GDI ISSUE PERSPECTIVE: INNOVATIVE FINANCE

WHY IT MATTERS:

The Sustainable Development Goals—the 17 call-to-action agreed upon by all countries in 2015—recognize that in order to end poverty and address social needs like education, health and job opportunities we must build strategies that build economic growth sustainably. These goals come with a staggering price tag: The UN Secretary-General's report on financing the SDGs projects needs of $2.5 - 3 trillion a year.[1] This is orders of magnitude higher than the development finance available between bilateral aid and philanthropy alone. This level of funding—and leveraging this funding—will require a different approach across a wide variety of asset classes and initiatives, from field building to fund development to capital advisory services. Blended finance is a critical component in closing this gap, through the intentional use of development dollars to mobilize additional private and commercial capital towards sustainable development in emerging markets.

Hidden within this need for innovation in development finance is a massive dichotomy in maturity between emerging economies and developed ones. Growth in the last 20-30 years in places like China, Korea, and Southeast Asia has largely come from industrialization and infrastructure development, financed through major capital investments. But if we look at the current state of many emerging economies, we see nascent infrastructure set up for local, largely agrarian needs, or systems based on the export of raw materials to developed countries. In order to achieve the SDGs, we need to look at value-added assembly and processing, urban development, affordable housing, and infrastructure such as ports and roads. Supporting these evolving agrarian and urban value chains will require significant investment in emerging market micro-, small-, and medium-sized enterprises. At the same time, emerging market countries have limited government fiscal capacity to support the social and environmental work that is critical for sustainable economic growth, ensuring the mistakes of today's industrialized countries are not repeated.

THE CURRENT STATE / THE OPPORTUNITY:

Overlaying this context is another exciting trend worth noting: $80 trillion of sovereign wealth funds, pension funds, and large asset managers are now looking for investments aligned with SGD—or "ESG" (Environmental, Social, and Governance)—goals. Fiduciary responsibility, historically understood narrowly to mean maximizing risk-adjusted returns, is now being seen in a much broader way, with risks encompassing environmental and social factors. This tsunami of capital waiting in the wings is looking for investments at the same time that sustainable economic growth needs investment.

There is a catch, however. Large project finance, private equity, and venture capital investment teams are complaining of a scarcity of investible projects or small and growing businesses. Unsophisticated project preparation, lack of capacity and skills, and low market transparency in terms of deal flow are holding back the promise of matching this supply with demand. If we maintain status quo, there is a risk that actors with high-risk appetites and little regard for community sustainability will drive the investment agenda, and emerging market government systems will not be able to support their growing populations in a socially and environmentally sustainable way.

[1] https://www.un.org/sustainabledevelopment/wp-content/uploads/2019/07/EXEC.SUM_SG-Roadmap-Financing-SDGs-July-2019.pdf

GDI sees an immense opportunity to bring creative approaches and smart financial engineering together to meet these challenges. There is a need for intermediaries and connectors to create linkages between investors across new geographies. We see a role for new products or vehicles to mobilize capital, such as blended funds for targeted populations or outcomes funds based on pay-for-results targets. And, we want to remove current barriers so the field can take off: supporting origination of products and deals; developing a body of work of replicable structures and products; and, incubating platforms that remove search costs between public and private investors. Without first movers willing to demonstrate market and profit potential, establish data-driven results and reduce risk, mainstream investors will often not act.

GDI's WORK:

Since the publication of GDI's co-authored report Innovative Financing for Development in 2016, we have been at the forefront of incubating and launching a wide variety of financing initiatives that have had a tremendous impact on how financing tools and investments are structured in favor of addressing the world's most important challenges. We see this as a core and vibrant area of our work.

- **Building the field.** In 2016, GDI co-authored a seminal paper, Innovative Financing for Development, calling for innovation and action. We then partnered with New America to produce the Bretton Woods II and the most Responsible Asset Allocator list, highlighting the importance of ESG in mainstream sovereign and government wealth fund investment strategies and a pathway for investment and shareholder value (evaluating $25 trillion in assets under management).
- **Connecting investors to investible deals:** Convergence is a global network for blended finance, generating data, intelligence, and deal flow to increase private sector investment in developing countries. With hundreds of institutional members, including IFC, USAID, Gates Foundation, FMO, and Christian Super, Convergence supports its members and drives the field forward through knowledge sharing, deal flow, and grant funding for the design of new blended finance structures.
- **Upstream project preparation.** Similar to our work with ISF Advisors in smallholder farmer finance and the Refugee Investment Network with forced migrants, GDI is working on a new partnership with UN Habitat called The Cities Investment Advisory Platform that aims to catalyze up to $500 billion in private capital towards sustainable urban development by translating the urban planning needs of governments into a pipeline of investable projects for private investors. It complements existing investment facilities and market making services, by looking at enhancing early stage design and origination.
- **Frontier and emerging market SME financing:** Having organized the small and growing business field with the launch of the Aspen Network of Development Entrepreneurs (ANDE), we are now launching the Collaborative for Frontier Finance, a multi-stakeholder initiative that aims to increase access to capital for small and growing businesses in emerging markets. Small and growing businesses (SGBs) create roughly 80% of formal employment opportunities in frontier and emerging markets, making them an essential part of every economy and an important lever for social and environmental impact. However, SGBs face an estimated $940 billion financing gap in appropriate capital they need to grow.
- **Outcome-based financing**: Funding mechanisms that shift the focus from inputs and activities to intended outcomes, like "pay-for-results" contracts and impact bonds, use development finance to incentivize evidence-based design and improved performance. GDI is driving expansion of this approach through multiple bonds including The Village Enterprise Development Impact Bond and the creation of an Outcomes Funds for Poverty Alleviation in Kenya and Rwanda, currently targeting $100 million. GDI is also exploring a broader settlement platform to act as an efficient clearinghouse for impact bonds.