MOBILISING DOMESTIC CAPITAL TO DRIVE **CLIMATE-POSITIVE GROWTH**

ACTION AGENDA
CONSULTATION VERSION

BLENDED FINANCE TASKFORCE

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ABOUT THIS **PAPER**

This paper presents an action agenda to accelerate growth by mobilising and growing domestic capital for climate action that has been developed by the Blended Finance Taskforce together with FSD Africa with generous support from the Open Society Foundations. The action agenda draws on expert interviews, analysis and virtual and physical roundtables held at events including the inaugural Africa Climate Summit in Nairobi and the 2023 World Bank Annual Meetings in Marrakech. The agenda identifies actions to accelerate the development of private financial markets in emerging markets and developing economies (EMDEs) to help capture opportunities for climate-positive growth, create jobs and build long-term economic resilience.

We offer this action agenda in a consultation paper and invite feedback and input from all those who read it. Our hypothesis is that bigger and better financial markets are critical to capture climate-positive growth opportunities. Building on the work of many others, this paper lays out the benefits and barriers which currently prevent this capital from flowing before detailing twelve actions to transform the system.

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Wherever we use “country” in this paper we are referring to emerging markets and developing economies excluding China. Additionally, this paper uses five essential terms as follows:

1. **Domestic capital** to refer to all private financial resources that are generated and used within a specific country. It encompasses various forms of wealth and assets that are owned or controlled by individuals, businesses and institutions within the borders of a particular country. The concept of domestic capital is often contrasted with external, international or foreign capital, which refers to financial resources originating from outside the country. This paper focuses on private domestic capital, which is referred to as domestic capital throughout the paper.
2. **Public capital** to refer to non-private financial resources including government budget (domestic) and donor funds (international) including donor / development agencies, multilateral development banks, climate funds etc.
3. **Local financial markets** to refer to the financial market that operates within a country. These markets facilitate the buying and selling of financial instruments and assets, providing a platform for individuals, businesses, and financial institutions to trade, invest and borrow.
4. **Mobilising domestic capital** to refer to the process of encouraging, attracting, or facilitating the flow of domestic private financial resources from individuals, businesses, and institutional investors towards investments, projects, or initiatives that contribute to climate-positive growth.
5. **Climate-positive growth** to refer to economic development driven by a transformation into a climate-aligned, low-carbon, nature-positive economy that not only avoids contributing to climate change but actively works to mitigate its effects and promote environmental sustainability while contributing to reaching other Sustainable Development Goals (SDGs).

FOREWORD

The climate crisis is intensifying, disproportionately impacting countries that have historically been the least responsible and compounding an already challenging economic environment of high inflation and pressure on national budgets. $5.4 trillion a year is needed by 2030 to finance sustainable development, but we are currently falling far short of that goal. Capital is simply not flowing fast enough, or at the scale required.

The good news is that many climate-positive solutions have a strong commercial case for investment and offer exciting opportunities for private investors. For example, EMDEs are home to some of the world's best renewable energy sources. Investment in these opportunities at scale will also shift many countries onto a long-term pathway of sustainable growth: in Africa, the energy transition is likely to be one of the most significant inflection points in the continent's current development trajectory, helping to reposition African economies for a green future.

But despite the strong business and socioeconomic case, investment levels remain low and the world is not on track to meet the UN Sustainable Development Goals (SDGs) for people and planet. Although significant progress has been made, we are still behind on many SDGs, including quality education, zero hunger and climate action. The impact of climate change will be felt everywhere but EMDEs will be hardest hit by climate change despite their limited contribution to historical emissions. Capturing climate-positive growth can be an essential driver for economic growth, driving progress on and creating further opportunities to invest in other SDGs.

I believe very strongly in the potential of bigger and stronger domestic capital markets to change this story. In many countries, these markets are already a sizable source of capital. But not enough of it is flowing to the many commercially-attractive, climate-aligned investment propositions that countries offer, and there is currently very little conversation on why this is the case, and even less conversation on what needs to be done to address it. It is time to reinforce domestic capital funding solutions in the climate finance agenda, and collectively harness their potential to drive sustainable economic development.

This consultation paper sets out the role that these markets can play in the sustainable development story, including how much needs to be invested and how it can be mobilised. It proposes the actions that regulators, industries and financial institutions need to take in order to grow and strengthen domestic capital markets in a way that captures the investment opportunities and generates climate-positive growth. Its analysis shows that targeted changes to policy, regulation and financial instruments could unlock trillions for climate aligned investment and climate-positive growth.

This is the right time for action. Momentum for change is growing and important shifts in the financial system have begun to take place. With the urgent and growing need for economic development, we are at juncture similar to the Bretton Woods moment, where radical change in the way development is financed is vital – and in reach. Great opportunities are emerging politically as global powers rethink their positioning. The Paris Summit for a New Global Financing Pact showed the critical role of using public money in a catalytic way to unlock private capital by de-risking sustainable projects and building investable project pipelines. And the Nairobi Declaration, following the Africa Climate Summit, very helpfully accentuated the role of domestic capital in Africa's green economic transformation. These are powerful conversations. And we need to bring local financial institutions and domestic capital allocators in the room. Regulators, industries and local investors need to join these important conversations which are shaping the changes at the centre of the global financial system that can speed up action on the ground.

Growing and strengthening local financial markets will bring huge benefits alongside sustainable, stable growth. No economy is built on foreign currency and international public capital alone – these have a role to play but should not be the sole financial solution. Focussing on local markets will create jobs, build local capacity and drive new sectors. Stronger local financial markets will make the global financial system more equitable as well: domestic markets that can deliver investment at scale reduce the need to seek international public capital.

I want to ask regulators, industries and financial institutions to consider the actions proposed in this paper, to comment on, question and refine them, so they serve as an agenda for the radical action on domestic capital that countries urgently need.

Tariye Gbadegesin

CEO Arm-Harith

EXECUTIVE **SUMMARY**

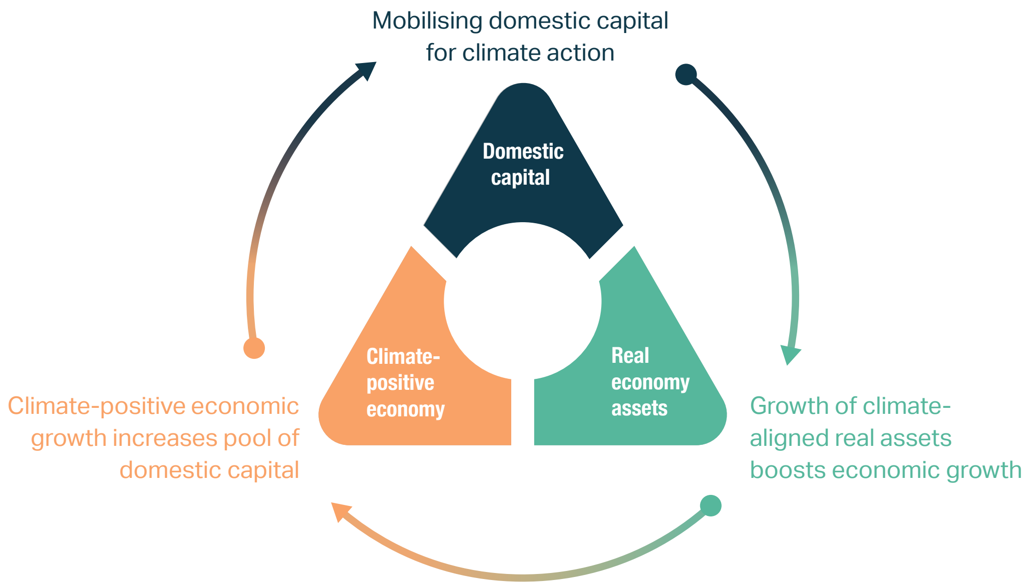
Unlocking domestic capital for climate action can trigger positive tipping points for growth in emerging markets and developing economies

Emerging Markets and Developing Economies (EMDEs) are home to some of the best climate investment opportunities in the world. Mobilising domestic capital into these opportunities is key to driving sustainable and inclusive growth. Technology tipping points are increasingly making climate-positive solutions in EMDEs commercially attractive. Domestic investors should have privileged access to these investment opportunities. With an estimated ~$17 trillion under management in EMDEs, mobilising domestic capital is a priority for climate action.

These investments, for example in wind and solar power generation, transmission infrastructure, green industry and regenerative agriculture, can be a lever for economic growth and job creation. This economic growth in turn increases the pool of domestic capital available, creating a self-reinforcing "virtuous" cycle that could be a positive tipping point or "super lever" for long-lasting economic growth and sustainable development.

Exhibit 1:

Unlocking domestic capital for climate action can trigger positive tipping points for growth in EMDEs



The ~$17 trillion of bank savings, insurance and pension assets in EMDEs could nearly triple by 2040. We estimate that domestic capital pools could increase by about $1.5 trillion a year to $45 trillion in 2040, linked to measures to grow and deepen national financial markets and underlying economic growth, which could be increased if domestic capital is invested in climate-aligned infrastructure and other assets. If a majority of the additional domestic capital was deployed in climate-aligned investments and instruments, we could effectively halve the ~$3 trillion annual investment gap for climate action and other SDGs in EMDEs as well as generate a major economic growth programme.

However, three key barriers prevent domestic capital from being invested at speed and scale into climate action, which puts the brakes on the virtuous growth cycle. First, national plans and policies do not yet create sufficient markets and incentives to develop and invest in climate-positive assets. Second, financial market regulation is not fit-for-purpose, for example often limits pension fund investment in infrastructure, private equity and other alternative asset classes that are critical to delivering climate-aligned outcomes. And third, limited availability, affordability or access to the right type of catalytic capital, especially local currency de-risking mechanisms and early-stage financing to develop projects, means domestic capital is not being deployed into climate-positive solutions at scale.

Going forward, governments, regulators and the private sector need to co-create national action plans that build on three essential levers. These national action plans, based on the global action agenda presented in this paper, can mobilise existing domestic capital for investments in climate-positive growth, grow the size of domestic capital and deepen local financial markets. These efforts have to be nationally driven but supported where possible by international climate and development finance institutions. National action plans for accelerating climate-positive growth through domestic capital can be based on three essential levers:

1. **Grow domestic assets**, by designing and implementing national and sectoral economic investment plans that drive climate-positive growth
2. **Update financial regulations** to grow local financial markets and enable and incentivise investments contributing to climate-positive growth
3. **Scale local currency financial mechanisms** that use public capital catalytically to mobilise domestic capital by de-risking investments and building the project pipeline

Exhibit 2 summarises the three essential levers with key actions connected to each lever. Collaborative efforts between governments, industry, investors, regulators, development banks and credit rating agencies will be crucial to growing and unlocking domestic capital for climate-positive growth.

Exhibit 2:

Action Agenda for mobilising domestic capital

3 Key Levers…	…delivered through concrete actions	Main Actors
1. Grow domestic assets Grow domestic assets, by designing and implementing national and sectoral economic investment plans that drive climate-positive growth	1. Co-create national investment plans for climate-positive growth with private sector	EMDE governments; Private domestic investors/FIs
	2. Provide dedicated technical assistance to support creation and delivery of national investment plans	MDBs/DFIs
	3. Build investor capacity and expertise in new sustainable asset classes	Regulators; EMDE governments; Private domestic investors/FIs; MDBs/DFIs
2. Update financial regulations Update regulation to grow local financial markets and enable and incentivise investments contributing to climate-positive growth	4. Revise risk assessment, capital adequacy & liquidity frameworks to reflect climate change	Regulators
	5. Invest in climate-aligned, country-specific corporate credit ratings	EMDE governments; Regulators; Credit rating agencies
	6. Create & adopt shared sustainable finance frameworks	Regulators; Private domestic investors/FIs
	7. Remove regulatory barriers overly restricting flow of institutional capital into real economy	EMDE governments; Regulators
	8. Introduce policies to expand formal domestic private savings, pension and insurance pools	EMDE governments; Regulators
3. Scale local currency mechanisms Scale local currency mechanisms that use public capital catalytically to mobilise domestic capital by de-risking and developing pipeline	9. Scale local currency de-risking mechanisms	MDBs/DFIs
	10. Scale local currency project preparation facilities	MDBs/DFIs; Donor governments
	11. Lift barriers to catalytic climate finance faced by domestic projects and investors	Private domestic investors/FIs; MDBs/DFIs; Donor governments
	12. Create local & regional aggregators to scale investment ticket sizes	Private domestic investors/FIs

Legend: *EMDE governments*; *Regulators*; *Credit rating agencies*; *Private domestic investors/FIs*; *MDBs/DFIs*; *Donor governments*

Examples show that implementing these essential levers is doable; this action agenda is about scaling and replicating them in a systematic way. Countries from South Africa to Brazil and Barbados are developing fully-costed, national investment plans ("country platforms") to create jobs, attract investment and support a climate-positive growth agenda while identifying ways to pay for the growing costs of climate change. In the past, Chile and Colombia have implemented ambitious regulatory changes to increase the share of pension assets in national infrastructure and other real economy sectors. Local currency catalytic mechanisms like InfraZamin in Pakistan and InfraCredit in Nigeria show that de-risking and early-stage stage finance mechanisms can mobilise private capital by tackling specific barriers to investment. These examples need to be replicated and scaled. This action agenda shows the way forward.

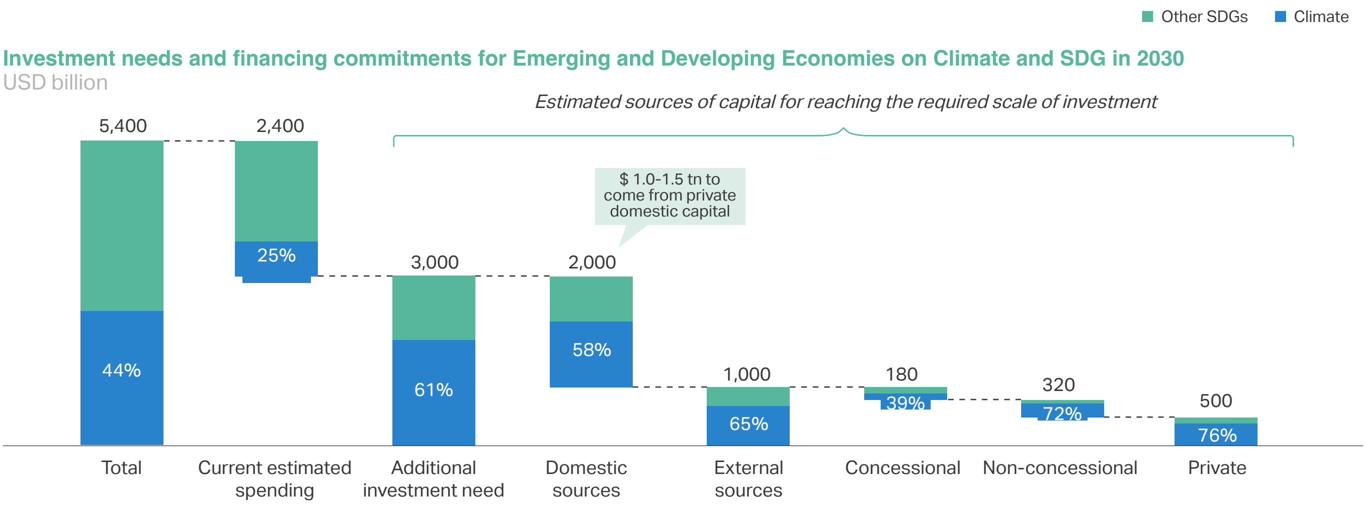
01
CALL TO ACTION

More domestic capital and deeper local financial markets are essential for long-lasting climate-positive growth

Additional investments of $3 trillion a year are needed for sustainable development, including for climate mitigation and adaptation. EMDEs need a total of $5.4 trillion of investment each year in development priorities such as good health, quality education, and climate action to keep the 2030 Sustainable Development Goals within reach. But current commitments to SDG-related investment fall about $3 trillion short of this figure. Commitments for climate action are particularly far behind: they must grow 5 times larger if EMDEs are to pursue long-lasting growth pathways, cope with shocks and become resilient to the impacts of climate change (Exhibit 3).[1]

Exhibit 3:

Investment need for sustainable development



Note: Scope: EMDEs excluding China, Climate is defined as energy transition, adaptation and resilience, sustainable infrastructure and agriculture, forestry and land use. SDGs refers to other SDGs, largely health and education. External financing means capital flowing from non-EMDEs countries. Current spending for 2019.

Source: G20 Report of the Independent Expert Group (2023). The Triple Agenda: A roadmap for better, bolder, and bigger MDBs.DGs refers to other SDGs, largerly health and education. External financing means capital flowing from non-EMDEs

Although countries face high risks of climate change, climate-positive growth also offers attractive economic opportunities for many. The transition to a climate-aligned global economy offers a unique opportunity for economic growth and creating jobs. EMDEs make up 95% of the top 100 countries in terms of global solar potential.[2] An average of 60% of mined production of four key energy transition materials - copper, nickel, lithium and cobalt - was in in 2022.[3] With the right economic policies, financial markets and catalytic use of public capital, countries can capture these opportunities to create climate-positive growth that creates jobs and contributes to reaching sustainable development goals.

Not all of these opportunities will be captured if countries remain reliant on public and international capital. Many countries face high existing debt burdens, severely limiting fiscal space. International public and private capital is not yet flowing at scale due to high risks, both real and perceived, limited insight in project pipelines and more attractive risk-returns in other countries. The current macro-economic environment with higher interest rates is exacerbating the issues.

The good news is that many of these opportunities can and should be financed with domestic capital. Public capital is stretched: some 60% of low income countries are either in or at high risk of debt distress.[4] Moreover, public capital is not the optimal source of finance for projects and firms that could attract private capital. Many opportunities are, or soon will be, commercially attractive as technology tipping points make these investments viable, meaning that much of the capital that is needed can come from the private sector. In Europe and the US 60%-75% of capital for climate action is already coming from private sources.[5]

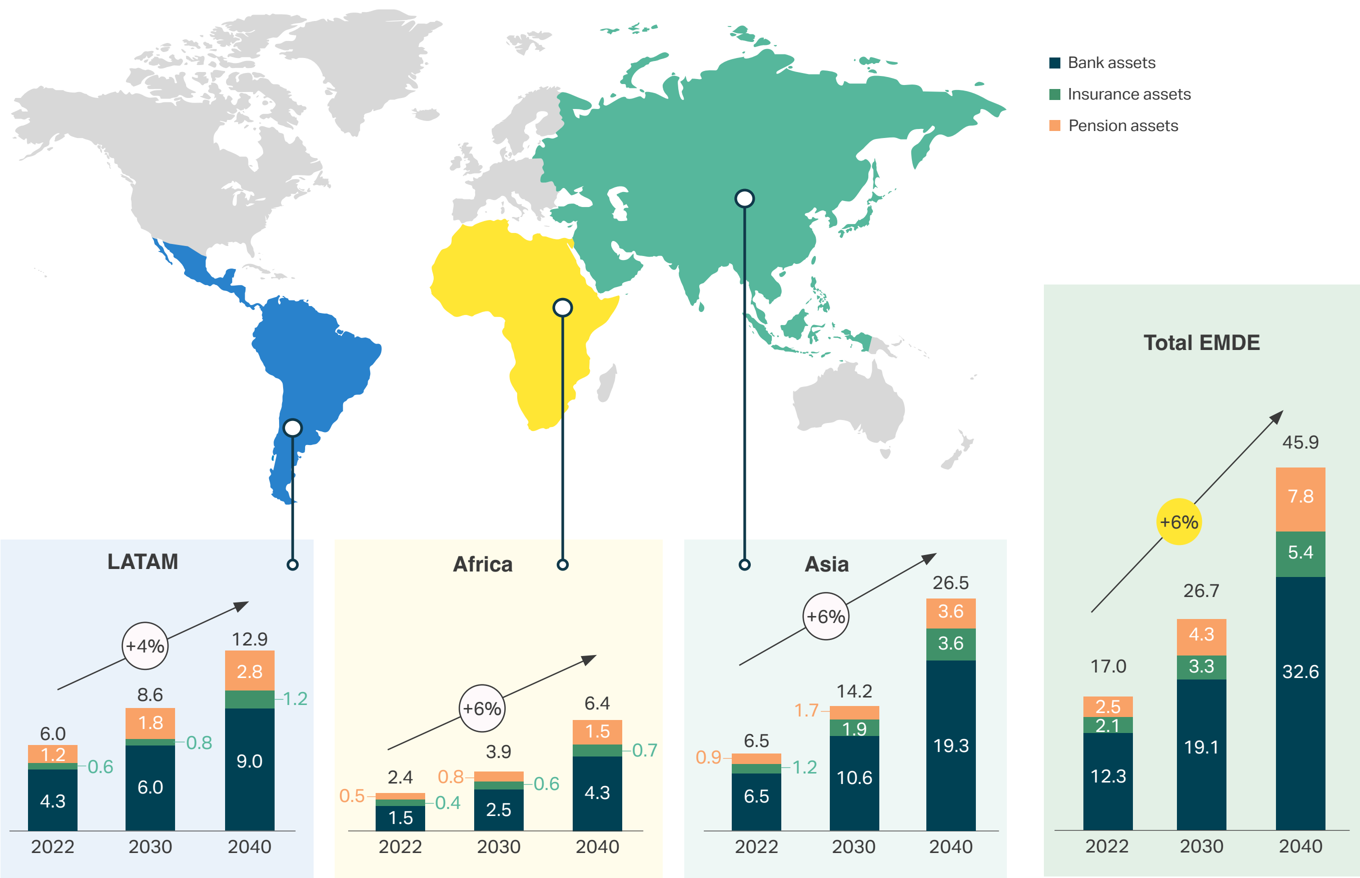
Domestic capital could halve the existing $3 trillion investment gap for climate action and other sustainable development goals. Current domestic capital under management estimated at ~$17 trillion, made up of savings, insurance and pension assets, could expand by about $1.5 trillion a year to $45 trillion in 2040 through economic growth and targeted measures to grow the size of private capital under management relative to GDP.[6] See exhibit 4 for a visual representation. Different countries will need different measures, depending on the current size and maturity of their financial markets. Naturally, not all of this capital will be deployed for investments related to climate-positive growth. However, a significant share could and should be mobilised to close up to half of the existing ~$3 trillion investment gap for climate action and other sustainable development goals.[7] The remainder will need to come from a combination of public national and international capital as well as international private capital.

Exhibit 4:

Investment need for sustainable development

Private Domestic Assets under Management per region - Emerging Markets and Developing Economies (excluding China)

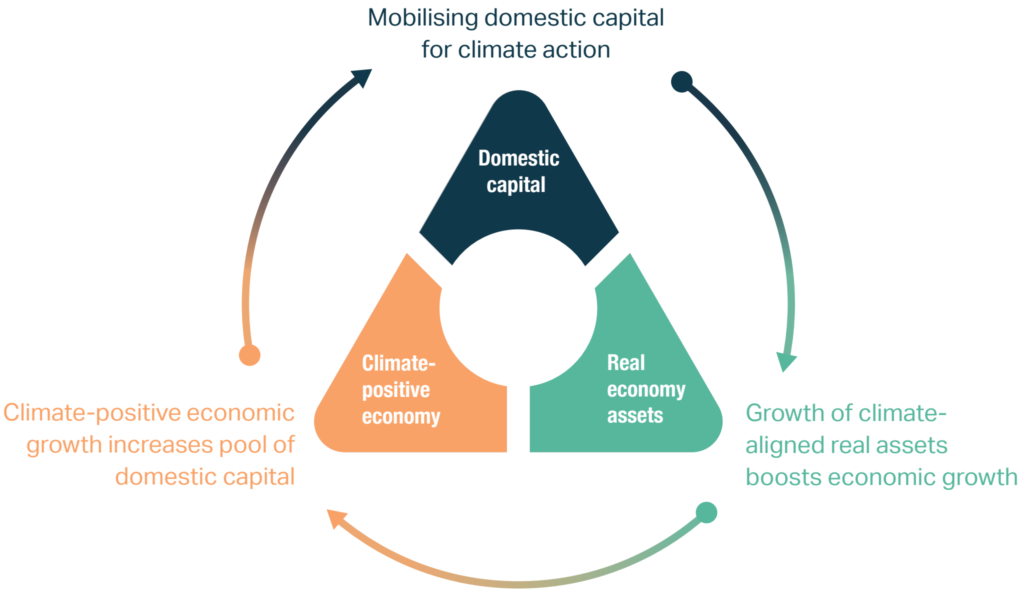
Assets under Management by category, 2020 (actual) and 2030-2040 (forecast)



Mobilising domestic capital for climate-positive growth could create a positive tipping point for long-lasting economic growth. Many investments for climate-positive growth have underlying business cases that, under the right conditions, could attract domestic capital. In turn, these investments into, for example, wind and solar power generation, transmission infrastructure, green industry and regenerative agriculture, will lead to growth of the economy and project pipeline, driving further economic growth, creating jobs and supporting the sustainable development goals. A growing economy based on robust domestic financial markets will further increase domestic capital, creating a self-reinforcing "virtuous" cycle that could be a positive tipping point or "super lever" for long-lasting economic growth and sustainable development. Exhibit 5 shows this mechanism visually.

Exhibit 5:

Unlocking domestic capital for climate action can trigger positive tipping points for growth in EMDEs



Achieving these financial tipping points offers significant and compounding benefits to economies. Not only will it accelerate sustainable, climate-positive growth, but it will also create local jobs, build local capacity and enable more risk-sharing, portfolio diversification and financial inclusion. These changes offer compounding benefits. For instance, growing local financial markets will create the local market expertise needed to manage private investment at scale. Access to local capital will give more local entrepreneurs the chance to create thriving small and medium enterprises. A bigger pool of domestic capital will reduce demand for "flighty" international private capital, which can easily flow out when opportunities elsewhere become more attractive. Finally, a lengthening record of successful investments will lower their perceived risk among providers of long-term international private capital, further expanding the pool of stable capital available for climate-positive investment in a virtuous cycle.

Stronger local financial markets will also help to make the global financial system more equitable and stable. At present, many countries depend on international public capital for investment. But its terms often end up increasing their debt burdens and crowding out private capital. Moreover, EMDEs are seldom adequately represented in the decision-making bodies of development finance institutions, which consequently do not always invest in line with national priorities. We expect international public capital to remain important to closing the sustainable development financing gap, but it is neither adequate nor sufficient to meet current financing needs in their entirety. International public capital needs to be deployed much more in service of national investment plans ('country platforms') and building private domestic financial markets.

Reaching financial tipping points is unlikely to happen without dedicated actions. Domestic capital will not automatically flow towards investment in the local economy, for example in infrastructure needed for climate-positive growth. Many countries will need to take additional steps to get more domestic capital flowing in that direction. First steps are being taken. Several country leaders, like President Ruto in Kenya, are already shifting the narrative about mobilising private investment at scale to realise such opportunities. Similarly, several EMDE governments, including Brazil, Barbados, Indonesia and South Africa, are developing fully costed, economy-wide investment plans targeting climate-positive growth, jobs and new ways to pay for the growing costs of climate change. These plans show where, how, and what type of capital needs to be deployed to build each country's economic, environmental, and social resilience and achieve the sustainable development goals. Other countries need the right resources and financial support to follow these examples. These plans will need to be supported by economic policy, updated financial regulation, and public capital used catalytically to mobilise domestic capital by de-risking investments that support climate positive growth.

02

EXISTING BARRIERS LIMIT DEVELOPMENT OF BIGGER, BETTER LOCAL FINANCIAL MARKETS

Overcoming these barriers will unlock domestic capital for climate-positive investments

Unlocking domestic capital depends on well-functioning private economic as well as stable financial markets. Evidence from around the world shows that strong local financial markets are built on sound regulation, economic policy, and institutions[8]: financial markets can flourish in stable regulatory and economic environments that reduce risk and uncertainty, making investments more attractive.[9] To work effectively, financial markets in turn depend on private economic markets delivering risk-adjusted returns on investments that match the expectations of capital providers.

The starting point of financial markets varies considerably. Any national strategy to strengthen financial markets must start by assessing their existing condition and the surrounding economic and regulatory environment.[10] For instance, Brazil, India, and South Africa have very deep existing financial markets, while in other countries like Ethiopia, Ghana and Mongolia, financial markets are in early stages. The actions each country takes to strengthen and deepen its financial markets need to be tailored their specific starting points.[11]

That said, analysis of efforts to strengthen financial markets so far shows that they encounter three common barriers. The nature and impact of these general barriers varies across countries and regions. Current macroeconomic conditions and trends are reinforcing the impact of these barriers, though in some countries more than others.

1. **National plans and policy do not yet create the enabling environment for private markets to develop and invest in opportunities that support climate-positive growth.** Green fiscal policies and incentives – like carbon taxes - are often absent and tax systems and subsidies still tend to favour fossil-fuel industries.[12] In Africa, fossil fuel subsidies are four times as large as investment in renewable energy.[13] A few countries are addressing this barrier. Governments of a handful of countries, including Brazil, South Africa, and Barbados, are creating fully costed, holistic national investment plans that are transforming economic policy and regulation.[14] Most countries need resources and financial support to create similarly credible national policy and investment plans that will reduce the real and perceived risks to investors and stimulate flows of domestic capital to projects in the real economy. The technical assistance that the global development community typically offers today does not always meet their need to develop and implement transformative national investment plans. Both the planning and funding model for this technical assistance needs to change.[15]

2. **Domestic financial market regulation is not fit-for-purpose, preventing domestic investment in the projects and asset classes necessary for climate-positive growth.** Driving investment into new asset classes such as green industries and infrastructure needs updated regulatory frameworks. Today, unclear definitions for sustainable investing and limited understanding of transition finance limit investment.[16] In some places very strict ESG definitions limit the amount of transition finance investors are able to provide as these typically increase exposure to carbon in the short term, before carbon reductions start. Across a range of countries, from markets with diversified financial ecosystems to more basic frontier markets, regulatory frameworks tend to restrict domestic institutional investors from investing directly in infrastructure projects (often for liquidity reasons). In many cases, these frameworks have not yet updated to include alternative investments, such as in green industry and infrastructure.[17] In addition, regulatory frameworks often do not contain updated clauses for dealing with de-risking instruments like guarantees, which limits their effectiveness as they do not result in optimal balance sheet and credit rating treatments. Domestic (institutional) capital tends to flow into securities and relatively safe assets classes rather than financing projects in the real economy, especially the kind of infrastructure projects that combat climate risk. For all these reasons, green finance products that have become mainstream elsewhere remain underused. For example, only $27 billion of the $487 billion green bonds issued in 2022 originated from EMDEs (excluding China), and 79% of the global volume of green debt in 2022 was issued in hard currencies, either dollars or euros.[18]

3. **Limited availability, affordability, and accessibility of the right types of catalytic public capital restricts the scale of domestic private capital flowing into climate-positive solutions.** A range of mechanisms and products has been developed that can de-risk investments. But these are commonly hard currency (dollar/euro) offerings targeted at international public institutions or foreign investors. In addition, complex processes for accessing climate finance today generate large transaction costs which are often prohibitive for local entrepreneurs. Simplification is needed. Climate finance providers should standardise their access procedures and streamline decision-making to make sure local entrepreneurs have direct access to their products.[19] In addition, early-stage equity financing and project preparation grants are currently largely unavailable. Where project preparation funding is provided, it is not supported by the necessary investor capacity-building. The African Development Bank (AfDB) identifies knowledge gaps on climate change and climate finance as one of the top three barriers for private sector participation in Africa.[20] According to the EIB, only a third of domestic African banks have staff with recognised climate risk qualifications, while 60% cite a lack of expertise, data and tools for assessing climate risk as impeding climate action.[21] As a result, local institutional investors remain unaware of many projects – whether small or large scale – that have robust business cases.

Today's macroeconomic and geopolitical conditions are reinforcing existing barriers.[22] Rising interest rates combined with high sovereign debt levels mean economies are receiving higher risk ratings.[23] At the same time, industrial policies promoting green domestic investment and job creation in advanced countries reduce competitiveness of EMDE producers, limiting export opportunities.[24] Examples of these policies include the Inflation Reduction Act in the USA and the European Union's Carbon Border Adjustment Mechanism. Conversations about how to bridge the gap between climate policies in different parts of the world and equitable trade are much needed. These trends are reinforcing the norm of investing the majority of domestic assets in government bonds and hard currencies in search of consistent market returns.

03
THE ACTION AGENDA

3 key levers to accelerate climate-positive growth through domestic capital mobilisation

Governments, regulators, industries, investors, Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs) all need to work together to create national action plans that can unlock existing domestic capital, drive climate-positive growth and create bigger and deeper local financial markets. This chapter presents 3 essential levers with 12 underlying actions to do so.

Different countries will have different priorities for action, depending on their socioeconomic circumstances and the size and depth of their financial markets. This action agenda offers a starting point from which stakeholders in EMDE financial systems and their counterparts in the global financial community can tailor national action agendas. Creation of these national action plans will be based on:

- **Evaluating the current status of local and regional financial markets** before detailed action planning begins. This evaluation can identify the size, depth, and dynamics of local private financial markets, the potential for mobilising capital from neighbouring countries, existing market strengths and areas that need strengthening.
- **Building local capacity to analyse financial markets and transactions.** Strengthening data collection across national and regional financial sectors, collaborating on more South-South data analysis, and applying the resulting granular local knowledge to investment decisions is critical for getting more bankable projects up and running.

Exhibit 6 shows the 3 key levers and related 12 actions. Together, the actions aim to produce economic policy, financial regulations and catalytic mechanisms that will expand and deepen local capital markets and channel more private capital to real economy projects, fuelling long term climate-positive growth at the national level in turn driving the creation of additional domestic capital that can be re-invested.

Exhibit 6:

Action Agenda for mobilising domestic capital to drive climate-positive growth

3 Key Levers…	…delivered through concrete actions	Main Actors
1. Grow domestic assets Grow domestic assets, by designing and implementing national and sectoral economic investment plans that drive climate-positive growth	1. Co-create national investment plans for climate-positive growth with private sector	EMDE governments; Private domestic investors/FIs
	2. Provide dedicated technical assistance to support creation and delivery of national investment plans	MDBs/DFIs
	3. Build investor capacity and expertise in new sustainable asset classes	Regulators; EMDE governments; Private domestic investors/FIs; MDBs/DFIs
2. Update financial regulations Update regulation to grow local financial markets and enable and incentivise investments contributing to climate-positive growth	4. Revise risk assessment, capital adequacy & liquidity frameworks to reflect climate change	Regulators
	5. Invest in climate-aligned, country-specific corporate credit ratings	EMDE governments; Regulators; Credit rating agencies
	6. Create & adopt shared sustainable finance frameworks	Regulators; Private domestic investors/FIs
	7. Remove regulatory barriers overly restricting flow of institutional capital into real economy	EMDE governments; Regulators
	8. Introduce policies to expand formal domestic private savings, pension and insurance pools	EMDE governments; Regulators
3. Scale local currency mechanisms Scale local currency mechanisms that use public capital catalytically to mobilise domestic capital by de-risking and developing pipeline	9. Scale local currency de-risking mechanisms	MDBs/DFIs
	10. Scale local currency project preparation facilities	MDBs/DFIs; Donor governments
	11. Lift barriers to catalytic climate finance faced by domestic projects and investors	Private domestic investors/FIs; MDBs/DFIs; Donor governments
	12. Create local & regional aggregators to scale investment ticket sizes	Private domestic investors/FIs

Legend: *EMDE governments*, *Regulators*, *Credit rating agencies*, *Private domestic investors/FIs*, *MDBs/DFIs*, *Donor governments*

3.1
GROW DOMESTIC ASSETS

Rationale

Countries' different circumstances mean they have different development goals regarding energy and food security, nature conservation, climate and jobs. A country's unique challenges and opportunities will determine its particular goals and investment priorities. Creating an integrated national investment and policy plan targeting the nation's goals is a powerful way for national governments to trigger a shift towards long-term sustainable growth. Aligning economic policy and regulation will be essential to achieving these impact goals, for example fossil fuel subsidy reform to ensure competitiveness of climate-aligned business cases.[25] Governments that work with the business community, domestic capital providers and civil society to draw up national investment plans have the best chance of producing credible plans to meet local needs in which local investors have confidence and are eager to invest.

Countries like Brazil, South Africa, and Barbados lead the way on national investment planning – others will need additional resources to follow. These countries have developed fully costed, economy-wide investment plans for climate-positive, job-creating growth which also identify ways to finance investments in climate resilience and adaptation to climate change. The plans show where, how and what type of capital is needed. National investment planning in these countries has been driven by local actors from the start.[26] Although some countries are showing the way, so far only a limited number of countries have created these types of plans. Moreover, the pioneer plans such as the South Africa Just Energy Transition Investment Plan face financing gaps because of familiar problems with the current financial system, such as a high cost of capital and scarce early-stage project funding for projects.[28] Domestic financial sectors are not always engaged from the start in creating these investment plans, while delivery of those plans will likely be strongly dependent on domestic finance capacity.[29]

Although there are multiple technical assistance facilities, these are usually fragmented or planned on a project-by-project basis, rather than as part of a strategic programme.[30] The AfDb notes that the lack of funding for appropriate technical assistance is a key barrier to establishing national climate funds.[31] More investment in such assistance overall is needed to attract more private capital into infrastructure financing,[32] where 80% of projects fail at the feasibility and planning stages.[33]

Critical actions

3.1.1 Co-create national investment plans for climate-positive growth with private sector

Key actors: Governments | Industries | Private domestic investors

The track record of public–private relationships on climate is mixed but development and delivery of national plans will depend on deployment of domestic capital.[34] Country platforms created in partnership with domestic investors can serve as a dynamic nexus between the public and private sectors, facilitating capital deployment through effective supporting policies. Key actors need to:

- **Co-create a long-term government vision** and actions for well-functioning private economic markets and sectoral roadmaps together with domestic and regional private (institutional) investors as well as regional development banks and national DFIs, for example as the Brazilian government did with the Ecological Transformation Plan.[35]

- **Align economic policies** to the development of local financial markets and encourage private sector investment in projects that underpin sustainable development by introducing appropriate incentive schemes. See, for example, the Model Law developed jointly by the African Green Infrastructure Investment Bank, Africa investor, the CFA Asset Owners Council, and global law firm DLA Piper, which leverages public-private partnerships (PPPs) to deliver the Nationally Determined Contributions of African nations.[36]

- **Agree voluntary targets with private domestic investors for investing local capital** in local climate-positive growth opportunities, in line with the national investment plan.

- **Draw on community savings** to finance local investments. Informal economic activity in various sectors is financed by smaller, local private savers, especially in lower-income countries.[37] Drawing on existing pools of informal savings in local communities to finance community-based climate-positive projects (for example distributed solar mechanisms and mini-grids) will not only deliver the projects but also improve the quality of life in those communities.

3.1.2 Provide dedicated technical assistance to support the creation and delivery of national investment plans

Key actors: MDBs/ DFIs

Targeted technical assistance to develop national plans and to scale first-of-a-kind projects today is limited. International climate and development finance institutions should focus on making technical assistance in support of national investment plans consistently available. Key actors need to:

- **Work together to support governments in creating national investment plans and related policy and regulation.** Many governments have limited resources, human and financial, for creating national investment plans and related supporting policy and regulation. Key actors should coordinate to use existing and new mechanisms for providing policy support to fill that resource gap and build local capacity.

- **Tie technical assistance for domestic entrepreneurs and private investors to national investment plans.** For instance, key actors could set up climate technical advisory panels staffed by sector and transactions experts to give *ad hoc* support to domestic entrepreneurs and investors on projects in line with the national investment plan. They could also organise knowledge transfer sessions between experienced professionals and project teams.

- **Get first-of-a-kind projects off the ground to provide credible proof-of-concept** for types of asset class and de-risking mechanisms that are new to local investors and companies. Launching first-of-a-kind projects is often complicated. Targeted support, technical assistance and knowledge-sharing can help to win early funding for them from local investors and provide project data that will help to raise finance for future similar projects.

Case Study

Colombia – Infrastructure Bank – FDN

FDN is a Colombian financial institution designed to catalyse domestic financial resources in infrastructure. IFC and Development Bank of Latin America acquired equity stakes in FDN, with the remaining stake owned by the local government. FDN provides long-tenor loans, subordinated debt and credit enhancements to increase participation of local banks and domestic investors. It also provides critical technical assistance for financial product structuring and execution of public-private partnerships. FDN has also liaised with the local government to introduce regulatory reforms to allow pension funds investment in infrastructure debt funds.[38] IFC has also supported FDN with transaction advice directly and indirectly for the preparation of 32 road projects totalling $14.8 billion.

The Fourth Generation Roads Concession Program (4G), in collaboration with the World Bank, has had a 1.5x multiplier effect on the GDP with growth percentage reaching to 5.6% and has supported in closing the financing gap through increased private financial participation.[39] In this way, FDN contributed significantly to increasing Colombia's capacity to manage and finance long term infrastructure projects.

3.1.3 Build investor capacity and expertise in new sustainable asset classes

Key actors: Governments | Regulators | MDBs/ DFIs | Private domestic investors

Attracting finance for sustainable projects depends on investors fully understanding the likely risks and returns. For many local investors, it will be their first time considering investment in sustainable assets for the first time. Increasing their knowledge and expertise is key to building market confidence in these new asset classes. Key actors need to:

- **Use first-of-kind transactions to build investor expertise** in evaluating new climate-aligned projects and in mechanisms for financing new asset classes such as infrastructure

- **Build financial sector understanding of the benefits** associated with green finance to create demand for sustainable finance in local capital markets.

- **Invest in training and capacity building for financial institutions** in issuing, monitoring and assessing green bonds.

- **Fund technical assistance for the design and structuring of dedicated facilities** such as green banks and national climate funds wherever they are needed to implement national investment plans.

3.2
UPDATE FINANCIAL REGULATION

Rationale

To capture opportunities laid out in national policy and investment plans, domestic investors need a stable and consistent regulatory environment, which incentivises investment of domestic capital in the plan's priorities. Aligning financial regulation with national plans clarifies the economic direction for investors, giving confidence to make long-term bets in the real local and regional economies.[40] Climate-positive growth will require large domestic investment in climate-aligned infrastructure projects, technologies, and companies competing in these sectors. Existing regulatory frameworks and risk assessment methodologies need a thorough overhaul to unlock that scale of investment.

Today's regulatory frameworks often provide relatively weak incentives for channelling domestic capital into the real economy.[41] In many jurisdictions, regulatory treatment of institutional capital is conservative, preventing or limiting its investment in real assets.[42] Multiple complex regulatory systems create a particular problem for infrastructure projects seeking investment.[43] Local entrepreneurs and investors underline the need to streamline regulation to increase the flow of local capital to local infrastructure projects.[44]

Conventional methods for assessing investment risk often overlook climate risk and national climate adaptation priorities. The current absence of standard regulatory taxonomies and risk assessment frameworks that accurately reflect the nuances of local climate risks distorts risk pricing and, consequently, the allocation of available domestic capital. There is no uniformly clear understanding of sustainable projects among the investment community. The AfDB reports that domestic financial institutions in Africa often do not finance climate-aligned projects, even with financial guarantees in place, due to knowledge gaps.[45] This "misunderstanding of opportunities" is observed in countries beyond Africa as well.[46] Similarly, corporate credit ratings frequently fail to reflect companies' real default risk because they are not based on detailed, local sector-specific data. Credit rating agencies often apply a "sovereign ceiling" policy, meaning corporations and local governments cannot receive a higher rating than the country in which they operate.[47]

Updated financial regulation has a key role to play not only in allowing existing capital to flow more easily into the asset classes and projects that are necessary for climate-positive growth, but also in fuelling the expansion of domestic pools of capital that are available for such investments.

Critical actions

3.2.1 Revise risk assessment, capital adequacy and liquidity frameworks to reflect climate change

Key actors:

Regulators

Financial regulation in place does not yet fully reflect the evolving landscape of risks and opportunities associated with climate change. Adjusting regulatory assessments to reflect climate considerations is needed to drive participation of financial institutions in transition financing through better risk evaluation. Key actors need to:

- **Review existing frameworks in the light of national investment plans** to understand how well capital adequacy and liquidity requirements for financial institutions reflect actual climate risk and influence climate-positive growth.
- **Integrate national climate risk** in capital adequacy assessment and liquidity requirements and provide institutional investors with new risk assessment guidelines.
- **Review and update regulatory approaches to de-risking mechanisms** to make sure their potential to reduce project investment risk is accurately reflected in risk metrics. For example, arranging training for regional regulators on de-risking instruments and their impact on project risk and domestic capital flows.

Case Study

Regional Financial Market Development Support Project in West Africa (PADMAFIR 2)

The African Development Bank (AfDB) is supporting the Financial Markets Authority of the West African Monetary Union (WAMU; also known by its French acronym, UEMOA) in modernising the regulatory framework governing regional financial markets in order to make them deeper, more attractive and competitive.[48]

In the second phase of this work, known as the AfDB's Regional Financial Market Development Support Project (PADMAFIR 2), the bank is providing grant funding to WAMU's Financial Markets Authority so it can create a financial and monetary code in line with international best practices. The project is also deepening mortgage and securitisation markets in the region by building their capacity and improving related legal and regulatory frameworks.[49] In addition, the AfDB offers training sessions for regulators on sustainable finance taxonomies, demonstrating the benefits of green finance instruments for debt and financial markets, and co-designing guidelines for issuing green bonds.[50]

Funding for PADMAFIR 2 will come from the Financial Markets Development Trust Fund, which supports the AfDB's initiatives to develop resilient local financial markets.

3.2.2 Invest in climate-aligned, country-specific corporate credit ratings to reduce reliance on sovereign caps

Key actors:

Regulators

Credit rating agencies

Corporate credit ratings currently do not always enable investors to make well-informed investment decisions as they are often based on limited data availability and subject to sovereign caps. Creating better methodologies and data availability for more accurate corporate credit ratings is critical to making financial markets respond appropriately to climate considerations. Key actors need to:

- **Avoid using sovereign caps for corporate ratings** and base risk assessments on domestic corporate intrinsic financials. These will give a more accurate reflection of corporate risk. When rating agencies avoid recourse to sovereign caps, financing terms for many corporates are likely to improve.
- **Make more and better quality data available to rating agencies.** For example, open MDB and DFI databases that contain credit default and loss data to help rating agencies base ratings on actual risks and improve corporate credit ratings that are unnecessarily low.
- **Increase collaboration between global and regional credit rating agencies** to leverage local expertise. Incorporating insights from regional credit rating agencies will make global risk ratings more accurate.

3.2.3 Create & adopt shared sustainable investing frameworks

Key actors:

Regulators

Private domestic investors

In the majority of EMDEs there is lack of consensus on the activities and investments that qualify as 'sustainable', which inhibits climate-positive growth and transition finance at scale. Creating and adopting sustainable finance frameworks collaboratively with the private sector will help domestic investors to standardise their approach to project evaluation. To implement, key actors need to:

- **Ramp up disclosure and standardisation** to enhance data quality and close data gaps. Establishing disclosure standards based on consistent metrics is a necessary first step towards building investor trust.
- **Develop standardised sustainable finance frameworks** to create alignment around what constitutes a climate-positive investment and what is transition finance. Regulators can build on existing frameworks to get such regulations fast off the ground.
- **Adopt and implement shared practices and voluntary standards,** developed by industry bodies, with input from financial institutions and local investors, and in alignment with national investment plans.

3.2.4 Remove regulatory barriers overly restricting the flow of institutional capital into real economy investments

Key actors: Regulators, Government

Domestic investors face limitations – often rooted in outdated policies – when it comes to investing in the asset classes and projects needed for climate-positive growth. Lifting these barriers will allow institutional investors to deploy their capital into the real economy at larger scale, naturally limited to the need for maintaining well-balanced portfolios. Key actors need to:

- **Review financial sector and investment laws,** including local pension fund and insurance company investment guidelines.
- **Remove any barriers** that unnecessarily impede institutional capital from being invested domestically while continuing to incentivise appropriately diversified investment.
- **Create mechanisms that support investment in the economy.** For example, governments and regional economic communities can create data sharing platforms to increase awareness of real economy investment opportunities among institutional investors.

Case Study

KEPFIC – pension fund association in Kenya

USAID's Kenya Investment Mechanism (KIM) and Spearhead Africa, in collaboration and initial support from MiDA Advisors formulated the Kenyan Pension Funds Investment Consortium (KEPFIC), a consortium of local institutional investors in Kenya.[51] Pension funds in Kenya have a growing appetite to invest in bankable and well-structured greenfield infrastructure projects. The consortium was set up to help them do so. It does this in four ways: by sourcing and screening appropriate deal pipeline, by conducting capacity building for trustees and fund managers using deal pipeline as case studies, by sharing of due diligence reports and lastly by supporting project sponsors on the use of capital market instruments as the preferred vehicle of pension investments.

The consortium's work was instrumental in the successful launch of the Lot 3 road development bond, one of the first vehicles for investing in infrastructure as an alternative asset class available in Kenya.[52] The bond was de-risked by a 100% secured guarantee from GuarantCo on the principal and interest and Stanbic Bank was the transaction advisor. The guarantee enables new investors to invest in the bond and begin to establish a track record for a new asset class, so it can attract more investors in future. The bond was oversubscribed by 157%. USAID's advocacy helped to shape new regulations on infrastructure investments in Kenya, paving way for more such transactions in the future.

Foreign funding agencies can provide valuable financial support for technical and legal assistance, facilitation and advocacy needed to get similar consortia off the ground and build demand for alternative assets.[53]

3.2.5 Introduce policies to expand formal domestic private savings, pension and insurance pools

Key actors:

Regulators Government

In many countries, the size of domestic capital pools is limited, putting a cap on the amount of capital available. Appropriate policies can both increase savings, pension and insurance assets under management and enable local financial markets to offer a broader range of financial products and instruments. Such policies should aim to support long-term financial planning and increase financial security, ultimately making the economy more resilient. Key actors need to:

- **Examine policy options for incentivising expansion of formal savings, insurance and pension pools.** Options to consider include creating government and sectoral pension schemes, introducing deposit insurance to reduce personal savings risk, and creating affordable insurance products. For example, Nigeria introduced mandatory pension schemes in 2004.[54]

- **Promote financial awareness and inclusion.** For instance, increase the share of the population with access to formal banking services through community outreach and by removing any unnecessary access barriers. See, for example, Fiji's national financial inclusion strategy, which incorporates inclusive green finance modules.[55]

- **Encourage digital saving, pension and insurance products to broaden access to safe financial services.** Many countries have seen steep growth in smartphone ownership[56] and mobile digital services. Making more digital financial services available will both expand formal financial markets and strengthen household resilience to climate shocks. For example, in Tanzania, only mobile money users were able to avoid a drop in their consumption following a record rainfall.[57]

3.3
SCALE LOCAL CURRENCY MECHANISMS

Rationale

Catalytic de-risking mechanisms in local currency hold significant potential to unlock domestic capital. Even where economic policies and regulatory frameworks support local investment in climate-aligned projects and firms, these may still struggle to mobilise private capital. This is mainly because of relatively high risks (both perceived and real) compared to returns, the lack of available early-stage capital, high transaction costs and small-scale projects that often fail the large minimum ticket size test for institutional investors.[58] A number of financial mechanisms are available that can tackle these problems and trigger higher inflows of domestic capital. These mechanisms commonly use public capital catalytically to mobilise private capital by lowering the risks of investing in specific opportunities. For example, they include green guarantees, early-stage equity and project aggregation platforms. The IEA estimates that USD 80-100 billion of catalytic finance a year will be needed by the early 2030s to unlock the full amount of private capital EMDEs are looking for to carry out their energy transition.[59]

Many viable business cases remain unfinanced because of high risks, both perceived and real compared to returns. Climate-aligned projects in EMDEs face higher capital costs relative to comparable projects in high income countries. And more difficulties in attracting early-stage capital. Large-scale infrastructure projects and other investments needed for climate-positive growth are frequently first-of-a-kind, and so by definition have unique and often unquantifiable risks.[60] Nevertheless, their risks could be overstated at times due to limited availability of relevant data, and the lack of local market expertise and familiarity with new asset classes, such as green infrastructure. Often high perceived risk of climate-aligned projects makes them non-investable for private players.[61] De-risking catalytic finance provided in local currency can help to overcome some of these barriers and unlock domestic capital, as demonstrated by facilities offered by InfraCo, InfraZamin and GuarantCo. However, most de-risking mechanisms are currently subscale and often in hard currency (dollars or euros).[62] When project or company revenues are in local currency, this creates exchange rate risk that often requires (expensive) hedging.

Affordable early-stage capital for projects and companies is scarce. Infrastructure investments typically feature large upfront investments before revenues start to flow. According to the Global Infrastructure Facility (GIF), preparation of infrastructure projects can take from three to eight years, with an average of six years, and the process can cost up to 10% of total project investment.[63] This makes infrastructure projects inherently risky and harder to finance in any location, but especially in EMDEs with relatively high political, regulatory and commercial risks. Very little of the risk-bearing capital and grant funding needed to prepare first-of-a kind projects is currently available. At present, de-risking mechanisms and project preparation finance can also be hard for projects and firms to access. Where available, such facilities generally target public capital providers rather than private investors. Both borrowers and lenders in the private sector tend to perceive MDB guarantees and other catalytic de-risking mechanisms as complex, highly variable across institutions, costly and time consuming to negotiate.[64]

Firms and projects are often relatively small, making it harder for large institutional investors to finance them. Small and medium enterprises form a significant share of all firms by number and contribute up to 40% of national income.[65] Among these, there are many innovators that are able to deliver first-of-a-kind projects, but the “ticket sizes” of investment they need are often so small, they are attractive given the transaction costs that institutional investors would incur by participating. This means many smaller projects with robust business cases stay below the radar of institutional investors.

Critical actions

3.3.1 Scale local currency de-risking mechanisms

Key actors: MDBs/ DFIs; Donor governments

De-risking mechanisms that target domestic investors with a tailored offering are not widely available. Scaling funding for local currency de-risking mechanisms can lower real and perceived risks for domestic investors and mobilise domestic capital at scale. Key actors need to:

- **Scale and replicate market-based, local currency guarantee mechanisms** and use them to enable private capital to come into these projects. InfraCredit's guarantee facility is an example of such a mechanisms. FSD Africa has recently extended a back-stop facility to support InfraCredit's local currency guarantees. This "guarantee on a guarantee" has enabled the Nigerian insurance industry to provide loan capital to small businesses in the renewable energy sector at an interest rate 8-9% lower than the banking sector can offer them. InfraCredit has mobilised $200m of domestic capital from pension funds to date.
- **Create local currency de-risking products** at existing facilities like MIGA and develop new products and new facilities. Engage domestic investors and local DFIs in their design to make sure they are relevant and all product options, existing and new, are properly evaluated. National DFIs have a track record of innovation in this area, for example, Indonesia's PT SMI's Energy Transition Mechanism.
- **Provide portfolio guarantees and re-insurance** for local currency de-risking products tied that are aligned with the priorities set in national investment and policy plans.

3.3.2 Scale local currency project preparation facilities

Key actors: MDBs/ DFIs; Donor governments; Private domestic investors

Early-stage firms and projects require significant investment at the early stages of development. Without risk-bearing capital in these stages, they are unable to grow and scale. Dedicating resources to create robust project preparation facilities in local currencies supports early-stage projects and businesses and contributes to a stronger pipeline of investment-ready opportunities. Such facilities should be paired with capacity-building on the investor side to ensure investment opportunities are evaluated appropriately. Key actors need to:

- **Build on project preparation expertise** in local and regional development institutions to strengthen the pipeline of investment-ready projects.
- **Scale and replicate market-based, local currency project preparation mechanisms**. Examples to replicate include InfraCo, PIDG's development arm, and Africa50, which can share the risks of early-stage project development and make equity investments in infrastructure projects.
- **Use existing grant funding procedures to strengthen domestic private financial markets,** for example, make the extent to which a project preparation grant will contribute to building private domestic markets one of the awarding criteria.
- **Earmark more funds for early-stage equity and deliver them in local currency** so domestic investors and local project developers avoid currency risk.

3.3.3 Lift barriers to catalytic climate finance mechanisms faced by domestic projects and investors

Key actors:
MDBs/ DFIs
Regional and international climate finance providers

High transaction costs including long lead times for de-risking and project preparation mechanisms often make them inaccessible for domestic investors and project developers. Simplifying procedures for accessing catalytic finance and making different de-risking and project preparation instruments consistent is key to scale their use domestically. This will require collaboration between local financial institutions regional and international development organisations. Key actors need to:

- **Simplify and streamline** application, deal approval, and claim payments processes to reduce transaction costs and lead times for investors and project developers.
- **Deploy catalytic finance through local facilities** where possible, for example through regional / national facilities set up and managed by or in cooperation with local DFIs.
- **Create "one-stop shops"** for project development services. See, for example, the Moroccan Agency for Sustainable Development (MASEN).

3.3.4 Create local and regional project aggregators to scale investment ticket sizes

Key actors:
Local financial institutions
Private domestic investors

Project aggregators bundle projects with relatively small investment ticket sizes into offers that cross the minimum investment threshold for institutional investors. For example, infrastructure investment trusts in India pool infrastructure projects in project aggregation platforms. Developers are able to sell a portion of their revenue-generating assets to institutional investors.[66] Collaboration on project aggregation between project developers, local financial institutions and private investors helps them to take a collective approach to investment in local and regional projects. Key actors need to:

- **Analyse the local and regional markets** to identify sectors with growth potential, investment opportunities, and areas where aggregation can bring synergies. This analysis should include domestic investors to understand, for instance, their specific expectations for risk-adjusted returns and regulatory restrictions they face.

- **Develop standard procedures and regulatory frameworks for aggregating projects** based on common metrics and KPIs. Adjust regulations and financial structures and instruments (e.g., investment funds, bonds) to facilitate project aggregation.
- **Integrate de-risking mechanisms and project preparation funding** (e.g., re-insurance mechanisms, portfolio guarantees) to aggregation platforms to ensure easier access to different types of capital that may be needed to achieve investable projects.

Case Study

InfraZamin in Pakistan

InfraZamin in Pakistan is an innovative for-profit credit enhancement facility funded by InfraCo Asia and Karandaaz Pakistan (equity capital). Its first-of-its-kind facility for infrastructure related debt instruments will issue credit guarantees based on its AAA rating from the Pakistan Credit Rating Agency (PACRA), the guarantee allows private investors to raise capital that they would otherwise be unable to invest in infrastructure sectors.[i] In this way InfraZamin acts as a catalyst for developing financial markets.

For its first transaction, InfraZamin provided a AAA rating to a loan facility provided by Habib Bank Limited to Multinet, Pakistan-based fiber optic and connectivity provider. The funds will help to extend fiber optic in tier 2 and tier 3 cities in Pakistan. The domestic markets respond quickly to the de-risking mechanism provided by InfraZamin. Additionally, it has provided a guarantee and interest cover to South Asia's first Gender Bond that will allow Kashf foundation to disburse 30,000 new micro-infrastructure loans for women.[ii]

04

LESSONS LEARNED

Projects that have succeeded in mobilising domestic capital offer lessons for growing and deepening local financial markets

Examples show that implementing the essential levers and key actions described in chapter 3 is doable. The experience of projects such as those developed by GuarantCo, FSD Africa, InfraZamin and many local/regional development banks and DFIs shows how strategic collaboration can overcome current barriers and mobilise the amounts and types of capital needed to get projects off the ground, within the confines of established economic policy and regulatory frameworks. Although some of these initiatives are still small in scale, they provide illuminating examples of what can be done. Other examples show how to drive new economic policy and financial market regulation. There is much to learn from these cases. This paper draws five general lessons from the examples studied.

1. **Economic policy reform has significant power to develop private markets in ways that unlock local private investment in projects that drive sustainable development.** The electricity generation and transmission grid sectors provide an example here. Legal reforms in Brazil, Chile and India introduced competitive auctions for the rights to finance and operate transmission lines. Allowing private investors to bid in the auctions significantly accelerated construction of new lines. For instance, in Chile, the share of renewables in power generation rose from 4% to 14% from 2015 to 2019 thanks to its introduction of transparently scheduled clean energy auctions and an effective net metering scheme.[67]

2. **Similarly, reform of financial regulation can unlock previously untapped sources of private capital.** Colombia's Fourth Generation Roads Concession Program (4G) is an example of this. The Colombian government designed a plan for infrastructure development to 2030 and then adjusted financial regulation so it accelerated implementation of the plan.[68] In 2014, Colombian regulators allowed pension funds to invest in a newly created category of domestic private equity funds focused on infrastructure projects.[69] This regulatory intervention has allowed pension funds to finance infrastructure debt used to build more than 7,000 km of toll roads. Colombia's strengthened enabling environment is expected to mobilise more than $14 billion to build its 4G network.[70] Introducing progressive financial regulation, such as transition finance frameworks, could also unlock new sources of domestic financing. For instance, AfDB has found that introducing a sustainable finance regulatory framework in South Africa, coupled with local capacity building, has boosted demand for climate-oriented financial instruments.

3. **Strong collaboration between investors, project developers, regulators and other actors on first-of-a-kind projects is key to getting them off the ground.** Intensive collaboration is needed. The actors most involved are typically financial institutions, project developers and guarantee providers. Collaboration within institutions is critical. For instance, pension funds need to have conversations with the trustees representing those whose pension savings will be invested. Such conversations are crucial to building trust and making well-informed investment decisions. Joint problem-solving by project actors can overcome financing barriers. For example, in Kenya, more than 20 pension funds have formed a consortium (KEPFIC) to invest in infrastructure. They are pooling their capacity to spot and overcome barriers. Similar collaboration across country financial systems is needed to progress the development and adoption of responsible and sustainable investment frameworks.

4. **Guarantees and other de-risking and blended finance mechanisms can be effective in mobilising domestic institutional capital.** The experience of guarantee providers like InfraCredit in Nigeria and GuarantCo shows that appropriate guarantees can get projects off the ground. Such catalytic mechanisms are a powerful means of directing more institutional domestic capital into real economy investments. They address the rising cost of capital as well as perceived risks. Credit guarantees are particularly useful for mitigating some of the risks inherent in first-of a-kind projects. Over time, as experience with new technologies grows and transaction records become more widely available, the need for guarantees often decreases and can be eliminated completely. Acorn, an affordable student housing project, is one example. The early phase was backed by a guarantee from GuarantCo and support from FSD Africa. Starting small to show proof of concept was critical. Another GuarantCo instrument allowed Kenyan pension funds to buy bonds issued to finance new road construction in Kenya.

5. **Technical assistance and capacity-building are key to building local expertise in sustainable investing.** Many institutional investors have limited experience with investing in the real economy, including infrastructure projects. First-of-a-kind transactions typically need technical financial and sector assistance as well as different types of catalytic capital. Developing local investors' expertise and capacity to participate in such transactions is crucial to unlocking the institutional capital they need. For example, capacity building provided by MiDa advisors, Crossboundary, and USAID led to a bond issue for road development in Kenya being 150% oversubscribed. Capacity-building includes extending awareness of successes, like those cited here, and encouraging continued dialogue and collaboration among pension funds and other institutional investors on how to deploy more capital in local climate-aligned businesses and innovation.

Lessons from these case studies provide useful guidance for the way forward and design of national investment plans, economic policy and regulation, financial regulation and catalytic use of public capital to capture opportunities for climate-positive growth.

05
NEXT STEP

This consultation paper makes the case for creating national action agendas that mobilise and grow domestic capital for climate-positive growth. It estimates that implementing these national action agendas could allow domestic capital to contribute up to half of the $3 trillion-a-year gap that EMDEs currently face for climate action and the SDGs.

Three levers will be instrumental in delivering these national action agendas. This consultation paper calls on governments, market regulators investors, as well as global and regional MDBs, MFIs, credit-rating agencies and donor governments to collaborate on three essential levers:

1. **Grow domestic assets by designing and implementing** national and sectoral economic investment plans and supporting economic policy that drive climate-positive growth. Drawing on close public/private collaboration in each country, this lever will help identify, prioritise and support the right investment opportunities to drive the climate-positive growth.

2. **Update financial regulations** to grow financial markets and enable and incentivise rather than hinder the flow of domestic capital into projects and firms that contribute to climate-positive growth.

3. **Scale local currency mechanisms** that use public capital catalytically to mobilise domestic capital by de-risking investments (e.g. guarantees, project aggregation platforms) and building the project pipeline. Coordinated action between public and private capital providers is pivotal to building pipelines of investable projects in line with national investment plans, providing effective de-risking, aggregating small projects and together mobilising domestic capital.

Pursuing this action agenda could create positive tipping points for long-lasting economic growth. Mobilising domestic capital for climate action holds significant potential to boost economic growth. In turn, climate-positive growth will increase the pool of domestic capital. Bigger pools of domestic capital and deeper local financial markets will not only help finance the shift to climate-positive trajectories they will also stabilise the local investment ecosystem in a way that supports long-lasting growth and job creation, reduces countries' reliance on international public capital, drives more efficient capital allocation across the economy and makes financial markets less susceptible to global macro-economic shocks. Eventually, a steadily increasing flow of local private capital into successful local projects will signal the lower risk profile of these investments, attracting international investors into similar future projects.

Implementing the action agenda requires a collaborative approach among governments, regulators, private investors, and global and regional MDBs and DFIs. Strong public-private partnerships will help build impactful action plans, including investment plans for climate-positive growth with supporting economic policy and regulation. Further, coordinated action between global, regional MDBs and DFIs in service of national investment plans, and local currency catalytic solutions to build project pipeline and reduce cost of capital can be pivotal to support progress. Together, these actions can help drive a significant scale-up of domestic capital for climate-positive growth and sustainable development.

The time to pursue this agenda is now. The widespread recognition of the imperative for climate action, coupled with growing investment opportunities, creates powerful momentum for co-ordinated action to successfully strengthen financial markets. Implementing this action agenda over the next 24 months could help capture significant opportunities for long-lasting climate-positive growth that creates jobs and help deliver the sustainable development goals.

We encourage input, case studies and suggestions to strengthen and progress this action agenda. Please reach out to contact@blendedfinance.earth with any questions and thoughts.

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