL projects are often designed as **multi-donor programmes** (either in parallel or joint financing), as well as in combination with the other financing instruments mentioned above.
- Increasing interest in PBG, but WB still main actor .

CASE STUDIES

Ghana – Performance-Based Grants

The Local Climate Adaptive Living Facility (LoCAL) of the UN Capital Development Fund provides performance-based climate resilience grants alongside technical and capacity building support, with the aim of integrating, funding, and verifying the climate change adaptation measures implemented by local governments in developing countries.

For example, through its grants, LoCAL Ghana provides Metropolitan, Municipal and District Assemblies in Ghana with financial top-ups to cover the additional costs of making investments climate-resilient, channeling the funding through existing government fiscal transfer systems.

Under this system, climate information and vulnerability and adaptation assessments are undertaken; needs and capacities are assessed; local governments develop adaptation programs; performance-based grants are disbursed; and the performance is assessed, and audits undertaken. Climate change adaptation is thus promoted in a sustainable, efficient and transparent way.

Read more here:

<https://www.uncdf.org/local/ghana>

<https://www.uncdf.org/local/performance-based-grants-for-climate-resilience>

Benin – WB Policy-based guarantee

Benin faces persistent problems in tackling poverty, ensuring balanced development progress, and improving a weak business environment. Its national development plan recognises the necessity of investing in human capital, infrastructure, and the power sector, but increasing public borrowing from domestic sources to fund this plan can be expensive, with debt potentially rising to unsustainable levels.

Recognizing this, the World Bank used a policy-based guarantee to cover private lenders against the risk of sovereign default, enabling Benin to access international financing on more convenient terms, helping it to reprofile its debt. Structurally, the PBG used only USD 45 million of funds to provide a guarantee of USD 180 million. The PBG offered a coverage of 40 % of the amount of private financing raised, such that Benin could access up to USD 450 million in commercial lending. The first PBG-backed loan of around USD 300 million was signed in September 2018; the second PBG-backed loan for USD 150 million was signed in December 2018.

Read more here:

<https://www.worldbank.org/en/results/2019/05/16/guaranteeing-success-in-benin>

Tunisia – Policy-based lending in the water sector

Germany has been supporting Tunisia with investment projects in the water sector for many years. To ensure that these projects are even more sustainable, including in the context of sectoral policy, Germany has also extended promotional loans anticipated to amount to EUR 300 million over three years to back reforms (2017-2019, with EUR 100 million disbursed so far). The measures fixed in the policy matrix provide sound support both to reforms in public financial management (PFM) and to water sector development, working in close cooperation with an IMF programme running in parallel to them. The activities in the water sector have included the passage of a new water law, national wastewater standards, and tariff changes.

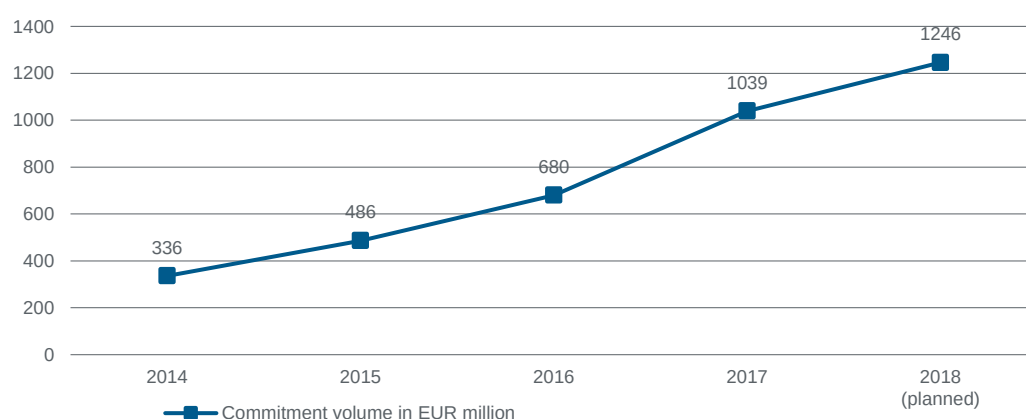
Montenegro – World Bank's Policy based guarantees

In 2020 the World Bank has approved the second of two programmatic policy-based guarantees of EUR 80 million (USD 91 million) to support Montenegro in executing reforms to safeguard fiscal sustainability and make the financial sector more resilient to potential shocks. It is expected that this guarantee will enable Montenegro to secure funding in the financial market in the amount of up to EUR 250 million, which will, to a large extent, satisfy the needs for financing, as well as the refinancing and repayment of public debt. The PBG is accompanied by technical assistance for financial sector and macroeconomic reforms.

OVERVIEW OF KfW PORTFOLIO

The Center of Global Development identifies KfW as a pioneer for policy-based finance amongst European development organisations. Examples include the Policy Based Loans for Financial Sector Development in Tunisia and Colombia, as well as the Indonesia Fiscal and Public Expenditure Management Programme. KfW's PBL portfolio has experienced a significant increase in the past five years (commitments around EUR 1 billion per year), with commitments widely dispersed both sectorally and geographically. Priority sectors include water supply and disposal, energy, peace development, transport, and environmental protection, while geographically the focus is on the regions of Asia, Latin America, and MENA.

KfW's commitment volume for PBLs (2014-2018)



Source: KfW (2018): What is "policy-based lending"?

MOST RELEVANT ADDITIONAL RESOURCES

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»»» Guarantees

KEY FACTS

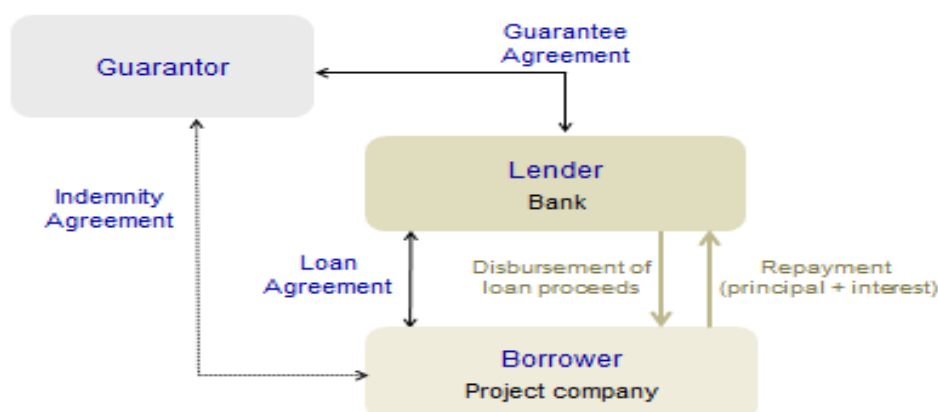
- Guarantees are typically used for borrowers and projects considered to be too risky to attract finance and investment on regular market terms, with the guarantee reducing the risk to an acceptable level. Guarantees can mobilise private capital at scale, thereby leveraging scarce donor resources.
- Guarantees are typically issued to lenders and investors in financing instruments (e.g., loans and bonds) to credit-enhance the obligations of debtors. Guarantees can also be used to enhance the payment obligations of payors with weak credit risk (e.g., an off-taker in project finance) or support equity investments directly or indirectly (e.g. by guaranteeing a fund that makes equity investments). Guarantees can cover multiple risks, and payment guarantees offer protection against losses not directly tied to credit risk (e.g. volume guarantees and liquidity guarantees).
- Guarantees are strong instruments when the gap between perceived risk and actual risk is high. For example, if the perceived risk for lending to a good quality project is overwhelmed by perceived high country risk, an all-risk or political risk guarantee can mobilise financing to the project.
- Guarantees in development finance comprise two types of obligations:

Financial guarantees are legally binding agreements under which the guarantor agrees to pay all or part of the amount outstanding on a financial instrument (e.g. loan) or loss in value of the instrument. The beneficiary of the guarantee is typically the debt holder or investor.

Payment guarantees are typically a contractual obligation to make the payment for a third party if that party does not make the payment (e.g. in Public Private Partnerships).

Basic Structure

Credit Guarantee – contractual parties



Source: Authors' compilation

Scope

- Guarantees usually target SDGs, sectors and projects with underlying commercial revenues.

- Guarantees should only be used when commercial financing on regular market term is not available.
- Guarantees can, *inter alia*:
 - support local currency bank lending or de-risk local bond issues, thereby strengthening domestic capital markets;
 - support long-term infrastructure financing; and
 - lengthen loan maturities and reduce collateral requirements for small enterprises.

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Unfunded credit risk protection	Target Group: Commercial investors and DFIs	Development Stage: ☐ Concept ☒ Pilot ☐ Proven ODA eligibility: No – only when drawn
Approach: Guarantee	Applicability Type of Countries: ☒ LDC/LIC ☒ LMIC ☒ UMIC	KfW experience: Yes as investor and funder of guarantee vehicles, less so as guarantor.
Product for beneficiaries (market): Financial guarantee and payment guarantee	Relevance for SDGs: SDGs with commercial revenues	Peer Experience: Sida, AFD, MIGA, USAID Development Credit Authority

Addis Ababa Action Agenda Impact Areas

Criteria	Assessment	Explanation
Mobilise additional private capital	10 out of 10	An OECD study demonstrates development guarantees have been the most effective tool among development finance instruments to mobilise commercial capital.
Strengthen local capital markets	6 out of 10	Most guarantees have negligible impact on local financial markets, particularly if they are used to support hard currency debt. However, guarantees of local currency bond issues as increasingly applied can indeed help develop local capital markets.
Debt Sustainability	7 out of 10	One of the main developmental benefits of guarantees is that they are frequently used to credit enhance local currency debt. As such, they can crowd in local capital and reduce the risk of over-indebtedness caused by currency mismatches.

MECHANICS & ROLES

How does it work? Typically, a guarantor commits against a fee to: (i) pay part or all of the outstanding value of a financing instrument (e.g. loan) or (ii) make payments of third-party obligors when that obligor does not meet its payment obligation.

Guarantors in development finance transactions are typically: (i) government & government agencies (e.g. EU Commission, USAID⁴⁴, AFD, Sida), (ii) MDBs/DFIs (e.g. KfW, EIF, IFC, MIGA) or (iii) specialised guarantee organisations (e.g. GuarantCo, African Guarantee Fund, CGIF).

A guarantor in a financial guarantee commits typically to pay either (i) the defaulted payment amount owing on a debt service date or (ii) the total (or partial) amount of the debt outstanding on the default date.

A guarantor in a payment guarantee commits typically to pay the defaulted payment amount owing on a contract in the event of non-payment by the obligor.

Guarantees are unfunded, which means that the principal amount of the underlying debt is funded by the financier (e.g. the guaranteed party).

Guarantees can cover: (i) commercial risk, where financial obligations are not met due to an asset or investment's non-performance; and (ii) political risk, where obligations are not met due to the host country government's actions or inaction, such as expropriation, regulatory adverse changes in law, currency inconvertibility or restrictions on FX transfers, or breach of contract.

In addition to credit risk protection, guarantees can benefit banks by enabling them to hold lower amounts of capital to back up their loans, enabling them to increase lending. For example, the BIS Basel Capital Accord allows for 50-100% capital relief on loans guaranteed by governments and DFIs rated Investment Grade, thereby allowing local banks to at least double their loan portfolios with a given amount of capital (subject to contractual terms of the guarantee agreements such as whether the guarantee is an irrevocable and unconditional payment obligation).

Guarantees and insurance can cover the same/similar risks. Unlike insurance, guarantees: (i) do not involve a claim filing and review process, but are relatively straightforward when invoked to cover a loss; (ii) cover a failure to satisfy obligations arising from many causes (while insurance typically covers losses arising from specified events or incidents); and (iii) involve three parties (lender, borrower/obligor, and guarantor) rather than two parties.

What are the different types? The main type of guarantee is the financial/credit guarantee, which covers all or part of the repayment risk on debt instruments (e.g. loans, bonds). A partial credit guarantee protects the debt investor up to a specified amount. The main variants of **credit guarantees** include:

Project-specific loan guarantee: The guarantor signs a Guarantee Agreement with a specific lender, who will extend a loan to a pre-identified project/borrower. Project guarantees are typically used for large-scale investments in infrastructure or industry.

Loan portfolio guarantee (LPG): The LPG provides credit risk cover on a portfolio of future eligible loans, allowing the guarantee beneficiary (typically a bank) to build a portfolio of eligible loans which is fully or partly covered by the guarantee. It is one of the most common types of guarantee – typically used to support lending to SMEs. A variant is the **balance sheet guarantee** where the guarantor guarantees a portfolio of existing loans freeing up capital for the bank to deploy in a new portfolio of loans.

Stop loss guarantee: The stop-loss guarantee corresponds to the concept of "excess of loss" in reinsurance. This is used in a situation where an insurer would be prepared to cover losses up to a predefined threshold ("attachment point"), and buy reinsurance to cover losses beyond that point. The stop-loss reinsurance protection would be capped at a predefined ceiling amount ("exhaustion point"), and can thus be viewed as a form of non-proportional guarantee.

Policy-based guarantees: Can be offered (typically by DFIs, such as the World Bank) to partner governments who issue debt (e.g. bond) with the proceeds used as budgetary support, typically for a specific development policy program.

Non loan-related guarantees include:

Payment risk guarantees cover the risk that a contractual counterparty does not meet its contractual payment obligation (e.g. sub-sovereign/parastatal entities not honouring their off-taker payments under a power purchase agreement, or early termination payments under a concession agreement).⁴⁵ Such guarantees can also be applied to sovereign commitments to guarantee the performance of sub-sovereign entities. (Cf. breach of contract guarantee by MIGA, and payment guarantees by WB/IDA.)

Advance market commitment is a contractual commitment to guarantee a viable market for a product/service once it is successfully developed for the market. AMCs are typically offered by governments, development agencies and foundations and have been used to support the development of vaccines at affordable prices for developing countries.

Role of donors in mechanism?

Donors can (i) issue guarantees to debt or equity funders of projects and (ii) provide grants, subscribe capital and/or issue counter guarantees to organisations that issue guarantees. The African Guarantee Fund or national credit guarantee funds (e.g. in Albania, Kosovo or Palestine) are examples of organisations that issue guarantees, and which are capitalised by donor and DFI capital, including counter guarantees from the EU and Sida.

Role of development finance institutions in mechanism? MDBs and DFIs can issue guarantees directly to projects or

⁴⁴ The newly formed U.S. International Development Finance Corporation (DFC) has incorporated the guarantee operations previously run by USAID/DCA and OPIC.

⁴⁵ Political risk guarantees are similar to payment guarantees to the extent that they cover private lenders against the risk of a government, or a government-owned agency, failing to honour its obligations vis-à-vis a private sector party.

local banks, or they can mobilise guarantees indirectly by providing capital to organisations such as the abovementioned organisations that issue guarantees. Both direct and indirect guarantees can be mobilised using DFI's own resources, as well as donor funding or donor risk sharing.

Role of investors in mechanism?

Private investors benefit from guarantees, typically directly as a beneficiary.

COMPARISON CRITERIA

Impact: Guarantees can have significant development impact when they allow a project to raise finance when it would otherwise not be investible. Guarantees can make projects that contribute to the SDGs investible in cases where the project is intrinsically viable, but the risks (actual or perceived) exceed what the market can tolerate, or regulations limit how much, or what type of, risk investors can bear.

Scalability: Highly scalable wherever there are viable but risky investments. Limited only by the amount of risk the donor and development finance community are willing to bear. Current OECD rules do not allow guarantees to count as ODA, therefore weakening incentives of development agencies to issue guarantees.

Efficiency: High efficiency of donor resources can be achieved: pay-outs can be covered by a designated guarantee reserve, funded by guarantee fees and discretionary guarantee subsidies.

Feasibility: Proven and mature in financial markets, but only a small number of development agencies and philanthropic foundations have substantial experience in issuing guarantees.

Mobilisation: Investments in projects in developing countries are often outside the investment criteria of institutional investors due to high country risk (median sovereign risk is "B"). The high creditworthiness of a guarantor can improve the risk of the project from unacceptable (e.g. below Investment Grade) to acceptable (e.g., Investment Grade). To avoid market distortion and economise on resources, the guarantee coverage level should be limited to the amount required to catalyse the investment to happen. For example, in the IFC/MCPP-Sida case, a first-loss investment of only 10 % was sufficient to improve the underlying loan portfolio from below Investment Grade to above Investment Grade, allowing institutional investors to invest the other 90 %. By absorbing a small portion of the total risk, guarantees can mobilise investors and lenders and thereby leverage significant amounts of investment.⁴⁶

Flexibility: Guarantees are flexible with regard to sector, type of obligor, and maturity of the underlying financial instrument. Guarantees can be tailored to mitigate only specific risks not readily covered by market actors in otherwise investible projects, such as construction risk in an infrastructure project or the risk of contractual breach by public sector counterparties.

SUCCESS FACTORS

Guarantees in development finance are intended to support near-bankable projects to become bankable and not to support unviable projects nor fix internal challenges within the organisation or project that raises finance (such as weak management, low commercial demand, or inadequate human capital).

Partial guarantees are preferred over full guarantees due to the moral hazard associated with the latter. For example, a financial institution may be disincentivised to properly screen and monitor borrowers if fully guaranteed.

Guarantees are not an eligible instrument to qualify in the OECD DAC calculation of Official Development Assistance, thereby disincentivizing donors to provide guarantees.

Guarantees are increasingly being used on a broader and bigger scale, focusing not on individual financing schemes but on larger program initiatives, such as the EU's European Fund for Sustainable Development (EFSD). Scale and breadth allow for diversification of risks, which is crucial for sustainable guarantee schemes.

Liquidity: Pay-out procedures applied by guarantors are crucial for guarantees to be an attractive instrument. If they are seen as conditional, lengthy and/or unpredictable, the guarantee can become unattractive.

Pricing: The fee for issuing a guarantee should be based on the value of expected future losses. The guarantor should estimate the expected loss for the guarantee, which should then be reserved (set aside). If the fee charged by the guarantor is not sufficient to cover the expected loss, then a subsidy source should be available to top up the fee collected. As such, the amount paid into the guarantee reserve would come from two sources: i) the fee which is paid by the guaranteed party; and ii) the subsidy. In cases where the guarantor is a bilateral aid agency, the subsidy may be funded by the aid budget of the donor country in question.

Some guarantors circumvent the complexities of estimating expected loss by applying a standard fee across all guarantees, or across a limited number of guarantee types. This, however, may cause unintended surpluses or deficits in the reserve.

TRENDS TO-DATE

- The growing importance of guarantees in development finance can be related to two ongoing trends: (i) increased awareness that unfunded risk mitigation instruments can be used to mobilise large volumes of **private sector capital**, thereby leveraging scarce donor resources and limiting public debt to finance SDG-related investments; (ii) the increasing emphasis on **local currency solutions** and development of domestic capital markets, where guarantees can de-risk local financing.

⁴⁶ EM Compass Note 53 (April 2018): Crowding-In Capital Attracts Institutional Investors to Emerging Market Infrastructure

- A study by the OECD demonstrates that development guarantees are **highly effective instruments to leverage private capital**. Between 2012-2018, USD 205,1 billion was mobilised from the private sector by official development finance interventions; guarantees had the highest share at 39%, followed by syndicated loans (18%) and direct investment in companies (18%).
- Within the development financing community there is a **movement towards increased use of guarantees on a broader and bigger scale**, focusing on larger program initiatives. This includes the use of guarantees under the European External Investment Plan, or launching sovereign development guarantees programs.
- For example, the EUR 1.5 billion **European Fund for Sustainable Development (EFSD)** is a major component of the EU's EUR 4.5 billion External Investment Plan (EIP). The EFSD will issue guarantees to attract DFI and the private sector capital to fund 28 projects in EU's Neighbourhood and Africa. The EFSD guarantees are backed up by EUR 750m in cash reserves from EU's aid budget.
- **Guarantees are not included in the OECD/DAC calculation of ODA**. However, the OECD has recently developed a new statistic – Total Official Support for Sustainable Development (TOSSD) to complement the traditional ODA measure. TOSSD aims to capture a wider range of resource flows to developing countries than grants and concessional loans, including non-concessional flows and private finance mobilised through official interventions (such as guarantees, insurance, syndicated loans and shares in collective investment vehicles).
- **Prominent multilateral guarantors** include: MIGA, the leading (in terms of volume) multilateral provider of guarantees for development purposes, which issued USD 4.8 billion of guarantees in 2017⁴⁷; the World Bank (IBRD/IDA) at USD 500 million and USD 128 million respectively⁴⁸; IFC at USD 540 million⁴⁹; the European Bank for Reconstruction and Development (EBRD); and the African Trade Insurance Agency (ATI). The European Investment Fund (EIF), as part of the EIB Group, implements the SME Window of the European Fund for Strategic Investments (EFSI). EIF, through the COSME Loan Guarantee Facility, provides loan portfolio guarantees and credit enhancement of securitisations of SME assets to promote access to finance for SMEs across Europe (EU + selected neighbouring countries).
- **Prominent bilateral guarantors** include (i) USAID's DCA (now DFC) issuing over 600 guarantees in 80 countries since 1999 and mobilising USD 5.5 billion of private sector credit⁵⁰; (ii) AFD; and (iii) Sida whose guarantee portfolio contained 41 guarantees at SEK 7 billion (~USD 770 million).
- **Specialised guarantee vehicles** include (i) GuarantCo which has supported over 50 projects in 17 countries with USD 4.4 billion mobilised in infrastructure-related investments and (ii) the African Guarantee Fund (AGF) which has issued about USD 1 billion of guarantees, making available about USD 2 billion for SME financing, of which

USD 1.3 billion has been disbursed. At end 2018, AGF's outstanding guarantee portfolio stood at USD 515 million. In addition, there are a number of national credit guarantee vehicles which particularly support SME financing (e.g. in Albania, Kosovo, and Palestine).

⁴⁷ Innovations in Guarantees for Development, CSIS and CDC – October 2019, Figure 3, page 7.

⁴⁸ Innovations in Guarantees for Development, CSIS and CDC – October 2019, Figure 3, page 7.

⁴⁹ Ibid.

⁵⁰ DCA One-Pager for Financial Partners (2018).

CASE STUDIES

Nigeria Azura-Edo PPP

Azura is Nigeria's first true project-finance independent power plant (IPP), a 459MW gas-fired power plant that seeks to provide electricity for 14 million people across Nigeria. The project reached financial close in December 2015 and began generating electricity ahead of schedule in December 2017. Azura was the first power generation project in Nigeria to receive guarantee support from the International Bank for Reconstruction and Development (IBRD) and the Multilateral Guarantee Agency (MIGA).

IBRD guarantees of USD 238 million included a USD 120 million payment guarantee to backstop the Nigerian Bulk Electricity Trading PLC's payment security obligations under the power purchasing agreement, and a USD 118 million debt mobilisation guarantee, which enabled the company to secure a tranche of commercial debt. Meanwhile, MIGA's guarantee covered commercial investors against various political risks, like expropriation and civil disturbance. Overall, USD 876 million of financing was raised from a consortium of local and international investors.

Read more here: <http://pubdocs.worldbank.org/>

African Energy Guarantee Facility (AEGF)

AEGF offers political risk insurance, covering sovereign or sub-sovereign non-payment risk, and other political risks such as expropriation or currency inconvertibility. The targeted clients are developers/sponsors of sustainable energy projects in Africa, and their lenders and investors that require political risk insurance with long tenor. The AEGF initiative gives the African Trade Insurance Agency (ATI) access to a large pool of international insurance capacity, enabling it to insure projects that would normally fall outside its reach. The financed investment projects will meet Sustainable Energy for All (SE4ALL) criteria. ATI will sell/distribute its risk mitigation product; each risk will be underwritten by ATI. The re-insurer is exposed to first loss up to a ceiling, above which the stop-loss guarantees by EIB and KfW/EFSD kick in (at the second loss layer).

Read more here: <http://www.ati-aca.org/>

ACRE Africa

The Agriculture and Climate Risk Enterprise (ACRE Africa) was launched in 2009. It is a pioneer of climate risk solutions in rural Africa, having become a leading provider of index-based crop insurance on the continent. Harnessing digital technology to offer localised solutions for the mitigation of climate risks, ACRE Africa has facilitated over 1.7 million insurance contracts and protected over 8.5 million farmers in Kenya, Rwanda and Tanzania.

More specifically, its flagship 'Replanting Guarantee' product provides insurance coverage for each maize seed purchase. Farmers register their location and planting date through SMS, which starts the insurance contract for their specific location. Insurance premiums are partly covered by the seed company. Claim payments are made as payments to farmers' mobile wallets or as replacement seeds in the event of drought, enabling farmers to replant immediately. Satellite technology is used to geotag and monitor farms, with payouts being calculated by comparing rainfall over a 21-day period during the planting with a prespecified trigger level.

Read more here: <https://acreafrica.com/>
<https://www.indexinsuranceforum.org/>

Managed Co-Lending Portfolio Programme (MCP) for infrastructure

IFC has launched the Managed Co-Lending Portfolio Programme (MCP) for infrastructure, to address the constraints for institutional investors to place their liquid funds in long-term debt assets in developing countries. The MCP platform leverages IFC's origination capacity to source opportunities for third-party investors to co-lend alongside IFC, on commercial terms. The MCP mechanism builds a B-loan portfolio for an investor that mirrors the portfolio IFC is creating for its own account (A-loan portfolio). IFC is the lender of record for the entire loan (A+B). In order to engage institutional investors in the form of insurance groups, the MCP structure was enhanced through the use of structured debt funds.

Read more: <https://www.ifc.org/>

OVERVIEW OF KFW PORTFOLIO

KfW has provided (i) equity and mezzanine finance to guarantee-issuing pioneering vehicles, e.g. African Guarantee Fund and InfraCredit, and (ii) a counter guarantee to GuarantCo. Recent examples are KfW's provision of cash collateral for the Regional Liquidity Support Facility RLSF, and KfW guarantees to realise a reinsurance package for AEGF and give comfort to new investors in ALCBF.

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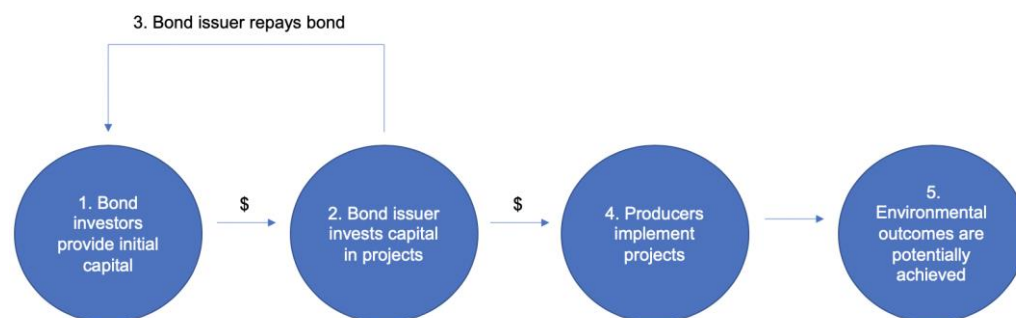
»»» Bonds

KEY FACTS

- Bonds in development finance are debt instruments issued in public capital markets or private debt markets to raise financing for SDG projects in developing countries. They are usually fixed income instruments compared to outcome based finance impact bonds where the investor return depends on the impact generated (see Factsheet on outcome based finance),
- Bonds are a key to mobilising private investment at scale since they are the most common investment instrument of institutional investors. Compared to traditional loans bonds are tradable, i.e. they can be bought and sold in secondary markets. Therefore, bonds have the ability to contribute to the strengthening of local capital markets.
- Investors usually (i) invest full amount of principal at bond issuance, (ii) receive interest payments over the term of the bond and (iii) receive full principal in a bullet repayment at the bond's maturity.
- Bonds for development finance can be issued by different types of issuers, including: (i) development finance institutions (DFIs) who typically issue bonds on international capital markets, (ii) local development banks who issue bonds on both local and international markets, (iii) corporations, and (iv) sovereign or sub-sovereign entities such as national and local government entities.

Basic Structure

Mechanics of Standard Thematic Bond – Green Bond



Source: Pay for performance toolkit. Accessed at: <https://www.enviroaccounting.com/payforperformance/Program/Display/greenbonds>.

Scope

- Bonds usually support a specific project or sector/segment (e.g. a large infrastructure project), but can target all SDGs, sectors and projects, in all countries (e.g. World Bank's SDG bond).
- Bonds are commonly distinguished based on:⁵¹
 - The challenge for which the proceeds are used: **Thematic bonds** channel capital to under-resourced development initiatives which are championed by issuers, mobilising private investors in capital markets and/or private debt markets to development themes. Examples include **Green Bonds** that raise funds for projects with environmental impact and are aligned with the Green Bond Principles; **Social Bonds** that raise funds for projects with

⁵¹ More information on guidelines and principles on <https://www.icmagroup.org/green-social-and-sustainability-bonds/>

social outcomes and are aligned with the Social Bond Principles; **Sustainability Bonds** that raise funds to finance or refinance projects with both social and environmental impact and are aligned with the Sustainability Bond Principles; **Blue Bonds** to finance projects promoting ocean conservation, and **Gender Bonds** for gender equality and empowerment projects. **SDG Bonds** encompass all SDG challenges and are further defined in the UNDP supported SDG impact standards.⁵²

- **Sustainability-Linked Bonds** are any type of bond instrument for which the financial and/or structural characteristics vary depending on whether the issuer achieves predefined Sustainability/ESG objectives. For example, the coupon might be reduced if targeted outcomes are achieved.
- With a **credit-enhanced bond**, bond investors receive reassurance from third party(ies) through an additional collateral, insurance or a third party guarantee. They reassure that the investors will receive contractual payments if the issuers are not willing to make payments.

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Debt	Target Group: Large SDG projects and companies and financial institutions Investors: Invest in bonds, and private companies and financial institutions issue bonds.	Development Stage: ☒ Concept ☐ Pilot ☒ Proven ODA eligibility: No. But technical assistance is and equity invested in a bond fund can be.
Approach: Bond Funds	Applicability Type of Countries: ☒ LDC/LIC ☒ LMIC ☒ UMIC	KfW experience: Yes
Product for beneficiaries (market): (local currency, corporate, government) bond	Relevance for SDGs: 8, 10, 9, 11 and 1	Peer Experience: World Bank and EIB

Addis Ababa Action Agenda Impact Areas

Criteria	Assessment	Explanation
Mobilise additional private capital	9 out of 10	The main function of a bond in development finance is to mobilise additional private capital for sustainable development. Bonds are the most frequent instrument deployed in innovative finance to mobilise commercial capital.
Strengthen local capital markets	5 out of 10	Most bonds issued so far have no / limited impact on local capital markets. Nevertheless, a bond can be designed with the intent to improve local capital markets, such as supporting the bond issuance by local actors, aggregating domestic capital into one issuer and/or raising local currency financing to fund development projects.
Debt Sustainability	2 out of 10	Most thematic bonds in development finance have been issued in hard currency (e.g. USD) with proceeds on-lent to SDG projects in developing countries in the same hard currency. As of June 2020, the issuance of bonds in local currency is on the rise.

⁵² See the SDG Bond standards, currently under development by SDG Impact, a UNDP initiative.
<https://sdgimpact.undp.org/sdg-bonds.html>

MECHANICS & ROLES

How does it work? Bonds are issued to raise funds from commercial investors in capital markets or private debt markets for the financing of development projects. While a thematic bond's proceeds are earmarked for development projects, it is the unconditional obligation of the issuer to make principal and interest payments to investors.

Most thematic bonds include standard payments of principal and interest. In the case of sustainability linked bonds, results-based repayment terms alter debt service payments based on the achievement of development objectives (e.g. decreasing interest or principal payments).

Issuers include corporations, sub-sovereign and sovereign entities, national development banks, and large-scale infrastructure projects.

Thematic bond proceeds are earmarked for development projects specified in the bond's legal documentation. These projects should have clear, assessable and quantifiable impact, with issuers required to report periodically on the use of the bond's proceeds to investors.

Most innovative bonds are issued with the full credit risk of the issuer, but others are linked to the underlying asset and expected project cash flow.

When high country and credit risk in developing countries or the issuer's creditworthiness exceed investors, donors and development organisations can support governments, financial institutions and companies to issue **credit-enhanced bonds** by issuing guarantees. With a credit-enhanced bond, bond investors receive reassurance from third party(ies) that the investor will receive contractual payments if the issuers are not willing to make payments.

What are the main distinguishing factors? Bonds can be distinguished for example, based on themes, payment terms and the primary issuer. Further classifications can be made, for example in the green bond market:

Use-of-proceeds bonds: Proceeds earmarked for green projects and backed by full credit of the issuer.

Use-of-proceeds revenue bonds: Proceeds assigned to eligible green projects. Bondholders have recourse to a specified revenue stream (which may be unrelated to the eligible green projects).

Project bonds: Proceeds invested in a specific green project and investors have direct exposure to the green project itself.

Securitised bonds: Relevant revenue stream is generated by a group of green projects or assets with no recourse beyond revenues.

The large majority of funds raised by green bonds have been use-of-proceeds bonds, carrying the full credit of the issuer.

Role of donors in mechanism? Donors can issue thematic bonds, provide risk mitigation for credit-enhanced bonds (e.g. guarantee), make "results-based" payments for thematic bonds

and provide technical assistance to support first time bond issuers. By issuing thematic bonds, donors can mobilise private commercial investors who are interested to fund social/environmental development. Thereby, they raise the profile of the development challenge targeted by the bond.

Role of development finance institutions in mechanism?

DFIs can issue thematic bonds, invest in bonds or credit enhance bonds. DFIs can act as an *anchor investor* to support the successful issuance of a landmark bond – please see Local Currency Factsheet.

Role of private investors in mechanism? Both international and local investors invest in bonds channeling their funds to the SDGs.

COMPARISON CRITERIA

Impact: Bonds provide long-term financing toward development projects in need of investment. Development impact objectives are designed for each bond/project.

Scalability: High – depending on issuers being able to identify commercially viable, investible development projects in developing countries.

Effectiveness/Efficiency: Thematic bonds, by virtue of their commitments to transparency and regular impact and financial reporting, can tie investors' capital to clear, assessable, and quantifiable impact outcomes. Therefore, standard setting and reporting is a key.

Feasibility: Thematic bonds are proven and mature, with credit-enhancements and results-based repayment terms in their early phase.

Mobilisation: By issuing thematic bonds, institutions signal prioritisation of the development challenge that they are looking to fund. Also, they implicitly accept the scrutiny and commitment to reporting transparency required by the international capital markets, which helps to mobilise private commercial investors.

Flexibility: High flexibility to mobilise debt investment to impact projects that would not otherwise likely receive commercial finance.

SUCCESS FACTORS

Well-developed capital markets are needed for thematic bonds to flourish. Green bonds, for example, have seen higher growth in developed markets compared to emerging markets, due to the greater market awareness and knowledge of the issuance process. TA is often deployed to develop capital markets in developing countries or to create a new type of thematic bond.

Creditworthiness of the issuer, as with normal bonds, also determines investibility and how costly it is to raise funds through thematic bonds.

Greater issuance of local currency-denominated bonds is needed to promote debt sustainability in developing markets and to raise the visibility of domestic markets to foreign investors. Most thematic bonds in development finance have been issued in hard currency (e.g. USD) to date funded in the bond's legal documentation. These projects should have clear environmental benefits, which should be assessed and quantified by the issuer.

Commitments that raised funds will be used as planned, since there is no assurance the funds will actually be used to fund the development project specified. To ensure this, detailed and comprehensive reporting at the project level is therefore required which can be time-consuming and costly.

Process for Project Evaluation and Selection: issuers should communicate to investors their environmental sustainability aims, and the process used to determine how the projects funded by the bond fit within these aims, including the related eligibility criteria.

Management of Proceeds: the bond's net proceeds should be credited to a separate sub-account and formally tracked throughout the project's life.

Reporting: issuers should make and keep readily available, up-to-date information on the use of proceeds, describing the amounts allocated to the projects and their expected impact.

TRENDS TO-DATE

- Sustainable Development Bonds rose to prominence before a comprehensive set of criteria was developed. In July 2007, the European Investment Bank issued the first Green Bond, followed by the World Bank in November 2008.
- Both these issuances were in direct response to an influential report, published by a UN Agency in 2007. It linked human action to global warming and created investor demand for a new asset class that, ideally, combined measurable (environmental) impact with market returns.
- The issuances outlined the importance of “impact reporting” – offering the investor a credible, measurable answer to the question “What non-financial return does this bond achieve?”, on both an *ex-ante* and an *ex-post* basis. The robust growth in green bond issuances since 2008 set the stage for the development of the Green Bond Principles (“GBPs”) in 2014, by the International Capital Markets Association (ICMA). The GBPs address “impact reporting”, by providing guidance (i) to issuers on how to structure a Green Bond and (ii) to investors and underwriters on how to evaluate environmental impact and what disclosure to request.
- For example, ICMA defines four key principles to consider whether classifying a bond as ‘green’ and recommends bond issuers to appoint an external review provider to confirm the bond aligns with the four recommendations. The importance of the GBPs as a voluntary market reference for impact reporting is evidenced by the strong growth in Green Bond issuance, and the enrichment of the thematic bond palette

over the past five years – with the launch of Blue Bonds, Social Bonds, and Sustainability / SDG bonds,

- In 2019, Green Bond issuance reached USD 500 billion cumulatively. Success led to the development of the Social Bond Principles (“SBP”) and the Sustainability Bond Guidelines (“SBG”), to offer similar levels of guidance on transparency, disclosure, and impact reporting that the GBP provides to Green Bonds. Another notable development has been the issuance of local currency denominated green bonds. While the EUR and the USD still predominate in terms of denominations (accounting for 40 % and 31 % of the annual green bond market by volume in 2018, respectively), this growing diversification is likely to raise the visibility of domestic markets to foreign green bond investors.⁵³

CASE STUDIES

Tamil Nadu Urban Development Fund Project

The Tamil Nadu Urban Development Fund Project is a pioneering project supported inter alia by KfW and the World Bank. Funds are deployed as credit enhancement for pooled municipal bonds that are bundled via a platform and issued on the capital market

More specifically, Tamil Nadu Urban Development Fund (TNUDF) provides a total of EUR 260 million in investment to municipal projects with high quality standards. In addition, the municipalities receive support in the issuance of bonds to raise additional funding on the capital market.

Read more here: <http://tnuifsl.com/tnudf.asp>

ENEL's SDG Corporate Bond

ENEL's SDG Corporate Bond Issuance is one of the first examples of a SDG linked corporate bond issuance. The large Italian energy firm ENEL, one of the largest corporate issuers of Green Bonds abandoned its Green Bond programme (~ EUR 3.5 billion issued in 2017-19, over 3 issues) in favour of the SDG Bond format with an inaugural USD 1.5 billion issuance – followed up by a EUR 2.5 billion multi-tranche (5y, 7.5y, 15y) SDG Bond in November 2019. The ENEL issues were very successful with large oversubscriptions with a measurable “Greenium” of 10-20 bps vs. ENEL bonds without sustainability features. Furthermore, both of them allow ENEL to diversify its investor base, by accessing sustainable investors.

Read more here:
www.enel.com/investors/fixed-income/mainprograms/sdg-bond
<https://www.enel.com/content/dam/enel-common/press/>

⁵³ Green Bonds, The State of the Market 2018.

Citi USD Green Bond Issue

Republic of Seychelles has launched the world's first sovereign blue bond – a pioneering financial instrument designed to support sustainable marine and fisheries projects. The bond, which raised USD 15 million from international public and private investors. The Seychelles blue bond is partially guaranteed by a USD 5 million guarantee from the World Bank (IBRD) and further supported by a USD 5 million concessional loan from the Global Environment Facility GEF.

Proceeds from the bond will include support for the expansion of marine protected areas, improved governance of priority fisheries and the development of the Seychelles' blue economy. Grants and loans will be provided through the Blue Grants Fund and Blue Investment Fund, managed respectively by the Seychelles' Conservation and Climate Adaptation Trust (SeyCCAT) and the Development Bank of Seychelles (DBS).

Read more here:
<https://sdg.iisd.org/news/seychelles-launches-first-blue-bond/>

Women's Livelihood BondTM (WLBTM)

The Impact investment Exchange IIX Social Sustainability Bond (ISB) pools high impact debt securities in a single portfolio which have undergone a rigorous due diligence process based on both social and financial criteria. It allows underlying borrowers to access large amounts of capital that otherwise would not have been raised individually. ISBs are designed to be sustainable instruments, offering attractive rates of risk-adjusted returns to impact investors who are interested in a double bottom line. ISBs will be listed on a stock exchange, adding an additional layer of secondary liquidity, mission protection and transparency. The first ISB is the Women's Livelihood BondTM (WLBTM) an USD 8 million debt security designed to unlock capital for Impact Enterprises (IEs) and Microfinance Institutions (MFIs) that are part of the sustainable livelihoods spectrum for women in South-East Asia.

Read more here:
<https://iixglobal.com/portfolio-item/iix-womens-livelihood-bond/>

OVERVIEW OF KfW PORTFOLIO

KfW has become one of the most active participants and largest issuers in the global green bond market globally since 2014, actively investing in green bonds on a global scale. In fact, KfW was the second largest issuer of green bonds in 2019, bringing USD 9 billion of green bonds to market⁵⁴. Proceeds are used for two loan programmes, one for renewable energy and one for energy efficiency.

German Financial and Technical Cooperation Interventions is also actively engaging in building local and regional bond markets to strengthen local capital markets. The African Local Currency Bond Fund (ALCBF)⁵⁵, launched by KfW in 2012 on behalf of BMZ, looks to help develop Africa's bond markets and improve the private sector's ability to access local currency financing (also see Factsheet 11 Local Currency Finance). BMZ also commissioned KfW with creating an anchor investment fund, the Latin American Green Bond Fund (LAGREEN).⁵⁶ The Tamil Nadu Urban Development Fund Project described above benefited also from KfW support.⁵⁷

MOST RELEVANT ADDITIONAL RESOURCES

BMZ: Green Bonds for Latin America. Accessed at:
http://www.bmz.de/de/zentrales_downloadarchiv/themen_und_schwerpunkte/klimaschutz/01_factsheets/en/BMZ_Green-Bonds_en.pdf.

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<https://www.climatebonds.net/market/explaining-green-bonds>.

Climate Bonds Initiative (2020): 2019 Green Bond Market Summary. Accessed at:
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https://www.climatebonds.net/files/reports/cbi_gbm_final_032019_web.pdf.

⁵⁴ Climate Bonds Initiative (2019): Green Bond Market Summary

⁵⁵ <https://www.alcbfund.com/>

⁵⁶ BMZ: Green Bonds for Latin America. Accessed at: www.enel.com/investors/fixed-income/mainprograms/sdg-bond.

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https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-green-bond-standard_en.
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 Accessed at
<http://documents.worldbank.org/curated/en/510581481272889882/pdf/110881-BRI-EMCompass-Note-25-Green-Bonds-FINAL-12-5-PUBLIC.pdf>.
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<https://www.sec.gov/Archives/edgar/data/821533/000119312519240748/d757618dfwp.htm>.
- Mera, G. (2020): Thematic Bonds: Essential Tools for Development. Accessed at:
<https://blogs.iadb.org/bidinvest/en/thematic-bonds-essential-tools-for-development/>.
- OECD (2017): Mobilising bond markets for a low carbon transition. Accessed at:
https://read.oecd-ilibrary.org/environment/mobilising-bond-markets-for-a-low-carbon-transition_9789264272323-en#page34.
- Republic of Seychelles (2018): Green Bonds 2.0: The World's First Sovereign Blue Bond.
- Reyes, S. & Rupérez, V. (2019): Transparency is the Key for Thematic Bond's Success.
 Accessed at: <https://blogs.iadb.org/bidinvest/en/transparency-is-the-key-for-thematic-bonds-success/>.

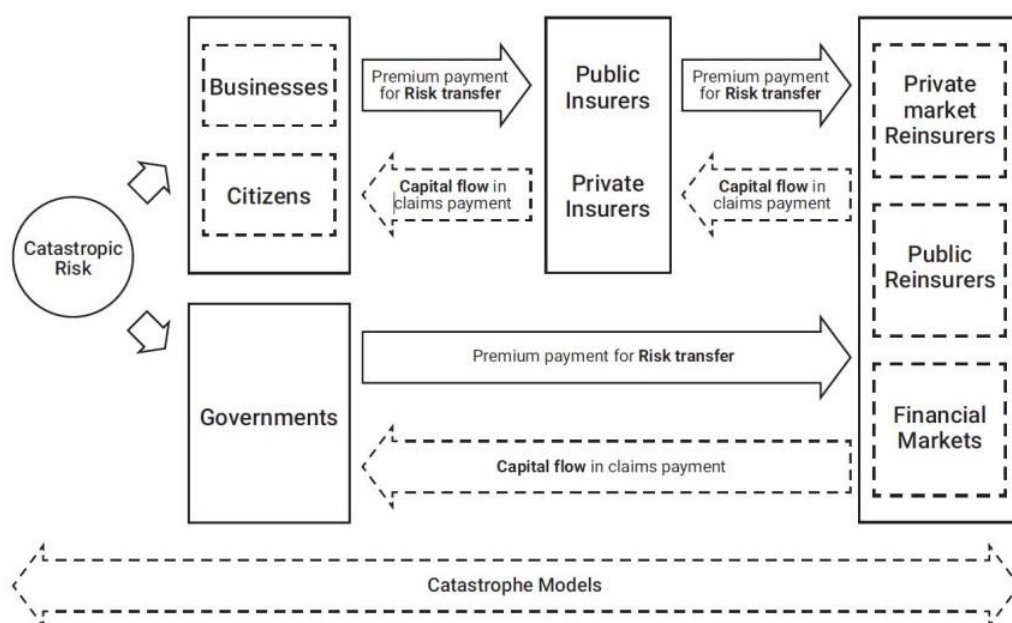
Insurance

KEY FACTS

- Insurance is a risk transfer mechanism that offers protection to insured parties against a range of specific risks in return for the payment of premiums. While insurance does not reduce the risk of an event happening, it reduces the financial burden caused by the event on the affected party. Moreover, insurance can also incentivise risk reduction and mitigation measures (e.g. through reductions in premiums in return), thus improving overall resilience (ability to recover) and reducing vulnerability (susceptibility to an extreme event).
- Extreme events (such as the COVID-19 pandemic or hurricane Idai in Mozambique) can have severe and long-term economic impacts. Apart from their financial implications, extreme events also have significant adverse effects on the attainment of the SDGs. As an example, according to the World Bank, climate-related disasters throw 26 million people back into extreme poverty every year. To reduce the financial burden and to mitigate effects of extreme events, insurance solutions come into play.
- Germany plays a key role in the development of climate risk insurance solutions for developing countries through the G7/G20 InsuResilience Global Partnership. This is also reflected in KfW's innovative insurance project portfolio, which is strongly geared towards climate risk insurance.
- Insurance is most effective for extreme events (low probability / high severity) that have the potential to cause severe loss. In case of events with higher probability and lower severity (e.g. smaller regional droughts), other mechanisms such as savings or reserve funds are in general the more adequate option.

Basic Structure

Insurance Landscape (example: catastrophic risk insurance)



Source: Jarzabkowski, P., K. Chalkias, D. Clarke, E. Iyehen, D. Stadtmueller & A. Zwick (2019): Insurance for climate adaptation: Opportunities and limitations." Rotterdam and Washington, DC.

Scope

- Insurance can cover a wide range of risks such as health, life, natural hazards, project risks or credit default (and many more). Generally speaking, insurance is very flexible, in particular in contrast to other instruments such as guarantees; covers can be defined as required.
- Given the wide range of risks that can be addressed by insurance, this instrument is applicable for all types of target groups and countries looking to mitigate the effects of unexpected events (LDC/LICs, MICs, LMUCs and UMICs).
- While insurance is an important instrument for innovative development finance in itself, as a bank, KfW does not issue insurance covers. In contrast, through the provision of equity, loans, grants and technical assistance, KfW contributes to the development and marketing of insurance products.
- In the following, examples of KfW insurance-related projects and KfW's role are listed:
 - Provision of equity and/or debt for regional risk pools or local players along the insurance value chain (e.g. through the InsuResilience Investment Fund⁵⁸, which invests in local insurers and aggregators, aiming to increase the availability of insurance products).
 - Provision of partial grants for product development to create a business case for insurers to design and distribute products for developing countries (e.g. through the InsuResilience Solutions Fund).
 - Premium subsidies or voucher schemes (e.g. health) to provide access to insurance/medical care.
 - Development of new financial products such as Shock Resilient Loans (SRL). These are loans that are combined with an insurance policy, which covers payment obligations towards the lender in case of a disaster, thus freeing up financial resources for emergency relief of the borrower.
 - Integrated insurance solutions combining insurance with other elements of a holistic disaster risk management approach, such as risk assessment, risk reduction and/or preparedness measures (e.g. R4 Ethiopia, African Risk Capacity).

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Grant, debt, equity, guarantee or derivatives.	Target Group: Individuals, businesses and public entities, with a focus of the KfW portfolio on the poor and vulnerable. Investors: Private sector / commercial investors: de-risking of investments.	Development Stage: ☒ Concept ☒ Pilot ☒ Proven High degree of innovation / new insurance products. ODA eligibility: Yes
Approach: Insurance	Applicability Type of Countries: ☒ LDC/LIC ☒ LMIC ☒ UMIC	KfW experience: Yes
Product for beneficiaries: Insurance coverage for risks under-provided by the market.	Relevance for SDGs: SDGs 1,2, 3, 4, 5, 8, 9, 10, 11, 12, 13 and 16	Peer Experience: World Bank, DfID (donor), ADB

Addis Ababa Action Agenda impact areas

Criteria	Assessment	Explanation
Mobilise additional private capital	9 out of 10	Insurance reduces the risk of financial losses, thereby facilitating increased lending to and investment in insured parties/projects. Insurance coverage can therefore help to make an unbankable project bankable. Most insurance programmes ultimately rely on the reinsurance capacity provided by the private sector. In that sense, all insurance programmes also mobilise substantial amounts of private capital. KfW finances funds and facilities that aim to improve the insurance landscape in developing countries. In many cases, these attract private capital investments into the fund structure and/or facilitate additional private capital investments in the partner countries.

⁵⁸ See also Facsheet Facilitie, Case Studies InsuResilience Investment Fund, p. 25.

Criteria	Assessment	Explanation
Strengthen local capital markets	7 out of 10	Insurance protection reduces financial risk and strengthens local capital markets due to the fact that the protection enables higher investment. An insurance portfolio as such holds financial assets (to back up liabilities), which is generally reinvested in local markets. KfW finances funds and facilities (e.g. InsuResilience Investment Fund) that invest in local insurers and banks, thus strengthening their capital base.
Debt Sustainability	8 out of 10	Insurance increases debt sustainability through providing immediate financial relief and preventing indebtedness (in contrast to loans) in case of disaster.

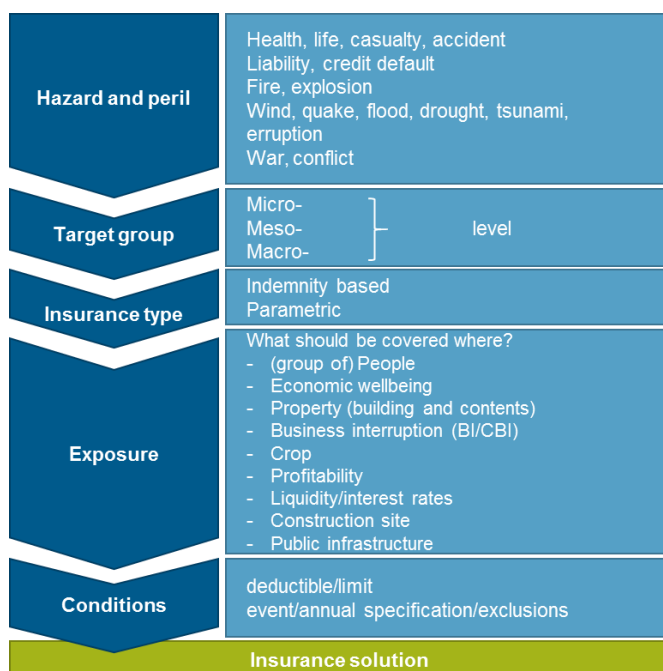
MECHANICS & ROLES

How does it work? Insurance transfers the risk of financial loss from one party (an individual, business, or public entity (such as governments)) to another, with the receiving party being in a stronger position to bear and manage the risk. The insurance sector and individual policies work on the principle of solidarity: many insured individuals or entities pay small, manageable amounts of premium to pay for damages caused by an unforeseen (extreme) event⁵⁹. The premium depends on the insured risk, and thanks to the pooling effect (e.g. the grouping of different policies under one insurance company), premiums can be offered at more affordable levels. Insurance uses historical data, probabilistic and statistical models to determine the cost of insurance premiums. Hence, data availability and quality are essential. Poor quality means additional uncertainty, which will result in higher risk factors causing more expensive premiums.

Today, insurance mechanisms are very flexible, and a wide range of risks can be addressed using insurance solutions. Given the complexity as well as breadth of insurance products, a snapshot of considerations when working on insurance and insurance-like solutions is provided below (chart 1).

The foundation of all risk transfer mechanisms is a sound risk assessment that enables, on the one hand, the selection of the right mitigation/transfer tool, and on the other hand, the calculation of adequate savings or insurance premiums. The development of those risk assessment tools is expensive in terms of data collection and know-how in risk modelling. In most cases, these tools need to be licensed and only few open-source models are available. Hence, it is important to invest in this field to empower not only insurance but the broad field of disaster risk management.

Decision making process in insurance



Source: own design

⁵⁹ One exception is health insurance, where in most cases preventive health services (such as medical check-ups) are also covered under an insurance policy.

What are the different forms of mechanism? Depending on the target beneficiaries of insurance, e.g. protecting individuals (health) or a group (poor and vulnerable against the effects of climate-related events), the protection instruments need to be deployed at different levels as described below:

Micro-level insurance is the direct insurance of individual people, projects, assets or businesses. Examples can be found in the health and agriculture sectors as well as in portfolio protection (e.g. insuring minimum sun levels and thus profitability of solar power plants).

At the **meso-level, insurance** is provided to a group of individuals under a collective body/cooperative. This meso-level organisation buys an insurance product that covers the collective; the individuals themselves are indirect beneficiaries of the financial protection and receive payments/services from the meso-level organisation based on insurance payouts.

In **macro-insurance**, the policyholder is typically a public entity, such as a government. In the case of a disaster, payouts can be used for multiple purposes on behalf of the population. Often, insurance covers at the country level are conditional on national contingency plans that provide guidance on the quick flow of funds into specific measures for relief – e.g. to maintain government services, or to support the most vulnerable with emergency aid, such as provision of food or animal feed. One example of this is the African Risk Capacity (ARC).

Moreover, insurance can be designed as indemnity-based or parametric insurance. **Indemnity-based insurance** covers the actual measurable loss or damage that has occurred. In order to receive a payment from the insurance company, an independent loss adjuster is appointed to inspect the damage after the event to evaluate the loss or cost to repair.

If the insurance aims to address immediate disaster response rather than actual loss, on the other hand, **parametric or index-based product types** should be used. These are products where a payout is triggered by a set of parameters, indices or expected loss levels due to an extreme event or disaster (e.g. amount of rainfall, magnitude of earthquake, or modelled loss). The insurance parameters – the triggering event as well as the payout amount – are agreed ex-ante and are not linked to the actual event or loss. The fast payouts of index-based insurance explain why these products are a leading component of innovative risk-financing strategies for disasters.

However, the following challenges need to be addressed in the case of parametric insurance: 1) the potential basis risk (the difference between the payout triggered and the actual loss) because these products rely on models rather than actual damage; and 2) the complexity of the product and the choice of the right product relative to the client's needs (triggering event vs. particular threat).

Role of donors in mechanism? Multiple. As mentioned before, the introduction phase of insurance products is particularly expensive, and start-up investment is needed. Donors can provide equity, loans, or grants for product

development and TA or premium subsidies. The latter is an enormous lever for introducing insurance for the poor and vulnerable. Donors can also provide equity to back up potential liabilities arising from insurance products, which allows in particular local insurance players to increase their offer of insurance products. Furthermore, donors can provide political incentives to foster resilience and reduce vulnerability especially towards climate change.

Role of development finance institutions in mechanism?

DFIs can provide commercial finance (loans and equity), grants as well as TA to insurance companies and vehicles. Please also refer to the paragraph on the role of donors.

Role of private investors in mechanism? In general, private investors, and their companies and projects, procure, invest and foster insurance or insurance-like facilities in order to earn return. Many private insurance companies, however, are willing to earn little to no return at the moment when working with developing countries. This is on the one hand due to corporate social responsibility aspects and their commitment to contribute to political initiatives such as the InsuResilience Global Partnership, and on the other hand to the fact that developing countries are new markets to most insurers, which allow to extend their business and which allow for diversifying the risk in their insurance portfolio.

Private investors are also clients and beneficiaries of insurance, e.g. to protect their assets and thus to increase investment opportunities.

In addition, insurance companies are almost always owned by the private sector and hence, private investors are a powerful source of insurance know-how. Finally, as shown in the chart on insurance, reinsurance as well as retrocession and the capital markets play a huge role in the overall system.

COMPARISON CRITERIA

Impact: Insurance improves financial resilience, thus reducing the impact of potential development setbacks through disasters. Immediate availability of funds for disaster recovery and reconstruction furthermore reduces the risk of knock-on effects. Hence, insurance plays an important role in stabilizing incomes and in fighting against poverty and famine as well as in enabling sustainable growth and the attainment of the SDGs.

Scalability: Insurance products are 'scalable' in the sense that risks can be pooled across regions and schemes can be amended with additional perils. Based on risk models, insurance products can be developed and extended as desired. In this context, global risk models as deployed for the Natural Disaster Fund or open-source models (e.g. by the Insurance Development Forum) open up new opportunities for insurance products. In addition, technical progress and digitalisation open new distribution channels, new markets, and facilitate monitoring (reduced cost), which has a positive impact on coverage and volume. Additional scale can also be reached through premium subsidies as this is a limiting factor in insurance take-up in many times, especially for the poor and vulnerable. Lastly, insurance can be scaled through investing

in local insurers and banks. Especially in the context of KfW projects related to insurance, funds as well as facilities can be increased in volume to generate additional scale.

Effectiveness/Efficiency: Generally speaking, insurance products effectively package and transfer risks away from those unwilling or unable to bear them, thus increasing financial resilience. Comparing traditional insurance products (relying on insurers' loss assessments) to parametric (index-based) insurance, the latter offers lower monitoring and loss adjustment costs and a more transparent indemnity structure. Hence, especially in development finance, this type of insurance is an effective tool with high impact for beneficiaries. In addition, and as already mentioned above, technical progress and digitalisation empower index-based insurance and reduce costs. At the same time, parametric insurance contracts also entail basis risk (where modelled and actual losses do not align). Moreover, insurance products also run the risk of payouts being denied or delayed due to overly rigid conditions defining the triggering event, despite a clear and obvious present need (e.g. World Bank Pandemic Emergency Financing Facility). Hence, there is a fine line between economically feasible premiums and perfect customisation of the product.

Feasibility: Traditional insurance covers already have a sound and mature standing and have proven to provide financial resilience. At the same time, insurance is a very dynamic field, and product development addresses new demand. In recent years, increasingly innovative approaches (e.g. Shock Resilient Loans) have emerged, and expectations are high that they will prove themselves effective.

Mobilisation: Generally speaking, insurance products and facilities mobilise private capital in multiple ways. Firstly, insurance reduces the risk of financial loss, thus enabling additional investment and making more projects bankable. Secondly, insurance solutions or pools rely on reinsurance capacity, which reduces the required solvency capital substantially. Finally, insurance vehicles such as (structured) funds, bonds or facilities can mobilise a large number of private investors, attracted by the uncorrelated nature of the assets and the resulting opportunity for diversification in many cases.

Flexibility: Insurance products are highly flexible and customizable to the needs and preferences of individual policyholders, businesses or public entities.

SUCCESS FACTORS

- Trust is the most important value in insurance. Hence, building trust on the supply side (e.g. understandable products that meet expectations) as well as on the demand side (preventing moral hazard⁶⁰) is essential in building a sustainable insurance environment.
- The take-up of insurance largely depends on the willingness and the ability of potential clients to pay for it. The former requires risk awareness of the clients, as well as the willingness to react ex-ante rather than ex-post. In addition, at time of market introduction as well as in times of crises (post disaster or during economic downtime) insurance

⁶⁰ Change of behaviour with insurance cover compared to behaviour without cover.

product subsidies are vital to provide continuous cover. Moreover, subsidies allow access to insurance for the poor and vulnerable who would not be able to afford coverage.

- Insurance contracts need to be provided by local insurers subject to national insurance regulation. Especially at the beginning, this can be an institutional barrier when it comes to market introduction and product distribution. Hence, supporting local insurance markets is essential to build the foundation of a functioning risk transfer mechanism.
- Risk assessment tools are an essential prerequisite of insurance. In the development context, data availability is limited, and weak data quality adds another level of uncertainty, which can lead to more expensive premiums. Moreover, statistical and probabilistic risk modelling to provide premium calculations is expensive. Hence, grant funds for data collection as well as the development of sound risk assessment tools are an important component of insurance solutions.
- The impact of insurance is enhanced when it is embedded in a holistic disaster risk management approach, and thus combined with other elements such as risk assessment, risk reduction and/or preparedness measures. For example, premiums can be significantly lower and thus more affordable if the risk is first reduced.

TRENDS TO-DATE

- In the development context, the pioneers in the insurance sector were micro-insurances addressing risks in sectors like agriculture, but **today's range of insurance products has become much broader**. One driver is the InsuResilience Global Partnership, under whose umbrella innovative climate risk transfer solutions have been developed and implemented. Development of **novel development finance products linked to insurance** such as Shock Resilient Loans enriches the insurance options and has the potential of promoting new insurance solutions.
- The **insurance market is growing**: Insurance in general is on the rise given growing risk awareness (especially due to climate change) and need. Some regional markets in developing countries are growing at over 30 % annually⁶¹.
- **Index based triggers become the preferred option**: Firstly international insurers prefer parametric (index-based) products given the cost-efficiencies. Secondly, index-based insurance enables immediate payout in the case of a disaster, which reduces the risk of knock-on effects of disaster. As a consequence, this type is a favored solution in development contexts.
- **Digitalisation**: Digital technologies (satellite and mobile phone technology as well as online platforms) have the potential to increase the speed, facilitate access and lower the administrative costs of insurance, factors which jointly contribute to higher customer up-take.
- **DFIs seek insurance**: Insuring DFI portfolios or specific projects is becoming increasingly important to increase financial resilience.
- **Rise of insurance linked securities (ILS)**: The continuous low-interest-rate environment in the leading OECD countries

has driven non-insurance-industry capital into the catastrophe bonds (CAT bond) / insurance-linked security (ILS) market, attracted by the relatively higher yields, along with the uncorrelated risk to traditional investment offered by such bonds.⁶² However, the current trend of increasing frequency and severity of pay-outs – whether caused by climate change or pandemics – may impact negatively on the appetite among investors to take up disaster-linked instruments.

CASE STUDIES

African Risk Capacity

KfW Development Bank is one of the key shareholders of the African Risk Capacity (ARC), a drought insurance for African countries under the umbrella of the African Union. As the insurance is index-based, disbursements can be triggered within days in case of a disaster. Corresponding contingency plans allow for an effective use of the disbursed funds. These swift mechanisms substantially reduce the costs of reversing long-term damages of extreme weather events. Moreover, early warning systems aim at monitoring emerging risks, allowing for early preventive measures.

An innovative partnership model (ARC Replica) which splits insurance costs between a humanitarian organisation and an AU member state while aligning their contingency plans has been successfully piloted this year with the support of KfW Development Bank.

R4 Rural Resilience Initiative Ethiopia

KfW Development Bank supports the upscaling of the R4 Rural Resilience Initiative in Ethiopia. R4 aims at increasing food and income security of vulnerable rural households through an integrated approach with four elements. First, drought insurance protects farmers against financial losses in the case of an extreme weather event. Second, poor farmers are able to finance premiums by working on public projects which increase the community's resilience (e.g. soil conservation). Third, the approach facilitates access to credit. Fourth, savings are incentivised in order to cover losses from smaller droughts. These four pillars thus reduce farmers' vulnerability to extreme weather events and help increase productivity.

Read more here:
<https://www.wfp.org/r4-rural-resilience-initiative>

⁶¹ IFAD/PARM (January 2020)

⁶² Catastrophe Bonds, Federal Reserve of Chicago (2018)

Shock Resilient Loans (SRL)

The instrument of “shock resilient loans” (SRL) has been developed by KfW Development Bank and is currently piloted with the West African Development Bank BOAD. SRLs combine loans with subsidised insurance against natural disasters. In the case of a disaster, the insurance covers the repayment of the loan to the lender, allowing the borrower to immediately use the funds for disasters response and reconstruction. This reduces long-term costs of a delayed response and avoids budget cuts or borrowing at high interest rates in the case of an emergency.

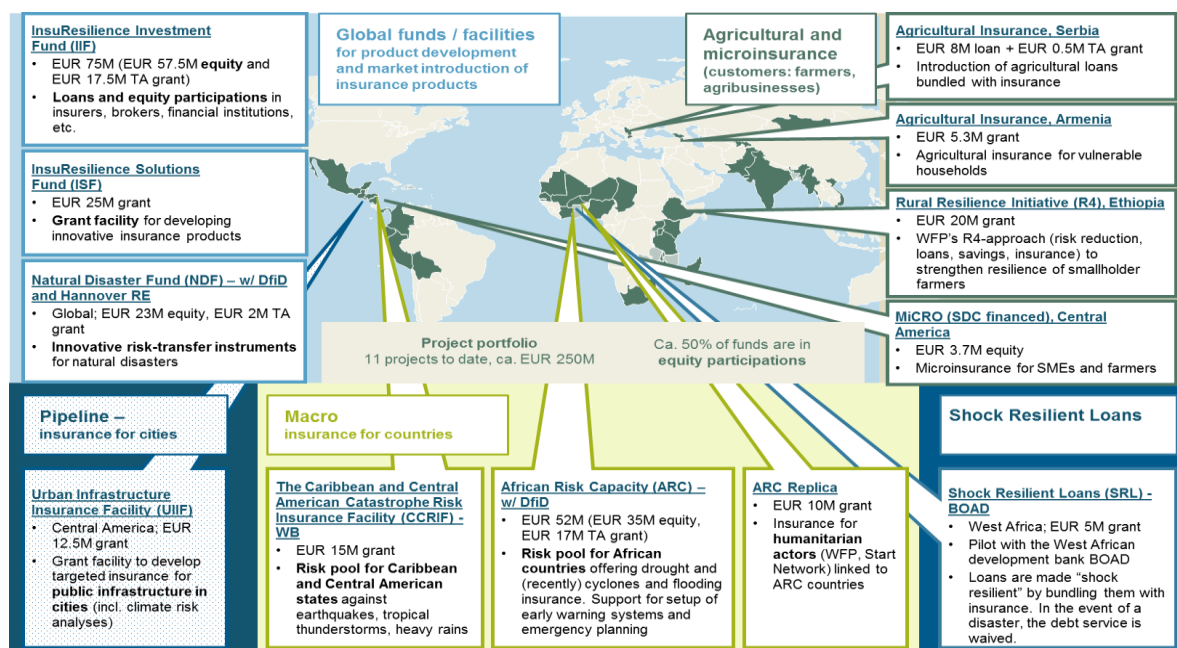
Read more here: <https://www.insuresilience.org/>

Health insurance in Pakistan

Together with the Government of Pakistan, KfW Development Bank co-finance health insurance in structurally weak regions of Pakistan, providing access to health services for approximately 800,000 poor individuals. This includes preventive measures as well as therapeutic measures, while providing incentives for ambulant treatment to alleviate the stretched capacities of inpatient services. The provision of essential services to underprivileged individuals helps to prevent extreme poverty as health risks are an important cause of extreme poverty in Pakistan.

OVERVIEW OF KFW PORTFOLIO

On behalf of BMZ, KfW is, together with the World Bank, a leader among development organisations in the insurance and resilience finance field. This is especially the case in the field of climate risk insurance. To date, the climate risk insurance portfolio comprises of 11 projects with a total investment of EUR 250 million:



Source: KfW

In addition, KfW has a significant portfolio of health insurance programmes supporting 34 active projects with a total investment of EUR 162 million.

MOST RELEVANT ADDITIONAL RESOURCES

Geneva Association (2018): Understanding and Addressing Insurance Protection Gaps. Accessed at: <https://www.genevaassociation.org/research-topics/protection-gap/understanding-and-addressing-global-insurance-protection-gaps>.

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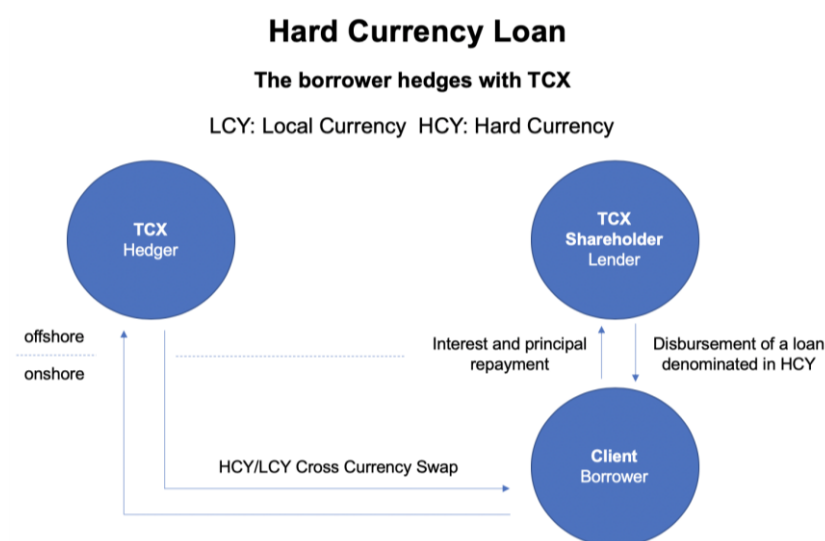
Local Currency Finance

KEY FACTS

- Local currency finance solutions cover a breadth of instruments and approaches that mitigate currency risk in development finance transaction for the recipient of financing and/or the investor. Most common instruments are local currency loans, FX hedges to mitigate hard currency loans and subsidies to reduce cost of those loans.
- In any financial transaction in which the contract is denominated in a currency different than (i) the revenues of the project, company or the country (e.g., a USD loan to a Kenya SME) or (ii) the target return currency of the debt or equity investor, currency risk is present. For example, when a company borrows in a foreign currency, and the local currency depreciates relative to the foreign currency, debt service costs in local currency increase leading to potential default and/or insolvency.
- Currency risk is the most predominant risk in development finance. In 1999, economists⁶³ coined the term “original sin” to refer to a situation in which countries are not able to borrow abroad in their domestic currency – at all or at acceptable interest rates and therefore borrow in hard currency. Even today, more than 20 years after demonstrating the high risk and negative impact of this approach, the large majority of cross-border debt in a majority of developing countries is denominated in hard currency and the large majority of equity investment is unhedged. Local currency finance solutions reduce currency risk for borrowers and investors. Furthermore, they reduce credit risk for lenders and increase national debt sustainability. On the one hand, local currency finance solutions allow SDG projects to be financed directly in local currency. On the other hand, they allow to finance indirectly through hard currency loans and currency hedges. They do that by sheltering projects from local currency depreciation and volatility when funded by hard currency loans. Similarly, equity investors are reluctant to make long-term equity investments in a local currency when the risk of depreciation over a typical 5-10 year investment horizon is significant.

Basic Structure

Typical Local Currency Swap with Hard Currency Loan



⁶³ Barry Eichengreen, Ricardo Hausmann and Ugo Panizza published their initial “Exchange Rates and Financial Fragility” and several follow-on research reports in 1999 – 2007.

Scope

- Local currency finance solutions are applicable to all SDGs, sectors and projects, but in development finance the challenge is most acute in infrastructure and MSME finance. Low-Income Countries suffer from both (i) lack of market solutions and (ii) higher likelihood of depreciation.
- The four most common local currency financing strategies include:
 - **FX risk avoidance** by increasing supply of local currency financing at market terms, e.g. mobilise local currency through bond issuance.
 - **FX risk hedging** to overcome a market failure where no market solution exists., e.g., contracting a currency swap.
 - **FX risk sharing** to reduce cost of local currency loan and to facilitate borrower access to local currency loans.
 - **FX risk acceptance** centers on bearing the currency risk with no hedge e.g. bearing risk unhedged using donor funds.

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Grant, Debt, Equity, Guarantee or Currency Hedge	Target Group: Microenterprises, SMEs and financial inclusion Investors: Solutions can reduce credit risks of debt investors and currency risk of equity investors.	Development Stage: ☐ Concept ☒ Pilot ☒ Proven ODA eligibility: Yes
Approach: Local Currency	Applicability Type of Countries: ☒ LDC/LIC ☒ LMIC ☒ UMIC More options available in MICs	KfW experience: Yes
Product for beneficiaries (market): Debt, Equity or Currency Hedge	Relevance for SDGs: All. Especially SDGs with projects procuring debt.	Peer Experience: Netherlands MFA, European Commission, AFD, IFC and EBRD

Addis Ababa Action Agenda Impact Areas

Criteria	Assessment	Explanation
Mobilise additional private capital	9 out of 10	The intent of a local currency finance solution is to increase the volume and stability of debt and equity investment from private investors and DFIs to projects in developing countries. An absence of solutions impedes cross border capital flows or increases borrower and country vulnerability.
Strengthen local capital markets	9 out of 10	Most local currency finance solutions involve local capital and financial markets, either directly or indirectly. Solutions deepen and broaden local markets.
Debt Sustainability	10 out of 10	Local currency financing prevent debt increase due to local currency devaluation. Hence, developing countries are less exposed to currency fluctuation. Local currency solutions allow cross-border debt to be financed in local currency and allow equity investment to happen.

MECHANICS & ROLES

How does it work? Advanced markets (e.g. developed countries) have deep and liquid capital and currency swap markets. But developing countries often have limited amounts of funding in local currency (e.g. low deposit base) and capital markets are non-existent, nascent or shallow. Low-Income Countries suffer from both (i) lack of market solutions and (ii) higher likelihood of depreciation.

Local currency financing and hedging can be delivered at market terms in some developing countries, but the large majority does not have medium-term capital markets and no/limited currency swap market. For example, the longest tenor of a Kenya Schilling to USD swap is four years at a prohibitively expensive rate.

There are many forms of local currency finance solutions – all centered on making local currency financing and currency risk management solutions possible or affordable. The mechanics of each solution are very different – see next section.

What are the different forms of this mechanism? **FX risk avoidance** by increasing supply of local currency financing at market terms: Local currency solutions can increase the supply of financing at market or near-market terms, thereby allowing more companies and projects to be debt financed in the same currency as the revenues. The KfW-backed African Local Currency Bond Fund (ALCBF) is a good example. The programme provides an anchor commitment in order to purchase a local currency bond issued by a private corporation. Thereby, they allow bond issues to be successful and larger. As well, several MDBs issue local currency bonds in domestic and global markets which enables them to extend local loans while hedging their currency risk.

FX risk hedging to overcome a market failure if no market solution exists. The Currency Exchange is a good example of an InnoFin to overcome market failures by creating and deepening currency swap markets. TCX is a blended finance organisation, funded by donors, DFIs and private investors, which provides currency swaps to its shareholders. This allows cross-border debt finance to be hedged to local currency. It currently offers swaps in 70 developing country currencies.

FX risk sharing to facilitate borrower access to local currency loans. The Credit Guarantee Investment Facility and GuarantCo are the simplest forms: providing guarantee for projects and companies in order to raise local currency loans and bonds.

FX risk hedged cost reduction centers on reducing the cost of the loan to the borrower by subsidising the interest rate or hedging/funding cost. This serves to transform unaffordable local currency loans into affordable and feasible ones. The interest rate of a local currency loan is the aggregate of (i) funding cost, (ii) hedging cost and (iii) credit risk. Regular capital market activity and TCX swaps can result in interest rates that make local currency finance unaffordable and unfeasible. InnoFins can be deployed to increase affordability by reducing hedging/funding costs or reducing credit risk. The LIFT program in Myanmar involves donors providing subsidies to reduce the cost of TCX hedges to affordable/feasible levels. In the EBRD SME Local Currency Loan program, donors

provide a partial portfolio guarantee to reduce EBRD credit risk, with EBRD reducing margins aiming to make local currency loans match local rates. KfW has a similar program to subsidise interest rates on local currency loans.

FX risk acceptance centers on bearing the currency risk with no hedge. The European Commission – EIB ACP program has provided local currency loans for over 12 years pricing expected depreciation into the interest rate. BMZ, KfW and Finance in Motion have established the SANAD Fund which provides local currency loans for SMEs. With BMZ/KfW subscribing to L shares that absorb the FX risk it shelters private investors who are not prepared to bear the FX risk.

The mechanisms cited above refer to debt. Similar approaches can be undertaken with regard to hedge currency risk for equity investors and risk of repatriation of investment capital at year 10.

Role of donors in mechanism? Donors have been required in all successful local currency finance solutions to date, providing grants (LIFT), deeply subordinate and concessional capital (TCX) concessional credit risk protection (EBRD) and TA to support fund managers and issuance of local currency bonds (BMZ via KfW).

Role of development finance institutions in mechanism? DFIs can play several roles. First of all, they invest capital in solutions e.g. the majority of TCX capital is subscribed by DFIs. They also enter transactions to increase viability of solutions: In the first seven years of TCX, DFIs entered a critical mass of hedges to make TCX viable. Furthermore, they bear FX risk to make local currency solutions feasible. Most DFIs do not take open currency risk in their debt portfolio, but they take full open currency risk in their guarantee and equity book. Therefore, they can increase guarantee and equity activity. They also actively issue bonds in local currency to access funding in the same currency as their loans (hedging their currency risk). At the same time, they deepen and broaden capital markets (IFC and EBRD have excellent track records).

Role of private investors in mechanism? Investors make equity and debt investments, for which they seek the solutions described in this Factsheet. Investors can also provide currency solutions, such as providing currency hedges, subscribing bonds, issuing local currency loans and investing in unhedged equity. Citibank and other commercial banks have expanded the breadth of developing currencies they can offer currency swaps.

COMPARISON CRITERIA

Impact: Local currency solutions provide some of the highest development impact in development finance. They substantially increase finance for the financial sector and real economy while making financing sustainable for borrowers and countries (in contrast, the large majority of current DFI finance is denominated in hard currencies). Some local currency programs are accompanied by local capital and financial market reform programs to deepen and broaden capital markets.

Scalability: In principle, highly scalable but in reality limited scalability due to high capital intensity, high transactions costs and narrow/shallow markets. Most developing countries require innovative local currency finance solutions – for example, around 85 % of DFI debt financing and 90 % of market debt financing to developing countries is in hard currency. But given the high risk multiplied by the required long tenor, solutions are very capital intensive with low leverage. For example, TCX underwrites maximum FX exposure equal to 3 times paid-in-capital. The EBRD SME Program has proven to be highly scalable since credit risk materialises much less frequently than local currency depreciation risk.

Efficiency: Currently inefficient. The best routes to efficiency are (i) aggregating projects/transactions to diversify currency risk (e.g., TCX), (ii) donors and DFIs collaborating on a limited number of development finance / blended finance solutions and local currency bond issuances (e.g., MDBs issuing bonds in MIC and LIC currencies). TCX is one of the few instances of an InnoFin gaining support from several donors (three) and many DFIs (14). But even then, after 12 years, TCX operates around 40-45 % of its capacity (see May 2020 S&P report) due to DFI's continuation of FX hard currency loans representing their highest volume product earning the majority of gross and net income. The KfW African Local Currency Bond and CGIF are good examples of donor-led solutions being created that can be replicated across multiple aggregated projects.

Feasibility: Some are proven and mature funds, but most of them are still in pilot phase.

Mobilisation: Local currency finance solutions currently mobilise small amounts of private investment due to the small size of the solutions, the capital intensity and DFIs' prevailing practices.

Flexibility: The local currency solutions profiled in this Factsheet evidence the high flexibility to mobilise debt or equity investment to impact projects that would otherwise not receive commercial finance. The general avoidance of currency risk at DFIs and financial markets reduces flexibility.

SUCCESS FACTORS

Delivering local currency solutions at market prices and/or feasible prices. Standard local currency solutions often result in a price (e.g. interest rate) well above market prices in the developing country or at unfeasible and prohibitively high prices. Local currency finance solutions are best deployed when they can increase the limited supply of local currency finance at market prices. If market prices are not feasible, then the solutions are possibly deployed below-market prices (if warranted). Donors can deploy ODA resources to provide subsidies to decrease local currency loans interest rates to feasible levels (see LIFT case study).

Alignment with donor interests is difficult and funding limited. Donors usually allocate development funds to countries, regions, sectors and development topics, with very limited funds available for local currency finance solutions. Over the past decade, the amount of donor funds allocated to local current solutions is likely equal to less than USD 100 million per year, which is less than 0.1 % of ODA. As described

above, local currency solutions are capital intensive, requiring higher allocation from donors.

TRENDS TO-DATE

- **Prevailing practices in development finance and private investment** result in huge FX risk in developing countries. The large majority of DFI income which is derived from FX loans and private investors are prepared to lend in FX bearing the extra credit risk of FX loans. TCX has expanded its portfolio to 70 currencies in low and middle income countries, and its annual volumes to a record. In 2019, TCX underwrote USD 1.35 billion of swaps, with only 40 % for DFIs. The USD 525 million is around 1 % of the USD 45 billion of DFI financing provided to private sector operations. This status quo is compounded by very low FX interest rates entrenching FX lending. The success requires building solutions despite prevailing practices, including (i) increasing the number of currencies to procure local currency funding/hedging (TCX now covers more than 80 currencies), making local currency loans affordable for borrowers and equalizing margins on hard and local currency loans for MDBs and DFIs .
- A study by EBRD in 2012 found local currencies of developing countries depreciate around 4 % per annum on average, with high volatility.
- Similar to “private investment mobilisation,” local currency financing in development finance has not caught up with the rhetoric. Volumes continue to be low for many reasons identified in the Factsheet.
- The World Bank Group and International Development Assistance donors have created the USD 500 million Local Currency Facility within the IDA Private Sector Window. It allows IFC and MIGA to provide local currency solutions in low-income countries.
- TCX annual business volumes and capitalisation are good proxies for trends: (1) annual volumes have doubled from USD 620 million in 2015 to USD 1.35 billion in 2019 and (2) TCX capitalisation has increased from USD 570 million to USD 950 million.
- In TCX, the EBRD SME Local Currency Loan programme, GuarantCo, CGIF and the Africa Local Currency Bond Fund, almost all donor risk capital has not been lost. The programmes demonstrate how donor risk capital can support multiple years of currency solutions leveraging private investment mobilisation.
- Two outliers in development finance are (i) the EIB ACP Investment Facility and the (ii) the Dutch MASSIF Fund. The EIB and FMO provide local currency loans with open currency risk (e.g., no hedging or funding in local currency). This is made possible by risk sharing from donors, which is FX risk acceptance. In 2015, the European Court of Auditor' reported that the ACP “provided access to local currency financing and generates a catalytic effect.”The German government will soon be a pioneer in offering local currency loans to developing countries pursuing reforms.

CASE STUDIES

African Local Currency Bond Fund (ALCBF)

The ALCB Fund is focused on developing domestic capital markets in Africa by (1) providing anchor investment commitment and (2) technical assistance to first-time or innovative local currency bond issuances from financial institutions and companies in Africa. At year-end 2018, the ALCB Fund had invested in 44 bond issuances across 16 countries for total of USD 115 million of Fund investment complemented by USD 972 million of private sector co-investment. The Fund has experienced no defaults.

The ALCB Fund was initially designed, capitalised and managed by the KfW Development Bank and GIZ, with IFC, FSD Africa, FMO, AfDB and FMP participating subsequently.

In 2019, Moody's Investor Services assigned a "Baa2" investment grade rating to the Fund.

Read more here:

<https://www.alcbfund.com/>

<https://www.convergence.finance/resource/>

EBRD SME Local Currency Programme

The USD 500 million Programme aims to develop local capital markets and encourage local currency lending for SMEs. The Programme combines EBRD capital, donor resources, TCX hedges, local capital makers and policy dialogue aiming to provide eligible companies with access to affordable, market-based funding, as well as acceleration in reforms to develop local currency intermediation and local capital markets.

To become eligible, the Ministry of Finance and central bank must sign a MoU to undertake reforms and improvements for local capital markets.

Read more here:

<https://www.ebrd.com/what-we-do/sectors-and-topics/sme-local-currency-programmes.html>

GuarantCo

GuarantCo is a facility which mitigates constraints in the supply of local currency financing for infrastructure projects in Africa and Asia. It provides guarantees to lenders which improves the credit for local currency debt issuance by infrastructure projects. Thereby it uses tools like partial credit guarantees and political risk guarantees to improve terms for borrowers.

GuarantCo is funded by the governments of the United Kingdom, Switzerland, Australia, Germany, Sweden the Netherlands, through the PIDG Trust. It was launched in 2006.

Read more here:

<https://guarantco.com/gco/>

TCX LIFT Program – Subsidy

The factsheet identifies the relatively high cost of funded or hedged local currency loans compared to hard currency loans – typically an 800-1000 basis point premium given current very low USD and Euro funding costs. TCX and the Livelihoods and Food Security Multi-Donor Trust Fund (LIFT) and TCX have partnered to provide over USD 80 million equivalent of local currency loans in Myanmar. LIFT provides straight interest rate subsidies to decrease local currency loan interest rates to viable levels for SME borrowers.

Read more here:

<https://www.tcxfund.com/tcx-lift-in-myanmar/>

OVERVIEW OF KfW PORTFOLIO

Within the development finance community KfW has recently started to promote Local Currency Finance Solutions and has helped set up the necessary structures and institutions. Four leading and pioneering examples are its contribution and on-going investments into 1) The Currency Exchange Fund TCX since its establishment in 2008, 2) the investment into GuarantCo's parent company, the Private Infrastructure Development Group (PIDG) since 2010, 3) the Africa Local Currency Bond Fund⁶⁴ and 5) more recently its subordinated debt into InfraCredit Nigeria. The latter serves as a great example of (i) domestic and international and (ii) private and public

⁶⁴ <https://www.alcbfund.com/>

partners risk sharing to boost local currency loans for long-term infrastructure projects (likely the most systemically under-provided form of development finance).
In January 2020, KfW hosted the most important local currency workshop in the past five years at the OECD Private Finance for Sustainable Development conference. The full breadth of local currency solutions were discussed with all participants. It was agreed that more funding needs to be allocated to the solutions identified in this fact sheet in order to overcome the continuing practice of original sin.

MOST RELEVANT ADDITIONAL RESSOURCES

- ALCBFund (2019): Issuing Bonds in the Domestic Market. Accessed at:
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https://www.eca.europa.eu/Lists/ECADocuments/SR15_14/SR_INVESTMENTS_EN.pdf.
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https://www.empea.org/app/uploads/2018/05/Expanding-Institutional-Investment-into-EMs-via-Currency-Risk-Mitigation_WEB.pdf.
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https://symbioticsgroup.com/wp-content/uploads/2017/10/GoingUnhedgedinFrontierMarkets_final.pdf.
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- TCX: Local currency bonds: Deepening frontier capital markets. Accessed at:
<https://www.tcxfund.com/lcy-bonds/>.
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<https://ida.worldbank.org/financing/ida18-private-sector-window/local-currency-facility-lcf>.

>>> Securitisation

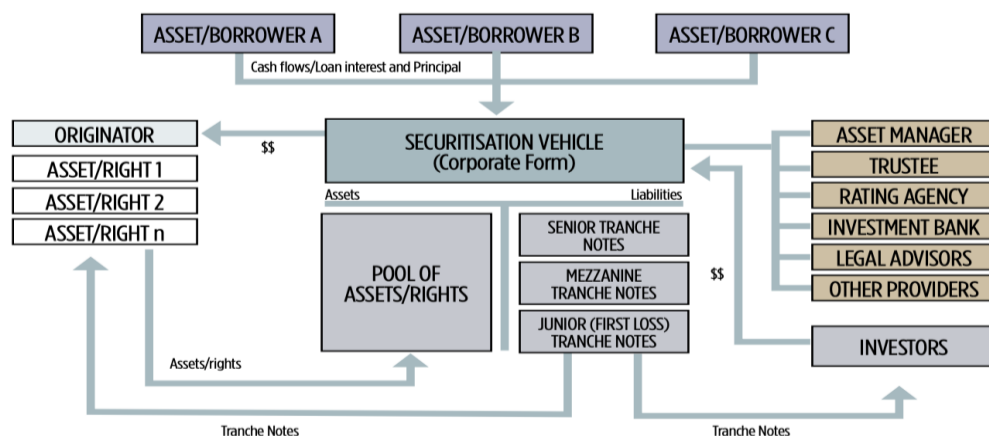
KEY FACTS

- Securitisation, in development finance, is a financial transaction where the risk and return of a portfolio of assets (such as loans) is transferred from the asset owner to a third party(ies). A third party(ies) earns returns over the life of the assets, such as interest and principal paid by the borrowers.
- Securitization has emerged as an effective risk transfer and way to mobilise commercial investors to traditionally illiquid asset (e.g. loans). Recently, synthetic securitization of DFI/MDB portfolios has emerged as a way to transfer risk, freeing up capital for them to fund new development projects. Furthermore, local banks and microfinance institutions are increasing the use of securitization thereby allowing investors to participate in high-yielding assets and local financial institutions to recycle their limited capital to lend to second and third cohorts of borrowers.
- Securitization allows SDG projects to be financed by the financial institutions best-placed to originate and arrange the underlying financial asset (e.g. a loan to a borrower), aggregate these assets into a portfolio, and then transfer the exposure to investors interested in the risk-return of the portfolio – generally institutional investors. Good practice in securitizations include the originator continuing to manage the underlying assets with ongoing economic exposure.
- Securitization allows development projects to be financed by illiquid assets (e.g. loans) with those illiquid assets packaged into liquid investment securities purchased by private investors. In securitizations, lenders transfer capital-intensive illiquid, long-term loans to investors, thereby allowing them to deploy freed up capital to provide new loans to new projects.
- Typical underlying assets in a securitization are standard, non-complicated, homogeneous assets, such as MSME loans, residential mortgages, personal loans, auto loans and credit card receivables. Investors in securitisations seek diversification of credit risk, therefore credit exposure is often granular with each loan typically representing less than 1 % of total assets. The standardization and granularity allow investors to focus on the general asset class and less on the credit risk of individual assets and are often requirements from regulators vis a vis capital requirements (and therefore viability).

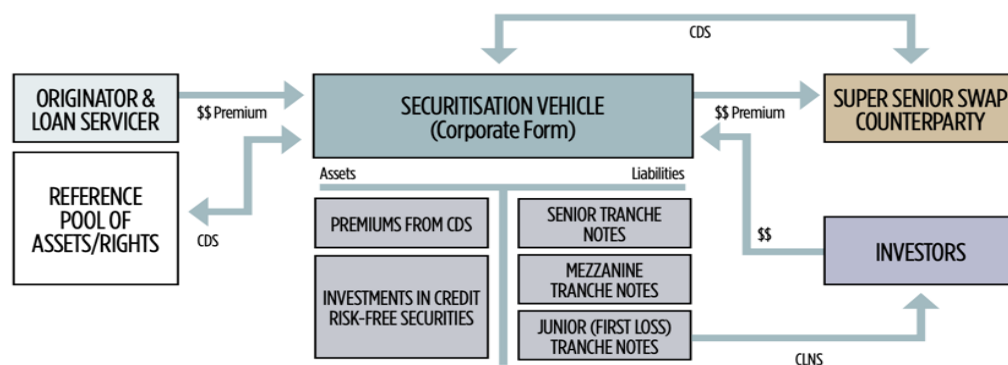
Basic Structure

True Sale vs Synthetic Securitization

Overview of True-Sale Securitization



Overview of Synthetic Securitization



Source: Eighteen East Capital & The Rockefeller Foundation.

Scope

- The main development objectives of securitization include:
 - Mobilizing additional private investment to finance more SDG projects;
 - Allowing local banks and microfinance institutions to deploy their comparative advantage to arrange and manage loans, transfer risk and recycle their limited capital to provide new loans to second and third cohorts of borrowers, including mobilizing local capital into a new asset class (e.g., loans);
 - Optimizing the capital of MDBs and DFIs, allowing them to arrange loans and transfer risk to investors, freeing up the original capital for new loans for more SGD-focused projects;
 - Demonstrating to cross-border investors the viability of asset classes in developing countries (e.g. SME loans).
- Securitization relies on investors prepared to invest in the underlying portfolio of assets. Given high country risk in developing countries, cross-border investors seek high-quality arrangers and managers of underlying assets and low-credit risk borrowers, with several MDB and DFI securitizations quite successful in the past three years. Within developing countries, local banks and microfinance institutions have completed some successful securitizations of MSME loan portfolios, usually mobilizing domestic capital into small loans.
- Applicable to sectors and SDGs with companies with low volatility of revenues. Securitizations can be enhanced by blended finance approaches allowing higher risk assets (e.g. other sectors and LICs) to be securitized given the extra risk cushion of donor funds in subordinate positions.
- There are two approaches important in development finance:
 - In a **true-sale securitization**, an asset owner / originator (e.g. a bank) pools the assets to be securitized into a reference portfolio, which it sells to a special purpose vehicle (SPV), which finances the purchase by issuing securities (often tradable in the capital markets). The securities can be sub-divided into tranches offering different levels of risk and return to investors.
 - In a **synthetic securitization**, the financial risk of the portfolio of assets is transferred by the originator to the investors, but the actual assets remain on the originator's balance sheet, requiring the originator to manage the assets on behalf of investors. Investors in the securities receive fixed or floating payments from a trustee account funded by the reference portfolio's cashflows. In development finance, synthetic securitization has been more popular allowing the MDB/DFI to retain ownership of the asset.

Criteria Overview

InnoFin Categories	Focus	Feasibility
Instrument: Debt and Guarantee	Applicability Target Group: Infrastructure projects and financial institutions	Development Stage: ☒ Concept ☐ Pilot ☐ Proven ODA eligibility: No
Approach: Securitization	Applicability Type of Countries: ☒ LDC/LIC ☒ LMIC ☒ UMIC	KfW experience: Yes, in the past at institutional level and limited to local markets for microfinance institutions, mortgage portfolio and future flows with commercial banks as investor or guarantor
Product for beneficiaries (market): Debt (and in principle could be equity)	Relevance for SDGs: 7, 8, 11 and 13	Peer Experience: IFC, AfDB, Sida and European Commission

Addis Ababa Action Agenda Impact Areas

Criteria	Assessment	Explanation
Mobilise additional private capital	10 out of 10	Securitizations are popular mechanisms for expert originators and managers of underlying assets to exercise their comparative advantage, but pass along financial risks to professional investors. Best practice is for originators to retain a portion of the exposure to the assets to avoid moral hazard. In principle, most loans can be securitized using blended finance subject to originators and/or donors providing "first loss" junior tiers (or credit enhancements) to enhance senior tiers to be comparable to market investments.
Strengthen local capital markets	6 out of 10	Securitizations can i) provide large amounts of financing to local capital markets and (ii) create investment securities subscribed by local investors.
Debt Sustainability	5 out of 10	Securitizations lead to higher debt sustainability when (i) they are executed in local currency (or hedged for FX risk) and (ii) allow longer-term maturities to be provided to local borrowers (e.g. local banks preferring short term loans can tap into institutional investors that like medium and long term tenors).

MECHANICS & ROLES

How does it work? A pool of (illiquid) assets with steady contracted cash flows (like mortgages or loans) are packaged by an originator into a pool/portfolio. They are then converted into investable securities often issued in the capital markets, providing investors with fixed or floating payments that are funded by the cashflows from the underlying assets. The securities are typically notes, but similar economic interests can be created by risk participation agreements, guarantees and credit default swaps.

What are the different forms of mechanism? Securitizations may differ in terms of the (a) underlying assets (typically bank loans), (b) type of originators (typically, a financial institution), (c) potential mechanisms for the originator to transfer its asset exposure and (d) investor type. Mechanisms include (i) a “true sale” or (ii) a “synthetic” transfer of the risk to a third party. Investors usually include commercial investors active in capital markets or private debt investors, like pension funds and insurance companies.

Securitizations in development finance are often created using blended finance approaches to mobilize commercial investors. In a typical blended finance transaction, an SPV is created with two tiers of capital: a senior tier subscribed by commercial investors, and a junior tier subscribed by donors. The tiering reduces expected probability of default and expected losses for commercial investors thereby credit enhancing the investment to an acceptable level.

Role of donors in mechanism? Donors can play three significant roles in securitization: (1) provide catalytic capital into junior tiers of blended finance securitizations to mobilise commercial investors into senior tiers, (2) provide technical assistance to support the structuring of a securitization to mobilise new investors into a new market and (3) provide guarantees to enhance a structure that will successfully mobilize investors.

Role of development finance institutions in this mechanism? DFIs can (i) establish securitizations using their own assets, (ii) invest in securitizations and (iii) support asset originators (e.g. microfinance institutions) to create securitizations. Through synthetic securitizations, DFIs can transfer credit risks from their balance sheets to private investors, enabling them to free up greater capital for development projects (or meet regulatory requirements). MDBs and DFIs can also deploy their comparative advantages originating and managing loans, and transfer economic interest to local and international investors.

Role of private investors in mechanism? Private financial institutions (e.g. banks and MFIs) can arrange and manage loans that become underlying assets of securitizations. Cross-border (institutional) investors can invest in securitizations gaining exposure to new asset classes they would not be able to directly access. Local investors can deploy their capital in local currency to borrowers which usually require authorities and licenses to finance.

COMPARISON CRITERIA

Impact: Multiple levels of impact. The first round of underlying assets (e.g. loans) finance SDG projects that have direct development impact. The securitization attracts investors into markets they could not otherwise finance, and the originator frees up capital, allowing it to finance a second round of underlying assets with their own, distinct development impact. Securitizations can have a strong, direct influence on local capital markets, if targeted. For example, a DFI working with local banks and microfinance institutions to securitize local currency loans into a structure that lists local currency notes to domestic investors would achieve many levels of development impact.

Scalability: Securitizations are highly scalable, ultimately depending on the ability to source asset pools with steady cashflows that can provide the payments for securitized portfolios. In developing countries, successful securitizations likely require multiple loan originators (e.g. local banks) to create a critical mass of assets that could justify a securitization. This mechanism is likely best applied on a regional basis, but could be possible in large Middle-Income Countries. Unfortunately, aggregation across multiple originators has not been deployed, with current individual bank securitizations a good step in direction of scale. Furthermore, MDBs have completed several synthetic securitizations, but scale would likely require several/many DFIs and MDBs to collaborate in a joint securitization.

Effectiveness/Efficiency: Securitization can increase the efficiency of financing illiquid development projects, raising or releasing capital in a potentially cost-effective and flexible way compared to traditional means. Synthetic securitization is simpler and less costly than true-sale securitization. This is especially relevant for the securitization of SME loans, which tend to have stricter ownership requirements (banks are often not allowed to sell them) and are usually too tailor-made to be bundled and passed on to SPVs via a true sale. In contrast, SME loans can easily be securitized in a synthetic way.

Also, with a synthetic securitization the originator retains the loans' ownership and servicing, continues to manage the loan portfolio consistent with credit and collections policy agreed with investors, and measures and reports on development impact.

Securitizations can be costly to execute, therefore minimum portfolio sizes are likely USD 200+ million.

Feasibility: Proven and mature in sectors like microfinance, which has been a main field of experimentation, driven by the efforts of microfinance asset managers to overcome the limitations of traditional fund structures (i.e. the need to maintain high liquidity levels and short portfolio duration due to the redemption rights offered to their investors).

Mobilisation: Securitised portfolios can attract different types of private investors (like pension funds, insurance companies, asset managers and retail investors). Investors are attracted by returns, liquidity, diversification potential, and credit quality (often assessed and established by an independent credit rating agency) of the securitized portfolio, as well as by the opportunity to access previously illiquid market segments. For

securitized portfolios sub-divided into separate tranches, investors can tailor their exposure to their unique risk tolerance and return requirements. Regulation, especially since the financial crisis of 2008-10, has changed significantly impacting institutional investors' (like insurance companies) ability to participate in securitizations.

Flexibility: Securitization is highly flexible. Synthetic securitizations hold several advantages over true-sale securitizations in development finance. Synthetic securitizations have lower transaction costs than true-sale securitizations, which can be relatively complex processes (legally and operationally), involving more third parties in the deal, like a hedging counterparty, liquidity provider, back-up servicer, trustee or paying agent.

SUCCESS FACTORS

MDB and DFI loan arrangement and asset management skills are significant under-utilized assets within development community. These organizations have strong presence and track-record, but currently have limited activities and intentions to originate higher loan volumes and subsequently securitize. In addition, MDBs and DFIs' roles as facilitators and anchor investors are systemically under-deployed. Owners of MDBs and DFIs could prioritize this activity taking into account bank regulations – transforming these organizations into private investment mobilizers.

Securitization in developing countries is best with multiple originators due to the small size of most originators, attributable to their small economies, small average loan sizes and small portfolios. However, cooperation across originators is low.

Securitization in developing countries benefits significantly from blended finance approaches due to high perceived risk of underlying loans. The median sovereign risk rating of developing countries is "B", implying high perceived country and credit risk for loans. Securitizations are most effective and efficient when benefiting from "first loss" donor protection – this creates an acceptable, market-based risk-return for investors.

Securitization relies on the underlying assets having stable cashflows and adequate portfolio size.

Securitization relies on solid originator underwriting standards and asset management skills (or agent). Most developing countries would not have third-party organizations with strong trustee / asset management skills to manage the underlying portfolio in a "true sale" securitization.

Securitization relies on countries having established legal and regulatory frameworks and developed capital markets. Donors can deploy TA to create appropriate environment for securitizations to be successful.

Commercial investors may shape the selection of pool assets according to their own sustainability / governance preferences in a way that may dilute development impact objectives and outcomes. Consequently, institutions must employ appropriate safeguards, and DFIs and MDBs must

focus on additionality as opposed to projects that can be securitized easily.

Regulations applicable to securitization, especially financial institutions/investors ability to invest and capital requirements, must be well understood prior to considering a securitization. Many investors simply do not have appetite/interest to invest in assets derived by securitization.

TRENDS TO-DATE

- **Until the financial crisis of 2008-9, the securitization market had been growing significantly, mainly in developed countries** – exceeding USD 3 trillion of outstanding debt in Europe alone in 2009 – driven by mortgage-backed securities, a market which had expanded 20-fold in 2000-2009. This led to a few innovative initiatives designed to bring the benefits of securitization to the development finance arena. At that time, microfinance was the main sector of experimentation, driven by the efforts of microfinance asset managers to overcome the limitations of traditional fund structures i.e. the need to maintain high liquidity levels and short portfolio duration, due to the redemption rights offered to their investors.
- In 2004-5, the **BlueOrchard securitizations** were the first Collateralized Debt Obligation (CDO) in development finance, followed in 2006-7 by the BOLD (BlueOrchard Loans for Development) issuances. The microfinance CDOs and BOLD raised an unprecedented USD 209 million, and further strengthened microfinance as an asset class with the entrance of a top-tier investment bank, Morgan Stanley, as placement agent.
- **Main asset classes in securitizations in developing countries have been homogeneous assets like MSME loans and mortgages.** Infrastructure securitization is another segment that has received much attention in recent years. But given the heterogeneous nature of infrastructure projects, success requires very strong loan arrangers and asset managers that will gain the confidence of investors. The IFC MCPP Infrastructure securitization attracted USD 1.5 billion of institutional investor debt to infrastructure.
- Despite these promising developments, the **financial crisis of 2007-8** – spurred by the failure of many US Residential Mortgage Backed Securities, and compounded when banks turned to similar mechanisms (Collateralised Loan Obligations) – significantly damaged the perception of the securitization market. Potential efforts to improve the perception of these instruments and guard against future deteriorations include (i) identifying case studies where securitisation approaches truly mobilised debt investors to investments in developing countries that they would otherwise not have made (e.g., IFC-Sida MCPP Infrastructure project) to produce additional development impact that otherwise would not have happened and (ii) encouraging mobilization versus excessive risk-taking such as donors ensuring the financial arrangers maintain material financial exposure to the performance of the underlying assets (e.g., MDBs maintain at least 33% exposure and continuing to manage the underlying loans).
- In recent years, markets like **green securitization** have experienced significant growth (accounting for over USD 28

billion of issuances in 2017 and potentially reaching an annual issuance figure of USD 380 billion by 2035.⁶⁵

- Within synthetic securitizations, the **European Investment Fund (EIF)** has been an outlier in the MDB and DFI community – in 2017 it supported financing to 60,000 European SMEs using synthetic securitization, followed in 2018 with 18 securitization transactions.
- A recent, innovative, and potentially promising application of synthetic securitization has been the **African Development Bank's "Room2Run Synthetic Securitization"**, a USD 1 billion transaction in response to the G20's MDB balance sheet optimization project, with the AfDB committing to reinvest freed up capital into new African infrastructure lending. Room2Run transfers the mezzanine credit risk on a portfolio of approximately 50 loans from among the AfDB's non-sovereign lending book.
- To date, most securitizations have **bypassed local capital markets**. Great potential to support local banks and MFIs to securitize their loan portfolios mobilising local capital into MSME loans – in local currency!
- **Securitization is a systemically under-developed area of development finance**. Despite promising developments in bringing the benefits of securitization to the development finance arena, the legacy of the financial crisis – spurred in 2007-2008 by the failure of many US sub-prime mortgage securitizations – has brought new regulations that impedes certain investor groups (e.g., insurance companies) from actively investing.
- However, over the last few years, **securitization has been touted by MDBs and DFIs exploring financial innovations to boost lending headroom**, in the context of boosting financing and investment toward the SDG

CASE STUDIES

AfDB – Room2Run

Room2Run is a USD 1 billion synthetic securitisation launched by the African Development Bank (AfDB), Mariner Investment Group, and Africa50 in 2018. The first portfolio synthetic securitisation between an MDB and the private sector, Room2Run transfers the mezzanine credit risk on a portfolio of approximately 50 loans from among the African Development Bank's non-sovereign lending book, including power, transportation, financial sector, and manufacturing assets. Receiving mezzanine risk protection on the 2% to 17.25% tranche of the reference portfolio (totaling USD 152.5 million), AfDB will pay investors a floating rate, plus a spread, with additional lending headroom of USD 650 million being created for AfDB.

The purpose of Room2Run is to enable the AfDB to increase lending in support of sustainable development, with the bank committing to redeploying freed-up capital into renewable energy projects in Sub-Saharan Africa, including projects in low income and fragile countries.

Read more here:

<https://www.afdb.org/>

<https://www.unpri.org/>

Bayfront Infrastructure Management

The Asian Infrastructure Investment Bank (AIIB) and Clifford Capital launched Bayfront Infrastructure Management in 2019. It is a first-of-its-kind platform that looks to mobilise institutional investment capital for infrastructure debt in Asia. The platform will purchase mainly brownfield project and infrastructure loans from financial institutions, subsequently issuing securitised notes onto the capital markets. The platform will also invest in the equity tranches or vertical slices of these securitised issuances to convey the alignment of its interests with those of institutional investors.

The idea is to relieve existing lenders of their capital constraints by purchasing their balance sheet exposures, while enabling global investors to access a diversified and accessible asset class.

AIIB has taken a 30% stake in BIM, while Clifford Capital has taken the remaining 70% stake. The two have committed equity of USD 180 million to BIM, with the Singapore government further capitalizing its debt issuance capacity to the tune of USD 1.8 billion.

Read more here:

<https://www.aiib.org/>

<https://www.infrastructureinvestor.com/>

OVERVIEW OF KfW PORTFOLIO

KfW has been a pioneer of securitization for local markets. For example, it arranged and counter-guaranteed the landmark BRAC securitisation (USD 180 million) and the ProCredit Bulgaria securitisations in 2006.

⁶⁵ Eighteen East Capital & The Rockefeller Foundation (2020).

MOST RELEVANT ADDITIONAL RESOURCES

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Annex 1 Glossary of key terms

Key Terms	What they mean
Additionality	A donor intervention is defined as additional if: Interventions are necessary to make the project happen, i.e. the private investor would not have engaged without public sector involvement (this is often defined as financial or input additionality); and/or interventions increase the development impact and sustainability of a project with positive implications for growth and poverty (this is often defined as development or output additionality).
Advanced market commitments	AMC is a commitment of development capital providers to guarantee price/market for products once they are developed.
Blended finance	Defined as the strategic use of (public and philanthropic) development finance to mobilise private investment to sustainable development in developing countries. All IDF mechanisms deployed to mobilise private investment are aligned with blended finance, and should adhere to the five OECD Blended Finance Principles .
Bonds	A debt security under which the issuer (typically a development finance agency, a national or local government or a company) owes the holders a debt and (depending on the terms of the bond) is obliged to pay them interest (the coupon) or repay the principal at a later date. Bonds have a longer duration than loans and can be sold and bought by investors.
Catalytic capital	Usually refers to actions aimed at stimulating positive change. The result of such actions – the catalytic effect – may be financial (funds mobilised) or non-financial (transfer of knowledge, sharing of new practices, introduction of a policy, etc.). It is generally recognised that catalytic effects are difficult to measure statistically. ⁶⁶
Concessional loans	Such loans offer better than market-rate terms, either through longer repayment times, low interest rates, or both. Development finance institutions often use these loans to de-risk or encourage certain investments.
Concessionality	Concessional financing is financing below market rates (or with maturity, grace period, security or rank offered on soft terms without being priced according to the market), keeping in mind that in many situations where blended concessional finance is likely to play a role, there is no real market rate and market rate proxies tend to be based on individual practices. Investment and performance grants are included in concessional financing.
Conditional Cash Transfers	In order to incentivise certain 'desirable' behaviours, conditional cash transfers are made when mostly an individual or a household meets specific criteria. This could be when an expected mother completes four ante-natal care check-ups, or for children's school attendance, or a number of other areas where these payments can stimulate community and individual investment in human capital.
Convertible debt	A form of investment where the investor wants to reserve the right to change their loan into a shareholding, i.e. take an equity position, of an enterprise, if the business meets certain targets or shows continued promise.
Countercyclical loans	Allow for adjustments in the repayment terms and maturities of loans in response to external shocks. External debt service is thus adapted to the ability of the borrower to meet its financial obligations.
Debt swaps	Debt swaps are financial transactions in which a portion of a developing nation's foreign debt is forgiven in exchange for investments in social or environmental conservation measures incl. debt-for-nature swap or debt-for-education swaps.
Development Finance Institutions	The group of multilateral and bilateral development institutions that focus on private sector investments.
Facilities	Pooled financing models in which developmental capital providers align on a common financing or investment strategy.
Financial approaches	Approaches are vehicles and financial structures that in IDF are often used in combination with financial instruments, including funds and facilities, securitisation, results-based finance and public-private partnerships (PPPs).

⁶⁶ OECD (2016): Development Cooperation Report.

Key Terms	What they mean
Financial instruments	A monetary contract between two parties, which can be traded and settled. The contract represents an asset to one party (the buyer) and a financial liability to the other party (the seller). Financial instruments particularly relevant for InnoFins include grants, concessionary loans, equity or guarantees.
First loss capital	First loss position is an investment's or security's position that will suffer the first economic loss if the underlying assets lose value or are foreclosed upon. Commonly used CFLC instruments include grants, equity, subordinated debt, or guarantees. Providers of first loss capital in InnoFins are mostly development agencies, foundations or governments. They aim to channel commercial capital towards the achievement of certain social and/or environmental outcomes. In addition, often – though not always – the purpose can be to demonstrate the commercial viability of investing into a new market.
Funds	Pooled financing models in which various capital providers with and without different risk-return-impact profiles align on a common financing or investment strategy.
Guarantees	Financial instrument or product where a third party provides an extra layer of protection for the beneficiary of a service (protect against capital losses or credit enhancement).
Hedging	Hedging is the act of entering into a financial contract in order to protect against unexpected, expected or anticipated changes, such as for example the changes in currency exchange rates.
Impact investments	Are investments made with the intention of generating positive and measurable social and environmental impact alongside a financial return. Impact investments target a range of returns, from below-market (sometimes called concessionary) to market-rate, depending on investors' strategic goals, and can be made across asset classes, including but not limited to cash equivalents, fixed income, venture capital, and private equity. ⁶⁷
Insurance	Mechanism as part of which the insurance provider promises to provide financial compensation in the instance of an event that results in a financial loss.
Local currency finance	Strategies to provide the borrower's home currency to avoid, share, hedge risks from exchange-rate volatility.
Mobilising capital	The difference between mobilising and catalysing (additional) capital is that Mobilise and leverage are usually used more restrictively to refer to the ways in which specific mechanisms stimulate the allocation of additional financial resources to particular objectives. In the context of OECD-DAC methodological work, the term "leverage" is usually associated with a quantitative indicator, such as a leverage ratio, while "mobilise" refers to a causal link between private finance made available for a specific project and the official flows that were used to incentivise them. ⁶⁸
Result based finance	Financing arrangement in which payments of the funder or commissioner to the implementor and/or incentivised agent are contingent upon the achievement of pre-defined and verified results i.e. outputs, outcome or impact rather than to activities or inputs.
Securitisation	Refers to the process of transforming a pool of illiquid assets into tradable financial instruments (securities).

⁶⁷ Based on the definition of the Global Impact Investing Network GIIN.

⁶⁸ OECD (2016): Development Cooperation Report.

Annex 2 Summary of references

*The listing includes general references as well as sectors specific reference in addition to those InnoFins specific references provided in each Factsheet. References on methodological issues regarding evaluation, additionality or concessionality as well as assessment of cases and evaluation reports are listed in **green**.*

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Contact

KfW Group
KfW Development Bank
Palmengartenstrasse 5-9
60325 Frankfurt am Main, Germany
Telephone +49 69 7431 0
info@kfw-entwicklungsbank.de
www.kfw.de

Authors

Anja-Nadine König (Social Impact Markets), Chris Clubb and Andrew Apampa (Convergence),
Fact Sheet Insurance: Brigitte Balthasar

Photos

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