Blended Finance for Climate Adaptation: Implications for Supervisors

Opening Remarks:

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Panelists:

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Babak Abbaszadeh:

Welcome everyone to Toronto Centre's webinar that we are organizing in partnership with our partner Convergence on "Blended Finance for Climate Adaptation: Implications for Supervisors". I am Babak Abbaszadeh, President and CEO, Toronto Centre. I'm happy to report that we have almost 600 registrants from 75 countries, and a really diverse group of countries. For example, Algeria, Angola, Aruba, Austria representing letter, A and Zambia and Zimbabwe - Z, I feel like it's Sesame Street, and many countries representing other letters of the alphabet in between. Since Toronto Centre's establishment 25 years ago, we have trained more than 23,000 central bankers and other financial supervisors from 190 countries and territories to become change agents for building more stable and inclusive financial systems. Our mission is sponsored by Global Affairs Canada, the Swedish SIDA, the IMF, and other very valued international partners.

Today we face multiple global headwinds, economic uncertainties, geopolitical upheavals, two major wars, and increasing climate risks, and climate risks translate into financial risks. As global leaders prepare for COP28, recent projections and scenario planning clearly point to an urgent need to significantly leverage public finance for private finance to support climate change mitigation and adaptation in emerging and developing countries. This is where blended finance comes in. We are delighted to be joining forces with Convergence today to hear about blended finance transactions and financial investments into agriculture, a critical component of climate adaptation and food security. Just a quick shout out to our friends and partner Convergence; I have known about them even before the word "convergence" was created as the concept for blended finance and Canada's support was being brute, and we've become very good friends with them. Joan Larrea is a great partner of us, and we look forward to working with them more closely going forward.

To help us better understand blended finance transactions and explore supervisory roles in the enabling environment, we have assembled a great panel to share their insights. You have already received their bios, so I won't read them. They are Dr. Nnamdi Igbokwe, Director, Knowledge and Thought Leadership, Convergence Blended Finance, based in Toronto, although I understand he's in New York. Laura Santa, Sustainable Finance Group Leader, Financial Superintendency of Colombia (SFC), an organization that we have had more than 10 years of intense relationship with. Andrew Ahiaku, Director and Head of Financial Sector, Aceli Africa, a market facilitator that works in African countries to unlock agricultural finance for SMEs. Alan Elizondo, General Director, Fideicomisos Instituidos en Relación con la Agricultura (FIRA) Bank in Mexico. FIRA is a unique bank structure to extend de-risk finance to the agricultural sector in Mexico through blended finance. Welcome to you all to this panel. The panel will be moderated by my colleague Demet Çanakçi, Senior Program Director, Toronto Centre. I think at this point I'm going to hand it to you. Take it away. Thank you.

Demet Çanakçı:

Thank you very much Babak for setting the stage for us. Hello everyone. I'm Demet Çanakçi, Senior Program Director, Toronto Centre. Welcome to our discussion on "Blended Finance for Climate Adaptation: Implications for Supervisors". Let me start by thanking Convergence for collaborating with Toronto Centre on this webinar. It's an absolute pleasure to be here; welcome to all of you joining us online. I also would like to welcome our all-star panel here.

As Babak highlighted in his speech recently, we have been hearing even more from the NGFS and the IMF as well as other international organizations that collective action by private and public capital is needed to bridge the climate finance gap. I'm looking forward to hearing our panel's view on this. We'll have two rounds; I will pose two questions alternating between each speaker and then I will take questions from the audience. In the first round, we will focus on what blended finance is and how it works, how it could be used for closing the climate finance gap, and the supervisory implications. In the second round, we will hear from our panelists about their lessons learned and future prospects. Please use the Q&A to submit your questions during this session. Let's begin.

Okay, so Nnamdi, let me start with you. Convergence is a global network for blended finance and serves as a focal resource for blended finance transactions globally. Can you briefly tell us how does blended finance help to attract investments into climate related projects? More importantly, why does this matter to emerging markets and developing economies? Perhaps you can also give us some examples on specific instruments or mechanisms commonly used in blended finance for climate projects. Thank you.

Dr. Nnamdi Igbokwe:

Sure. Thank you, Demet, thank you Babak and a special thank you to the Toronto Centre as well. We're very happy to co-host this event. So, good morning and afternoon to all. I'm Dr. Nnamdi Igbokwe, Director, Knowledge and Thought Leadership, Convergence Blended Finance. Very quickly, a word about Convergence. We do three things primarily: number one, provide data and intelligence to build the evidence base for blended finance. Secondly, we offer a membership network with a live deal platform to facilitate deal flow. And finally, we have a design funding arm for market acceleration. So, fundamentally at Convergence, we're focused on the reality of de-risking to create assets that meet the fiduciary requirements of the private sector to enable them to invest. So, when we at Convergence talk about blended finance, we're referring to any kind of use of catalytic capital, and this can be from philanthropic institution or development agency, to increase private sector investment in sustainable development and climate in developing economies.

So, a blended finance transaction should have three signature markings. Number one, it should have a positive financial return in line with the market. Number two, it should contribute towards SDGs in a developing country through impact. And number three, it should have leverage, meaning the public and philanthropic parties leverage catalytic capital to make a deal happen that would not otherwise attract private capital. So conceptually, the role of blended finance has always been to solve large scale global problems. Perhaps the biggest one facing us all is climate. The annual SDG and climate investment needs in lower-income and middle-income countries are estimated at nearly $5 trillion. So, we have now around a $3.5 trillion dollar gap. That's the not-so-great news. The good news is that there's now, much more than ever, a huge appetite from the private sector to invest alongside the public sector on net-zero in green initiatives.

So, whether it's reliable clean energy, reforestation projects, or water infrastructure, when these seemingly disparate forms of capital come together, when it's done right, when it's win-win, when charitable concessional money is combined with commercial money that's called blended finance. So, in principle, through de-risking, blended finance is bending the economics disproportionately towards a party that needs to make a commercial return while also allowing the other party to achieve impact. So, we're bending that arc to bring in the private sector into areas that are deemed too risky, and without this modulation of risk, there's minimal participation that should be expected from the private sector. So, in theory, we always hear about the abundance of capital, this quantum of capital that sits within the private sector that's ready to be mobilized for climate transitions and projects.

But from the private sector perspective, there really is no natural investment thesis to enter developing economies in emerging markets. Why is that? Well, the risk return profile just doesn't add up, right? The perception of country risk and political risk is often far greater than is actually the case. But real or perceived there is just an inherent aversion to these markets. We also think about the macroeconomic climate that we're in currently. High inflation rates, high interest rates, debt burdens, all of these make it even more challenging for the investment climate in many emerging markets and it reveals a harsh truth; without enhanced risk sharing and greater public sector willingness to shoulder potential losses, substantial private capital flows into these emerging regions will not be realized. So, we really have to catalyze, or we have to apply catalytic capital and the structuring mechanisms of blended finance in a way to mobilize the private sector.

So, if we think about why blended finance for climate and how, the why, as I've just explained that private investment is a necessary condition at this point to meet our funding targets. Emerging markets and developing economies have substantial climate vulnerabilities, yet often struggle to really attract sufficient commercial climate financing due to the risk profiles. And again, the macroeconomic shocks currently has really redirected cross border capital and increased the risk profile of these developing countries that already found it difficult to attract private investors. 88% of emerging markets are non-investment grade, which really precludes a lot of investment activity, at least on the debt side. And 85% of blended finance transactions occurred in countries with non-investment grade sovereign risk ratings. This is important because most private institutional investors have investment policies directly tied to favoring investment grade jurisdictions. So, there's a mismatch here that prevents capital inflows into climate initiatives. So that's where blended finance would come in in part. If we think about adaptation specifically, it becomes even more necessary as its greater investor risk perceptions are associated with adaptation and has a less proven business case.

Quickly, we'll talk about the how for blended finance through the archetypes and the vehicles, four primary archetypes that are used in climate blended finance. Number one, concessional capital. This is used 77% of the time. This is a layer of protection in the capital stack where a donor of public funds occupies the first loss position to reduce the cost of capital for private investors. Second, you have guarantees used as credit enhancement mechanisms to cover risks like political risk or other currency volatilities. You have technical assistance which supplements capacity and covers transaction costs. This is actually seen in 40% of adaptation deals that feature technical assistance, and finally we have design funding grants for market acceleration. And then, we think about the vehicles and how these mechanisms are deployed. Project transactions really lead in terms of climate. Blended finance, 40% of climate blended finance deals utilize projects. You also have funds, companies, and facilities, but if we're really thinking about the scale and really thinking about meeting these targets, the portfolio level projects, and aggregation of portfolio funds is really where we're spending most of our time in terms of getting these pools of projects together to apply blended finance solutions. So that's a broad framework for the understanding of what blended finance is, why it's important for climate investment in emerging markets and developing economies, and how it's applied.

Demet Çanakçı:

Thank you very much, Nnamdi. You put it in excellent context, especially in this global environment. We have so many challenges, it'll be really hard for emerging market economies to attract investments, from the private sector in particular, to reach the climate targets. So, thank you for putting it in a very good context for us.

Let me move to Alan. Alan, welcome, and can you briefly introduce FIRA to our audience and provide an overview of FIRA's blended finance business model and how it operates to support sustainable rural development?

Alan Elizondo:

Hello everybody. Thank you, Demet, for the introduction and let me introduce FIRA. FIRA is an institution that is turning 70 years old next year. We are a second-tier development bank, in the form of a trust, and we are managed by the Central Bank of Mexico, but the capital of FIRA is provided by the Ministry of Finance. FIRA provides three instruments: technological support for small holders, we also provide funding to a network of intermediaries, and guarantees. We are focused on agricultural and rural activities with three main objectives: the first one is to enhance financial inclusion in our country to boost productivity and also to remain sustainable, not only socially but with the weather. So, the activities are focused on climate sustainable technologies. We also participate in 60% of all the loans provided through the agricultural sector in Mexico. One of our instruments is involved in 60% of the cases.

We started with soft funding from the central bank in 1954, and when the central bank became autonomous in 1994, we started funding our operations in the financial markets with our own capital and in alliance with international financial organizations like foreign banks, such as the IDB, the World Bank or the Agence Française in France. Well, the way we do blended finance basically by using concessional capital the same as the Convergence center, we also provide the guarantees. Guarantees are helpful not only for our intermediaries to go further into more risky projects, but we also provide guarantees for them to get funds in the markets. So, with a guarantee from FIRA, they can turn their debt into AAA and get funding from the markets. We also structure transactions such as securitizations of loans, so these loans are structured in small trusts, and debt is issued to the markets, and we guarantee these loans. Finally, we also provide direct funding to financial intermediaries, which is very needed with the small non-bank financial intermediaries in our country, which are the ones that are more specialized in providing funding to small holders. Thank you, Demet.

Demet Çanakçı:

Thank you very much for this, that was great. Mexico is one of the countries with a lot of work in this climate-related area, and we have been working with Bank of Mexico as well, and they also have this, climate finance and biodiversity-loss related. A lot of work going on, and good to hear from you on this as well, thank you. We will come to you in the second round for more. Andrew, let me pose the question to you. So, Aceli Africa acts as a market facilitator bridging the finance gap and unlocking the growth and impact potential of agricultural SMEs in Africa. Can you tell us briefly about your work and what has been achieved so far?

Andrew Ahiaku:

Thank you Demet, and my colleagues who have spoken so far. Aceli is a market incentive, or if you like, a blended finance facility that supports partner financial institutions to bridge the gap between capital and capital supply and demand. So, we provide or support financial institutions to increase lending to high impact Agri-SMEs in Africa. Currently we cover Kenya, Rwanda, Tanzania, Uganda, and now Zambia. Aceli arose because at a point the network of small-scale agricultural finance organizations realized that they were not making money generally because of the risks they face lending to AGRI-SMEs.

So, thank you to USAID: they provide some initial capital for the research, in which research revealed that for the first time an institution was able to put the number to risk, and the research revealed that lending to AGRI-SMEs was twice riskier than any other segment in the chosen market that we did the research in; that was East Africa. And this risk is determined by the level of MPL (Maximum Probable Loss).

So, if you took for example agriculture, if the MPL was four, then the MPL for other sectors was two, and that is how we determined how much to lend them. The research also revealed that the returns to AGRI were 45% lower than expected, which sort of builds or defeats the financial logic. Usually the higher the risk, the higher the return. Unfortunately, in this case, although the risk was high, the returns were lower. As a result of this, we designed Aceli to respond to these challenges. So, in order to reduce the risks they face, we provided, with the support of Convergence at the design stage, a first loss cover which, Nnamdi spoke about. Then to support partner financial institutions improve their profitability, as designed originally for the SMEs in the rural areas, we also introduced the Origination Incentive which supported to defray the cost of originating loans to addresses.

So Aceli is made up of a financial incentive, technical assistance, all this underpinned by data and lending, and that is how Acelia has operated thus far. Some of the early successes so far include working with 38 plus lenders, which cover banks, non-bank financial institutions, and social lenders. In addition to that, we have assets; last week, we mobilized about 44 million, and our leverage ratio currently is appendix, which we think is doing well. Aside from that, 60% of the SMEs that borrow through our lenders are new borrowers, and 27% of the SMEs that come back for repeat or returning loans have seen an increase in their revenue. So, we think there are early signs of growth. Among our personal financial institutions, we're beginning to see a drop in interest rates. Some of the lenders have diversified into other segments, whereas others have also reduced their collateral requirements. So, as Nnamdi said, blended finance can be used as a vehicle to catalyze or bring about catalytic change within an environment. We think this is good for a social sector like agriculture and that is how far Aceli has progressed. Thank you.

Demet Çanakçı:

Thank you very much for letting us know about Aceli Africa's important work on SMEs in Africa. Now I would like to move to Laura. Laura, welcome, you bring a supervisory perspective to the panel. So, tell us why supervisors should care about blended finance and what potential risks blended finance transactions pose to the financial system? Thank you.

Laura Santa:

Thank you Demet, and good morning and good afternoon to everyone. Thanks to Convergence and to Toronto Centre for this invitation. I would like to start with something that already Dr. Nnamdi pointed out and is the environmental, the financing of environmental, because the pandemic has exacerbated preexisting socioeconomic issues in Latin American, the Caribbean, and other emerging and developing countries. Currency volatility has often avoided consistent investment in climate initiative in these kinds of countries, which is actually accentuated by the high-interest environments we're in, contributing to even greater currency risks. High inflation is another issue, and the ongoing global monetary policy tightening has exacerbated structural difficulties for climate financing. The deterioration in the global economic outlook this year is also exacerbating already elevated debt distress in many countries, constraining their ability to implement climate policy reforms.

Given this current limited fiscal policy space, and the high debt levels in many emerging and developing countries after the pandemic, private capital is becoming vital to finance climate adaptation and mitigation efforts.

With this context, blended finance already comes into the picture, because it has an important role in demonstrating investability in emerging and developing economies, and because it can enhance the risk reform profile of climate adaptation and mitigation projects. So, blended finance becomes a tool that solves market failures as it can price externalities such as biodiversity and resilience. Considering all these and the developmental mandate that many supervisors have, it is important for us to engage with blended finance because it can help to address some gaps in their economies. But it's also important for us to raise awareness of its risk because it is expected that financial entities may become more involved in these kinds of structures, but they come with some risks that need to be understood.

Blended finance is often time and effort intensive, and it requires more complex treatment by investors within their governance and investment processes. So, it is important to understand the risk entering in these projects to be financed and how effectively this risk will be mitigated by the various enhancement provided by other parties because in the learning process and while these learning processes are taking place, higher risk and potentially weaker risk management are going to be seen in the supervised entities. This is why credit risk and operational risk may be exacerbated considering this complexity I just talked about, and it may lead to ineffective mitigation. So, also considering the short fiscal space, regulators and investors should also address potential risk associated with an increase in external financing considering the interest in this kind of investment that is going to come from abroad. Considering that most of the financing or even this concessional financing will come from abroad, as I just said. So, currency risks are also one of the most relevant risks to be cautious of as well as political or regulatory uncertainties that may appear in these kinds of countries.

But commercial risk is also to be considered because the projects to be financed may not be profitable or commercially viable and as Dr. Nnamdi said, it has to have a return for all parties because it's not going to change the mandate of the parties or the actors that are going to be involved. So, currency risk may be exacerbated by this risk as well. And finally, investment mandates, low risk ratings, and liquidity are all additional barriers to investment in emerging and developing countries. So, many investors do not have the mandate to invest in transactions that are below investment rates and are too risky. This is why supervisor has also a role in order to clarify the spaces where blended finance can be developed and it's important to know that risks are also harder to measure and more accurate in developing countries. So, this is something that has to be addressed by supervisors.

Demet Çanakçı:

Thank you very much, Laura, for identifying all those inherent risks in any blended finance related transactions. Before moving to the second round, I would like to take this question because it's quite relevant to what you just said. Thank you, Lynn, for asking the question. I would like to ask this to you, Laura, and then maybe Nnamdi can also chime in. It's up to the other panelists.

"There is increasing concern about greenwashing in the financial community with the rise in regulatory responses and litigation. Is blended finance equally at risk from greenwashing or does it have any additional protection mechanisms?"

Laura Santa:

Thank you. As you know the kind of financing structures, it is important to mitigate greenwashing risk. So, for blended finance it's also recommended for supervisors to enhance the standardization of the information provided.

This is going to be also helpful in order to adequately price the risk and in order also to understand that this kind of financing can be investible in emerging and developing countries with this kind of a structure that are going to share the risks that are involved. So yeah, information is really important to bring transparency to all the actors in order to where the impact is going and in order to make really effective to make effective these flows and not going maybe for something that is not going to effectively impact the SDG goals that we have.

Demet Çanakçı:

Thank you. Laura. Nnamdi, would you like to add anything to this?

Dr. Nnamdi Igbokwe:

Yeah, sure. I'll just add that we have to remember the blended finance is a structuring tool and it's not an approach on its own merit, right? So, it's very important when we think about distorting markets and things like greenwashing, it's very important to remember that blended finance should not be applied wholesale in terms of "let's look at problems in applied blended finance." It should be you start with what you're trying to solve for, whether it's climate, whether it's adaptation, whether it's mitigation, whether it's something specific. And then you see if blended finance is an apt tool that will help crowd in the private sector into transactions that otherwise would not be financeable without that additionality. So, it's always important to remember not to think of blended finance as just this overbearing, this broad umbrella, or this silver bullet that just applies to everything. It should be used tactfully and tactically and applied where necessary.

Demet Çanakçı:

Thank you very much Nnamdi. Now as you can see this is going to be a really fascinating panel as we go forward. Those are excellent and interesting questions and answers and couldn't have been more diverse. Let me move to the second round. So Nnamdi, I'll start with you again, the same structure. From your vantage point, what are some of the key barriers to blended finance for climate solutions and what would you recommend going forward?

Dr. Nnamdi Igbokwe:

Yeah, thank you. There's several key barriers that hinder blended finance for climate solutions, particularly with adaptation. I'll quickly go through a few and give some recommendations at a high level. Number one is the insufficient pool of concessional capital. Convergence estimates that $500 billion in concessional capital will be required through 2035 for clean energy alone. But concessional capital flow, whether it's from donors or philanthropic capital, has really stagnated since 2017. So, this is constrained de-risking capacities to crowd in the private sector, recommendation would be for donors, foundations, MDBs, and those that are deploying concessional capital to increase the flexibility to be more patient with the capital. And really MDBs and DFIs who typically are the largest concessional providers, need to exit senior positions and occupy more subordinate or mezzanine positions in the capital stack to really increase the mobilization effects for the private sector.

Additionally, we have to prioritize facilities over projects. Many institutional investors feel that public grants and grant equivalent financing have been too targeted on funding for individual projects rather than being used to mitigate risks more broadly to crowd in the private sector. So, keeping those two things in mind with the use of concessional capital would be very vital.
Another impediment is we've been talking about the macroeconomic landscape; it has heightened risk perceptions in emerging markets, it's triggering capital flight back to stable jurisdictions. So, we have blended structures for local currency financing and currency hedging to reduce FX volatility. We have credit guarantees and insurance to protect against interest rates or political risk, but these concessional instruments do have limitations. So, we really have to widen the enabling environment and support sustained private sector participation and think about some of these non-financial risks where government should foster policies to create more certainty, streamline regulations where possible and really provide incentives that denote climate financing commitments to build local capacity.

So, it's not only on the financial side there are non-financial risks that should be attended to, and part of the mix when we're thinking about de-risking another impediment is this commercial perception, right? Investors still think that climate investments are excessively risky in these regions, especially when you think about adaptation with unproven revenue models, limited track records, and long durations. So again, I'll go back to the point I made earlier. Institutional investor risk appetites are directly tied to credit ratings. So, blended structures should maximize credit enhancements like using guarantees to achieve investment grade ratings where suitable. Where not suitable, we really should leverage and prioritize the use of grant funding for TA to build local capacity or for design funding to really demonstrate viability and proof of concept in maybe more nascent areas and sectors.

Another impediment is scale. So, it's related, all of these are really related, but the median size of a climate blended finance transaction is about $30 million. This is relatively small for the institutional investor. They really need larger ticket sizes to justify some of the costs and the diligencing that goes through with trying to participate in some of these transactions. So again, aggregating projects into funds where possible would be a great recommendation to sort of meet that challenge. Then the last one, I would say, is the taxonomy around adaptation. There's a lack of a clear taxonomy and metrics to evaluate adaptation finance and this really poses valuation challenges. So, a few things can be done here. First, standardized disclosure methodologies to reduce some of this ambiguity really allow for climate aligned investments from asset owners and from asset managers to be more harmonized. Our data at Convergence shows that one third of total climate financing is invested in hybrid solutions, right, the mix between mitigation and adaptation. So, if the broader climate finance community begins to effectively outline a taxonomy for adaptation, concessional players could pay for benefits that may not be immediately monetizable.

Also expanding this taxonomy can direct investors to solutions that are currently beyond their radar. So, if a company's helping to manage drought disease or supply chain disruptions and other climate impacts may not often be referred to as recognized as climate related, but expanding a taxonomy in this way addresses some of the risks and gaps associated with structuring and also increases the pool of climate solutions that are bankable. And then lastly, I'll just say that MDBs could also to this disclosure process to generate more data through more transparency to support measuring benefits to help scale climate blended finance. So, those are just a few areas and impediments for scaling and increasing climate blended finance solutions and a few recommendations to go along with them.

Demet Çanakçı:

That's great. Thank you very much Nnamdi. Thanks for identifying all those key important barriers and your views on what could be done to address those. That was very helpful. Let's move to the next speaker. Alan, can you tell us about the key lessons or good practices FIRA has learned from its experience with blended finance in the context of agriculture and rural development?

Alan Elizondo:

Thank you Demet. Let me start with one key lesson we have learned with time: it is important for blended finance, and particularly if you're to finance with a good environmental conscience, to be in the form of a second-tier institution. If we were not, if we were just a first-tier institution, it would be difficult for us to compete with other institutions to finance because it is typical that you have one methodology for credit risk, but then you have an additional methodology for an environmental risk. So, if you are the one that introduced this methodology in a first-year fashion, then this becomes a negative competitive tool in the sense that you take more time to originate loans. However, if you are a second-tier institution and you represent 60% of the funding of the sector, then it is easier and it becomes more relevant. We have introduced methodologies to finance agriculture, which are good for the environment, mitigate risks, and we apply them to a network of 130 intermediaries. So, this has become a standard and this standard is used by these 130 institutions on the proportion from what we represent from their funding. So, this is an important key lesson that we have learned through time.

The second one is very similar to what we have heard. It's important for the prices of our products to be at market prices. We cannot subsidize; if we are to subsidize, we have to make things explicit. So, not introducing price distortions is something that has provided sustainability to our model, financial sustainability, and lets things place exactly where they should be. Well, one important lesson, also, is to, notwithstanding we are a second-tier institution, it is very important for us to have a presence all over the country to structure the projects to help small holders to structure good projects to sell their products in the market, and we also transfer technology. For example, good technologies for the environment or certifications our institution provides to small holders. And this makes a difference for them to produce in an environmentally friendly methodology, and then they can sell their products, with an advantage, to the export companies that work in our country.

And finally, another lesson that we have learned is to work not only with banks, banks have a good presence in the agricultural sector, but we have to be knowledgeable of the reality of our country. The rural areas are served more by other types of intermediaries, non-bank financial intermediaries that are the smaller and more specialized. It's very important for us to work with them not only because they will reach further into financing the smallholders but also because you will have more impact in the way they do these things. These will be the four most important lessons we have learned through time. Thank you, Demet.

Demet Çanakçı:

Thank you Alan for sharing these lessons learned; it's very useful to others to benefit from it, and you also mentioned how you use this information in your work. Thanks for that, and Andrew, you have recently issued a learning report on the effect of central bank policies on lending to agricultural SMEs in East Africa. How do central bank policies impact the accessibility of financing for agricultural SMEs in the region? Can you share your experiences with us? Thank you.

Andrew Ahiaku:

Thank you, Demet. Of all the challenges that we normally mention that are involved in lending to AGRI-SMEs or SMEs in general, in Africa or emerging markets, we usually don't look at the policy angle nor do we check the regulatory environment to see whether they support or do not support lending to AGRI-SMEs. And so, in 2021, Aceli kept hearing from our partner financial institutions that they would've done more but they think there are some challenges with the "big brother" who looks after them. So, we went into the market, did some surveys, did some research, and came out with five major findings that we thought impact lending to AGRI-SMEs in Africa. These include the IFRS 9 which replaced IAS 38, the capital adequacy ratio regimes of central banks in East Africa banks, loan classification and provisioning, SME collateral requirements, and the treatment of guarantees. Of these five findings, two of them are influenced by the Basel III commission or they come from the Bank for International Settlements.

And so, although they're challenging to East Africa, we think that those might require a lot more discussions and advocacy to bring about it. For example, IFRS 9 has a formula called expected credit loss. All of a sudden, losses which used to be accounted for when they occurred, now have to be forecasted. So, now lenders are called upon to become focus based, to be able forecast into the future to determine whether a sector will take a loss, or an SME will take a loss or not. And mostly, this is driven by the risk of the sector, the probability of default, and what would happen if the loss occurred. The overall effect of this is that if a sector is risky, a lender will not want to touch it because the more you touch it, the more money you have to set aside to meet the expectations of IFRS-9. Our view is, IFRS-9 is great, but as we found out it has had unintended consequences.

For example, it's gradually pushing lenders away from impactful sectors which carry more risks. We have blended finances, we have other tools that can de-risk the sector, and so we think expected credit loss as designed is not helping. We think sectors that have development impact should be considered rather than looking at the risk alone. On the capital adequacy ratio, although Basel III sets some criteria, our colleagues in East Africa show the high end. So, whereas globally banks are supposed to set aside 6-8% of their capital as capital adequacy ratio, in some of our markets, they set aside up to 15%. Now when that happens, what it means is that it is taking our own money that is otherwise used for lending, and being set aside as capital adequacy ratio, and we think this needs to be looked at, but as I mentioned earlier, the IFRS-9 capital adequacy ratio takes a regional amount we will need more to make a difference.

However, the last three, low classification and provision, SMEs collateral requirement, and the treatment of guarantees we think are within the reach of the various local central banks and they can make changes in them. And I want to take a glance at two of these. Let's look at low classification and provision; the challenge with that is, according to the World Bank and the African Development Bank, agriculture is a special area and therefore requires special regulatory and provisioning requirements. Our view is we shouldn't treat agriculture like any other sector, run the program as though it was commenced. No; if you go to India, if you go to Pakistan, they have a set of rules dedicated towards agriculture. We think that local central banks, the various countries, especially emerging markets including Africa, can take a cue from that.

Let's use one practical example. One guideline from the IFRS world is when you do a loan, and the loan is nonperforming, it moves from one bucket to the other. That loan must meet repayment four times before you can move it back to the previous bucket.

So, let's look at agriculture, assuming you supported a mutual fund, or a fund that an annual problem, even if the business is doing well, you have to wait for four cycles, four years, and be providing accepting aside capital for the four years before you can bring it back. We think this is inimical to lending to AGRI-SMEs. Let me quickly look at the way, through the central bank's own doing, lenders in our part of the world do not use guarantees as intended. Guarantees were designed as credit enhancement tools. They were supposed to support lenders to move into high-risk areas, move into segments that are uncharted and when they become efficient then the guarantees can be and then they'll continue to the sector. However, because the central bank discounts guarantees and does not treat them as risk-mitigating instruments, the bank also tends to treat guarantees as collateral replacements. In fact, in my days in banking, we'll only think of guarantees for a client when the client doesn't have sufficient collateral. So, instead of guarantees supporting us to take on more risk, it's not, and we think that the central bank, especially for the A-rated sponsors of guarantees they must keep them at a sub-zero rating or treat them as near cash-positives so as to support lenders in East Africa or Africa for that matter to use guarantee in the right sense that there is. Thank you very much.

Demet Çanakçı:

Thank you very much Andrew for sharing your challenges and how these central bank policies impact the accessibility of financing SMEs in particular in your region and you always have a very important mission to accomplish. And now Laura, you have the last say; in your opinion what regulatory and supervisor frameworks or policies can be put in place to ensure that blended finance initiatives align with financial stability and supervisor objectives? Thank you.

Laura Santa:

Well thank you. Let me say that safety and soundness of the financial system is still the main objective of most supervisors. But, depending on specific mandates and conscious circumstances, policymakers can help also to promote blended finance, for example, engaging with donors to understand and facilitate access to existing instruments. But a supervisor's suspected role is to have the right climate policies in place, such as carbon pricing, and to strengthen the climate information architecture, which is going to be key in order to understand the stability of these options but also to understand the risks. This includes high quality, comparable, and reliable climate data, appropriate pathways to adopt disclosure standards, and establishment of classification system and transition taxonomy, just as Dr. Nnamdi mentioned. It is also important to have robust governance and transparency standards in place because of the complexity of these structures. The governance process and the investment process has to be more robust, and policy makers have a role also in order to clarify where blended finance is needed, as I mentioned earlier, in order to allocate adequately so the flows in the goals that are needed are locally prioritized, and this is the right amount of concessional funding necessary to finance and finalize a project, thinking that this concessional financing is not going to be permanent. It must not be permanent; it is going to help to mature this system but it's not going to be permanent.

It is also recommended to promote greater standardization to help reduce the information asymmetries that may be between investors and project developers, leading to more efficient allocation of capital and a better risk assessment for investors. Additionally, supervisors and policymakers should promote effective risk mitigation and support innovative blended finance solutions to encourage risk diversification, understanding the risk, and understanding if these guarantees or these mitigation aspects are going to be enough for the risk that is raised. This diversification can attract different sources of private capital with different risk for files and investment type horizon, which is going to mature more and deepen the financial markets.

Policymakers should also provide greater regulatory clarity for blended finance and address potential practical and regulatory barriers, such as those raised by colleagues, which may incentivize private sector participation.

It is important to promote information from intermediaries, such as credit risk agencies and ESG providers in order to improve the understanding of the investability of emerging and developing countries in these kinds of projects. A robust information architecture is always important; I once again point out the taxonomies as a way to improve and to mitigate some of the risk in the allocation of capital. Just thinking about it, the promoting of this blended finance structure should have in place a development objective which has to leveraged or be based on the local context. It may have an additionality in order to move the capital towards the projects that are not going to move forward without this capital. It has to support local priorities and enable development or commercial mandate without comprising under standards their mandates of the commercial and the development banks is not going to change. Return is going to be an aspect of blended finance and it is important to monitor the transparency and the results of this financing with KPIs in order to assess effectiveness and efficiency of the financing allocation, enhancing transparency and public accountability which is going to improve the market information, the risk assessment, and efficient pricing, as I mentioned earlier, I think those are the most important frameworks that has to be put in place to improve this environment.

Demet Çanakçı:

Thank you very much Laura. Thank you. So, we have a lot of questions, and we have limited time left, so I would like to move to the questions. Nnamdi, there's a specific question named for you, so I'll just start with that one. So, our participant says, "You mentioned that the flow of concessional capital has stagnated since 2017. How could you re-incentivize the public, who are conventionally motivated by capital gains, to invest in these initiatives?"

Dr. Nnamdi Igbokwe:

Yeah, thank you. It's a really important question and one I'm happy to provide some context to. So, first we have to understand that it's not the role of private capital to solve development in climate challenges. It's the role of governments, the role of development finance institutions to ensure that conditions are suitable for the private sector and are optimal to generate the finance that's needed to address some of these issues. The private sector is not going to come into where the risks they don't understand are and the landscape that they don't get. So, this is where all of that de-risking and mitigating risk to blended finance comes in. To speak specifically about concessional capital and re-incentivizing. So, Convergence actually wrote and published with USAID an action plan that identifies how a small amount of public and philanthropic capital can act as a catalyst, to combine strategically with their investments, to move the international system from $240 billion to $530 billion.

I'll place that in the chat a link to that report because it goes through a five-pillar action process, how that can occur. But maybe more relevant to the discussion here today is, I'll point to philanthropic capital and the role that philanthropic capital can play. Between 2017 and 2022 philanthropic organizations provided about 10% of all concessional capital to climate blended finance. So, there is a large but untapped opportunity to expand our participation. So, really to show the muscular nature of philanthropic capital, we have to better align with local mechanisms to forge strong collaborations. And what do I mean by that? So, for example, if we think about it through a regulatory lens or a government lens, philanthropic capital has PRIs: program related investments that serve as a bridge that combine the intent of charitable giving with the mechanisms of below market investment through de-risking.

So, what regulators can do in this sense is lead incentives to promote and facilitate more philanthropic activity. For example, the Monetary Authority of Singapore has recently encouraged singles family offices to use Singapore as a base to conduct more philanthropic activity. They have an incentive-laden tax scheme to do just that. There's something similar going on in Brazil, where philanthropic capital and impact investors are pushing for tax code amendments to better utilize such funds. So, to broadly answer the question, re-incentivizing the private sector is really through de-risking. That risk return balance has to make sense, otherwise there's no activity, there's no participation. On the public side, just more strategic use of catalytic capital; I've already talked about what MDBs and DFIs can do directly, but I think philanthropic capital in this sense can really unlock and open up some of the mobilizing of the private sector if regularities can come into play and do certain things to allow some of that capital to be better programmed and better applied.

Demet Çanakçı:

Thank you Nnamdi. I would like to ask Mika'il's question to Alan. Maybe Andrew can also add to that: "What strategies can be implemented to attract lenders and offer guarantees for agroforestry projects?"

Alan Elizondo:

And thank you. Well in FIRA, we have an agreement with the National Forestry Commission, so they are very interested in directing money to agroforestry, but that is one program. The second one is with the KFW, the German bank. So, the way these two programs work, I'm going to start with the KFW. They have brought to Mexico consultants that will help us find projects on agroforestry from small communities. So, this consultant will gather together with our personnel to find those projects. Then once you have identified some projects, we will fund them as an institution using the German funding. Then, in order to have financial intermediaries interested in the project, we have designed a guarantee product. This is a first loss guarantee where an institution or financial institution can build a portfolio. So, the 20% first loss of that portfolio is taking from this guarantee provided by the KFW institution. So, this has attracted two things. First, identification of projects that are sustainable and can be financed, but also the interest of a lot of financial intermediaries locally in Mexico because of this guarantee product that this has been built together with the German institution.

Andrew Ahiaku:

Maybe quickly to add to what Alan said, beyond the guarantees, which is spoke about with Aceli, we also have the Origination Incentive that we offer to lenders that support SMEs into these high impact areas including agroforestry. We also identify agroforestry as one of the climate and environmental practices and we have reduced the lower limit for those that qualify for that period and offered more impact-driven incentives, just to encourage lenders to do that. Finally, we offer advisory services to some lenders and their SMEs to better appreciate and understand the sector and more climate and environment-related facilities. Thank you.

Demet Çanakçı

Thank you very much Alan and Andrew. That was great. So, unfortunately, we'll be closing the session. So, let me thank this fantastic panel and thanks again for joining the conversation. You'll receive a brief survey from Toronto Centre right after this. Your views are important, and it'll help us to identify what to cover next on blended finance for climate adaptation and supervision. So, please take time to do that when you receive it, and I again thank you all very much for joining us and thank you for the panel.