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POLICY BRIEF

INNOVATIVE FINANCING MECHANISMS AND SOLUTIONS

CONTEXT, DEFINITION, LANDSCAPE, AND DEVELOPMENTS

Shortly after the UN Millennium Summit[1], which saw the introduction of the MDGs, several development partners agreed to explore alternative sources of finance to Official Development Assistance (ODA) for financing development. In 2002, at the Monterrey Conference[2], the concept of innovative finance was borne and in the years leading up to the Paris Conference on Innovative Development Financing Mechanisms there was a growing realisation that achieving the MDGs was unlikely unless access to finance became more equitable. In 2006, 93

BOX 1
Selected examples of Innovative Financing

- Specific examples of popular innovative financing mechanisms used over this period include:
- Solidarity Levies applied to airline travel with a small tax added to airline tickets.
- International Finance Facility for Immunization utilises the long-term borrowing capacity of States - UK, France, Norway, Italy, Sweden, South Africa, and Spain – to collect funds on the markets and finance immunization programmes in 70 countries within the framework of the GAVI Alliance.
- Advance Market Commitments (AMC) are where donors commit to guarantee the price of vaccines once developed and so reducing the uncertainty and prospects for creating a sustainable market.
- Debt2Health initiative (or deferred repayment schemes), which is a partnership between creditors and grant recipient countries under which creditors forgo repayment of a portion of their claims on the condition that the beneficiary country invests an agreed-upon counterpart amount in health through Global Fund approved programmes.
- (PRODUCT)RED, is a brand licensed to companies to raise money for the Global Fund to fight AIDS, Tuberculosis and Malaria.
- Socially responsible investments (SRI) seek to maximize the financial return and social good by setting criteria to direct lending.
- Emissions and particulate trading (cap and trade) is used to cap the carbon emissions by developing a market for the sale of emissions licences.

KEY MESSAGES

- ▷ Innovative finance includes mechanisms and solutions, which increase the volume, efficiency, and effectiveness of financial flows.
- ▷ Innovative finance has taken many forms and continues to evolve by instrument as well as its application to development goals.
- ▷ With traditional – ODA – development finance falling far short of what is needed globally to finance the SDGs, particularly post-COVID-19, new financing mechanisms and solutions are essential if we are to succeed.
- ▷ Building forward better requires full use of the policy levers available to governments to best incentivise finance mobilisation. New partnerships, enhanced roles and institutional capacity will be required for governments, central banks, private finance, development actors and academia to succeed and sustain action.
- ▷ Identifying, developing new and strengthening existing linkages between SDGs outcomes to better target finance at multiple outcomes will be required to ensure the impact of every dollar of development finance is maximised.

States met in Paris to review new innovative development financing options and in 2009 the i-8 Group published Innovative Financing for Development, which described 8 innovative mechanisms for financing development[3] that had been operationalised.

At the Third International Conference on Financing for Development in 2015, there were strong calls for greater inclusion in microfinance; lowering transaction costs on remittance flows; expanding philathropic finance; developing long-term bond and insurance markets; carbon pricing and for new mechanisms and solutions to combine public and private resources such as green bonds[4], vaccine bonds, triangular loans and pull mechanisms. Others were also invited to join the Leading Group on Innovative Financing for Development (LGIFD) to help advance the development and rollout of innovative financing solutions. With the introduction of the SDGs, the Group of Friends of SDG Financing was formed[5] to supersede the LGIFD and in 2020, working groups were formally established to focus on financing selected areas across the SDGs.

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Innovative Financing Mechanisms & Solutions

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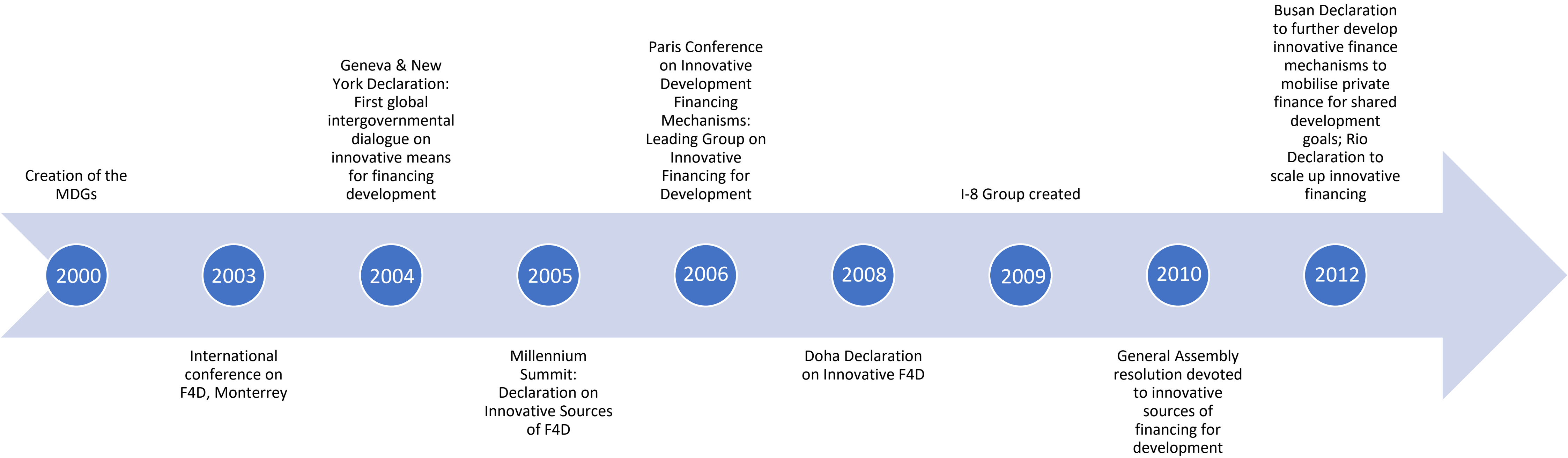
Brief history of Innovative Finance



Source: Dalberg

Brief history of Innovative Finance (Cont.)

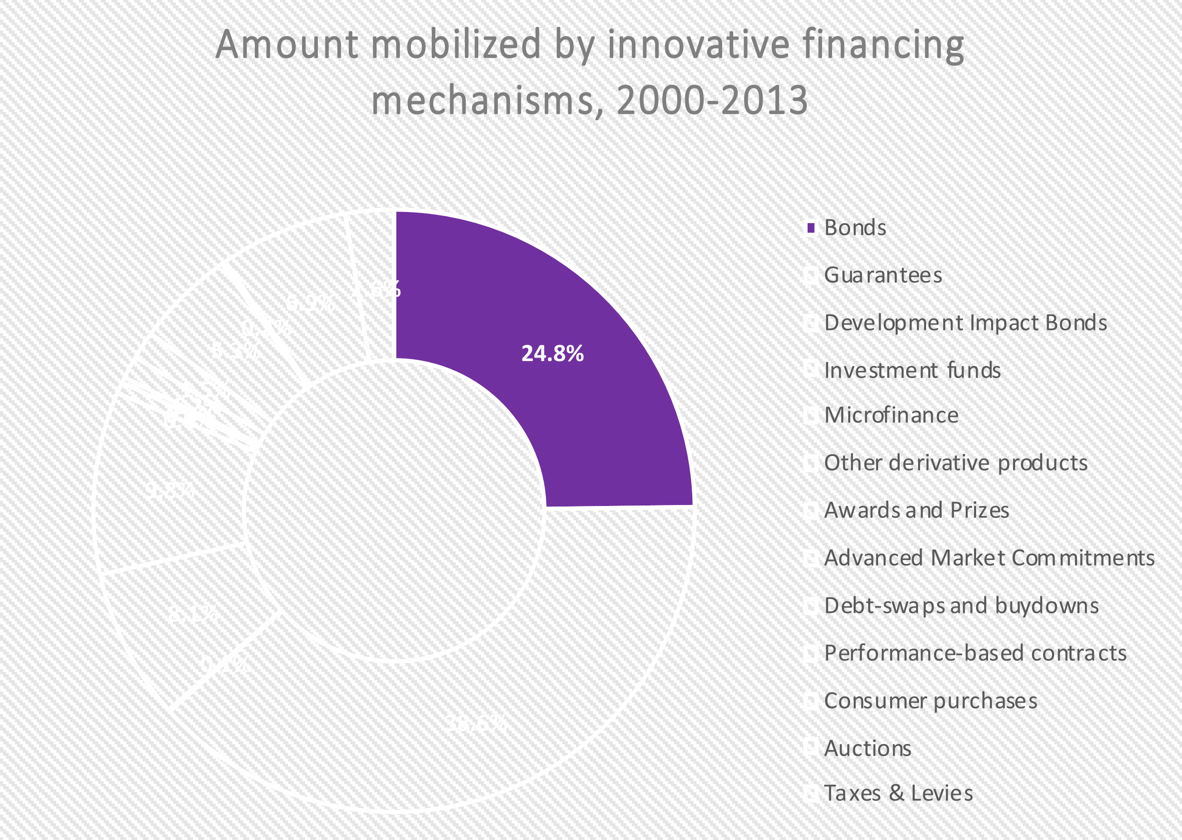
- **2013**: UN General Assembly to develop post-2015 goals
- **2015**: Sendai Framework for Disaster Risk Reduction; Addis Ababa Action Agenda of the Third International Conference on Financing for Development; Transforming our world: the 2030 Agenda for Sustainable Development; Paris Agreement on Climate Change.
- **2016**: Group of Friends of SDG Financing formed to replace the Leading Group
- **2020**: High-Level Event on Financing for Development in the Era of COVID-19 and Beyond convened by Canada, Jamaica and the UN.
- **2022**: Discussions to consider the need for a Fourth International Conference on Financing for Development at FfD Follow-up forum.

Definition, Scope and challenges

- Innovative financing is designed to compliment traditional international resource flows (inc. aid, FDI, and remittances) and mobilize additional resources for development through private investors.
- It has a dual role of:
  - Enabling a broad range of approaches to mobilize resources
  - Increase the effectiveness and efficiency of financial flows that address sustainable development.
- The is no single *agreed* definition of innovative financing but some overlap.
  - 'non-traditional applications of solidarity, PPPs, and catalytic mechanisms that (i) support fund-raising by tapping new sources and engaging investors beyond the financial dimension of transactions, as partners and stakeholders in development; or (ii) deliver financial solutions to development problems on the ground' [**World Bank**]
  - 'mechanisms of raising funds or stimulating actions in support of international development that go beyond traditional spending approaches by either the official or private sectors, such as: 1) new approaches for pooling private and public revenue streams to scale up or develop activities for the benefit of partner countries; 2) new revenue streams (e.g. a new tax, charge, fee, bond raising, sale proceed or voluntary contribution scheme) earmarked to developmental activities on a multi-year basis; [or] 3) new incentives (financial guarantees, corporate social responsibility or other rewards or recognition) to address market failures or scale up ongoing developmental activities' [**OECD**]
  - 'An innovative development financing mechanism is a mechanism for raising funds for development. The mechanisms are complementary to Official Development Assistance. They are also predictable and stable. They are closely linked to the idea of global public goods and aimed at correcting the negative effects of globalization' [**Leading Group on Innovative Financing**]
- Consequently:
  - There is substantial scope for misinterpretation of what the practicalities of innovative financing might involve.
  - Lack of standards, data, liquidity, and performance metrics makes it difficult for investors to assess innovative financing opportunities.
  - Creating new innovative financing mechanisms - especially mechanisms without evidence-based track records - can be costly.
  - Innovative financing mechanisms for development, particularly those still in the nascent stage, may fail to offer risk-return profiles that fit investor requirements.

Source: K4D

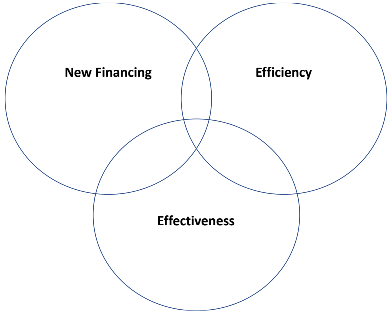
Landscape & Developments



Source: Innovative Financing Initiative Database; Dalberg

- When the goals were adopted in 2015, UNCTAD estimated that $2.5 trillion was required to achieve them in developing countries.
- The gap now stands at about $4 trillion per year [56% increase] after the outbreak of COVID-19. [Sept 22]
  - Positively, at $4tn this is less than 1% of global finance [$486.6tn, Jan 23].
- Past trends strongly indicate that new innovative financing will bridge some of this gap in future years.
- PwC estimated that Global investable assets for the asset management industry will increase to more than $100trn by 2020 from $37.3trn in 2004.
- Innovative financing can also have substantial leveraging potential.
  - The World Bank estimate that the $7.7bn in guarantees issued to support investments in developing countries between 2000 and 2008, levered addition investment financing of US$20bn (2.6x).

Mechanisms and solutions for New Financing, Enhancing the Efficiency, and Improving the Effectiveness of Development Finance

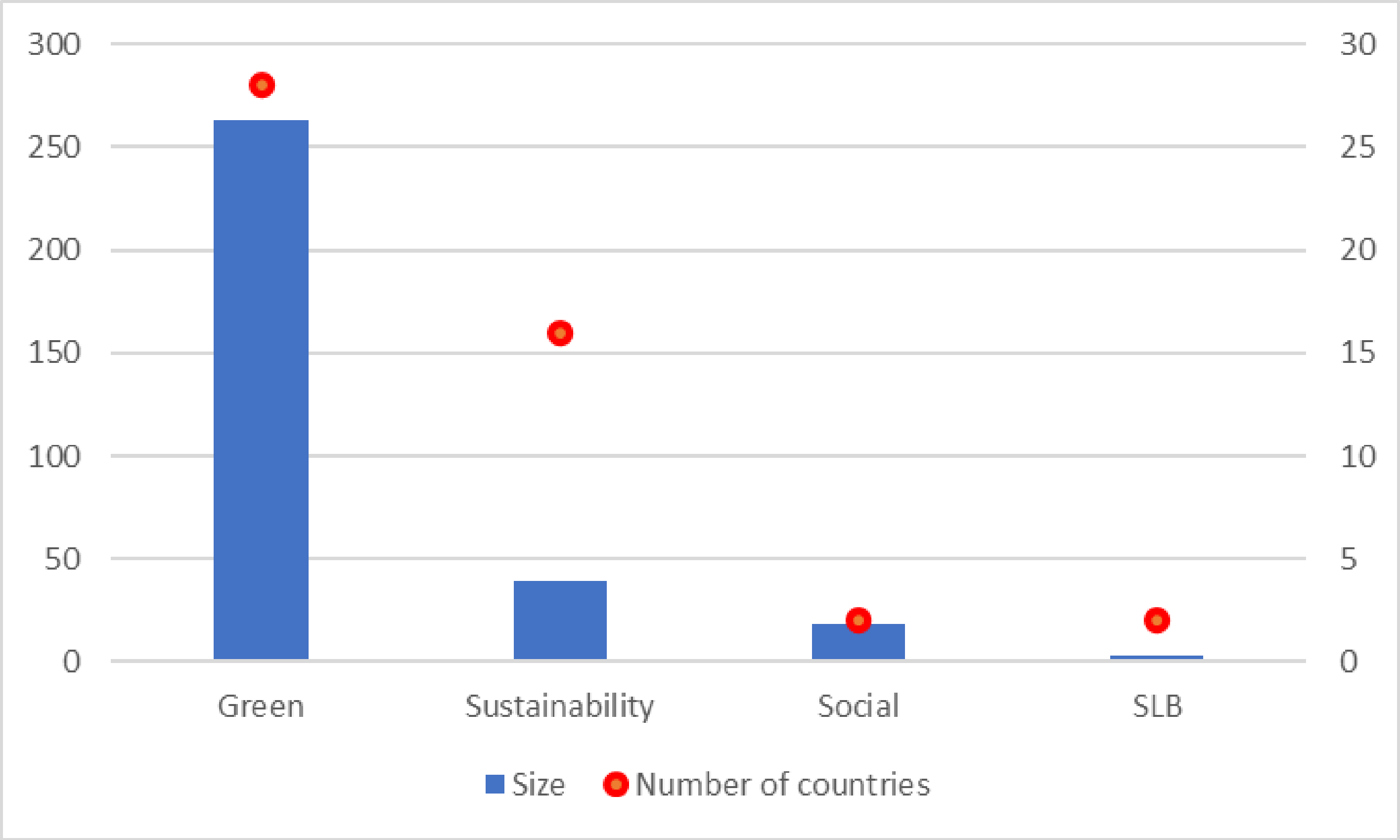


	1 **Financial Products**	2 **Risk Mitigation Mechanisms**	3 **Results-Based Financing**	4 **Technology-Based Solutions**	5 **Taxes & Obligatory Charges**	6 **Voluntary Solidarity Contributions**	7 **Debt Management**
Description	*Generally, refers to instruments to raise funds from the Capital Market.*	*Mechanisms designed to reduce (perceived) risk.*	*Payments linked to agreed outcomes.*	*Mechanisms or models that leverage technology.*	*Compulsory Contributions to a country's fiscal revenue.*	*Voluntary contribution to a social or environmental outcome.*	*Mechanisms the reduce or extend a country's debt when certain outcomes are met.*
Instruments	- Bonds - Loans - MSME Finance - Impact Investment Fund - VC & Private Equity Funds	- Subsidies - Guarantees - Insurance	- Development Impact Bonds - Social Impact Bonds - Outcome Based Funds - Advanced Market Commitments - ESG & Responsible Banking	- Blockchain - Digital Technology - Crowdfunding - Initial Coin Offer - Initial Exchange Offer	- Taxes	- Donations as part of a customer purchase	- Debt Buydown - Deferred Drawdown - Debt Swap - Debt Exchange

Source: UNDP

Promoting New Financing - Labelled Bonds: A Growing Market

Labelled sovereign bonds market size, $bn and number of countries, end 2022



Source: Climate Bonds Initiative

Labelled Bonds: The good and the not so good

Benefits

- «Greenium» is elusive but broader investor base
- Signalling effect
- Halo effect
- Debt structure
- Market development
- Performance incentives in sustainability-linked bonds

Limitations

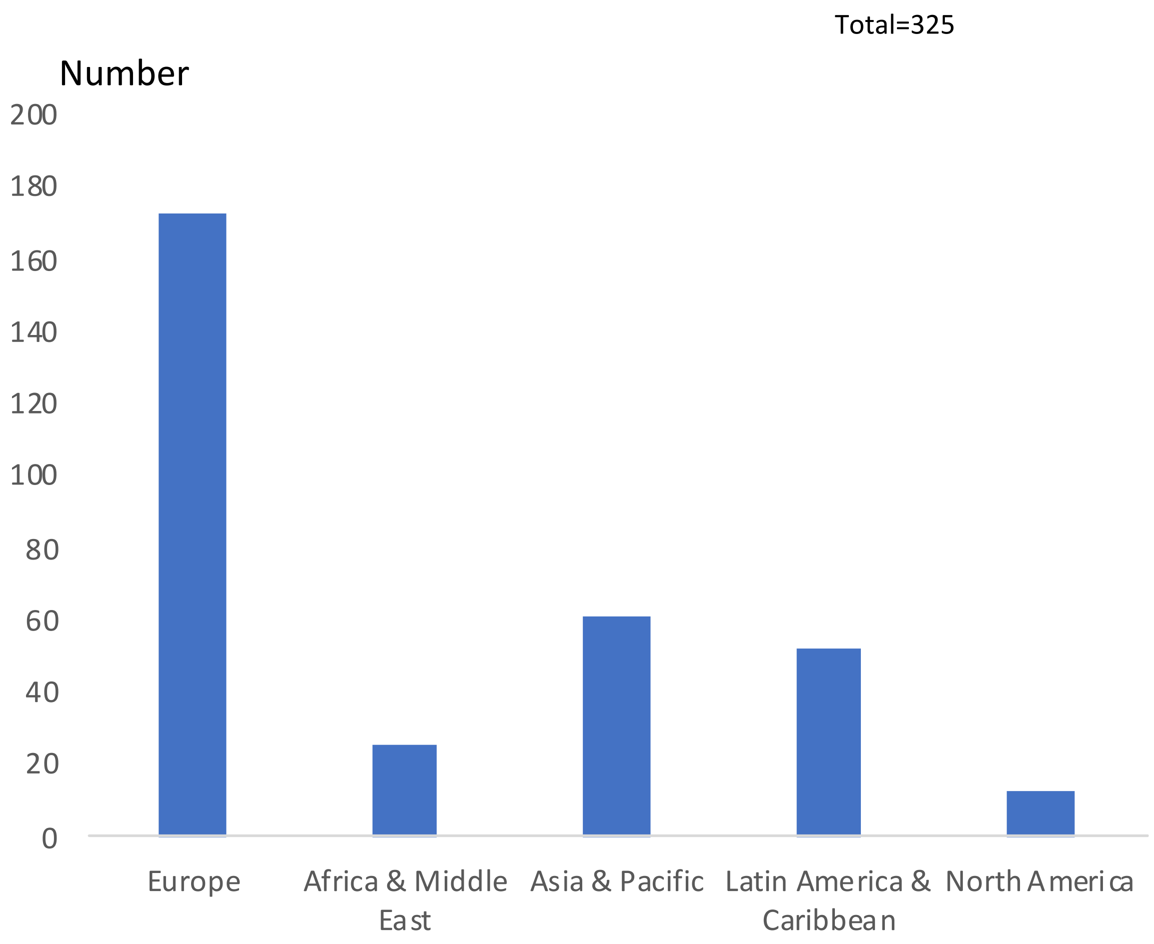
- It is debt!
- Coordination is costly (but also useful)
- Additional issuance costs
- Not a «reputation eraser»
- Exchange rate risks

Promoting Effective Financing: Principles of Responsible Banking

- Designed to be integrated into banks' strategies and portfolio of activities, the PoRB brings purpose, vision and ambition on sustainable finance.

- The **6 principles** are:

1. ***Alignment***: of business strategies to be consistent with individuals' needs & society's goals, as expressed in the SDGs, Paris Climate Agreement and relevant national and regional frameworks.
2. ***Impact & Target Setting***: continuously increase positive impacts, while reducing the negative impacts on, and managing the risks to, people and environment resulting from activities, products and services.
3. ***Clients & customers***: work with clients and customers to encourage sustainable practices.
4. ***Stakeholders***: consult, engage, and partner with relevant stakeholders to achieve society's goals.
5. ***Governance & Culture***: embody effective governance and a culture of responsible banking.
6. ***Transparency & Accountability***: Review and report positive and negative impacts on society's goals.



Source: UNEP FI

IF Roles for selected Development Actors

Government
- Taxes & Subsidies, licensing and fees
- Regulations & Standards
- Market monitoring
- Information pooling & disseminating
- Insurance & Guarantees
- Convening power & network development
- Pooling risk via investment partnerships (PPP)
- Infrastructure investments (digital/Fintech)

Central Banks
- Differentiated rediscount rates & capital reserve requirements
- Convening power & moral suasion to promote sustainability criteria
- Disclosure rules to highlight and mitigate sustainability risks

Donors
- Development capital platforms
- Technical Assistance
- Convening power & network development
- Support new mechanism & solution development
- Financial standards, regulation & monitoring

Multilaterals
- Loans, Grants, Insurance & Guarantees
- Technical Assistance & Monitoring
- Convening power & network development

CSO & other
- Funds development
- Lobbying and Advocacy

Private Sector – Financial and other
- Funds development
- Corporate Social Responsibility
- ESG and principles of Responsible Banking

Innovative Financing Opportunities: Jamaica Case Study

Financing sustainable development in Jamaica is constrained.

- **Net ODA as a percentage of gross capital formation:** Jamaica's upper middle-income status means access to concessional financing is restricted.
- **Fiscal space for additional debt**: GOJ's commitment to reducing its Debt/GDP to below 60% by 2028 means that both fiscal space will be squeezed and a limited appetite for additional debt.

Opportunities for Innovative Financing

- Development of Impact bonds
- Partnership with Caribbean Philanthropic Alliance to access in excess of US$1.5trn
- Leveraging diaspora funding by channeling better Jamaica's strong remittance flows

Challenges

- Ready-investible pipeline for investors and it for purpose financing instruments tailored to Jamaican context.
    - Project development capacity failures
    - Private finance failures

Source: UNDP

Concluding points

- Innovative financing includes mechanisms and solutions that increase the flow of finance; improve the efficiency of financing flows; and enhance the effectiveness of financing flows.
- Innovative financing can and has taken many forms and continues to evolve to suit the context and application.
- Traditional sources of financing will fall far short of what is require to finance the SDGs, and more so following COVID-19.
- Building forward better will require the full use of policy levers available to governments to mobilize finance.
- New partnerships between governments, central banks, private finance, academia and development actors will be needed to sustain action.
- Identifying, developing new and strengthening existing linkages between SDG outcomes to better target finance to multiple outcomes is needed to be most impactful.

Final Thought…

- **Context**: How best to arrange innovative financing that supports sustainable economic transformation in vulnerable resource constrained countries?
- Theory of change…
  - A more diversified economy enables higher per capita incomes; lower volatility; poverty reduction and better long-term growth prospects.
  - Economic diversification occurs as we develop more progressively sophisticated baskets of goods and services over time.
    - It involves greater **economic complexity/structural transformation**.
  - For greater economic complexity we need to reallocate factors of production from low to high productivity activities and sectors.
  - And to do this, countries need to increase their productive capacities.
    - Productive capacities are multi-dimensional covering human; natural; energy; transport; ICT; private sector; and structural change.
  - The extent to which countries can enhance the mix of productive capacities will depend on accessible resources, structural vulnerabilities and stage of development.
    - Access to finance, expertise, technologies and trade networks are especially important to those resource constrained.
  - **[Proposition]** Countries at lower stages of development maybe more likely to pursue diversification strategies that are less sustainable than countries at high stages of development.
  - They may develop a mix of productive capacities that promote less sustainable economic complexity; diversification; and economic transformation and lead to higher future levels of environmental degradation; wider inequalities and greater socio-economic volatility.
- We are trying to better understand the linkages leading to sustainable economic transformation, <u>as well as</u> identify what suite of innovative financing is required to bridge the sustainable economic transformation financing gap.
  - That is:
    - To build the right mix of productive capacities that promote sustainable economic complexity, and
    - Enable countries to diversify and develop a more progressively sophisticated and wider basket of goods that support the environment, reduce inequalities for sustainable development.

Source: Financing for Sustainable Development Report 2023;

D Tennant, Davies, S, Tennant, S and Whitely P: Promoting Sustainability Through Economic Diversification, Complexity and Productive Capacity Enhancements: University of the West Indies: March 2023

Thank you