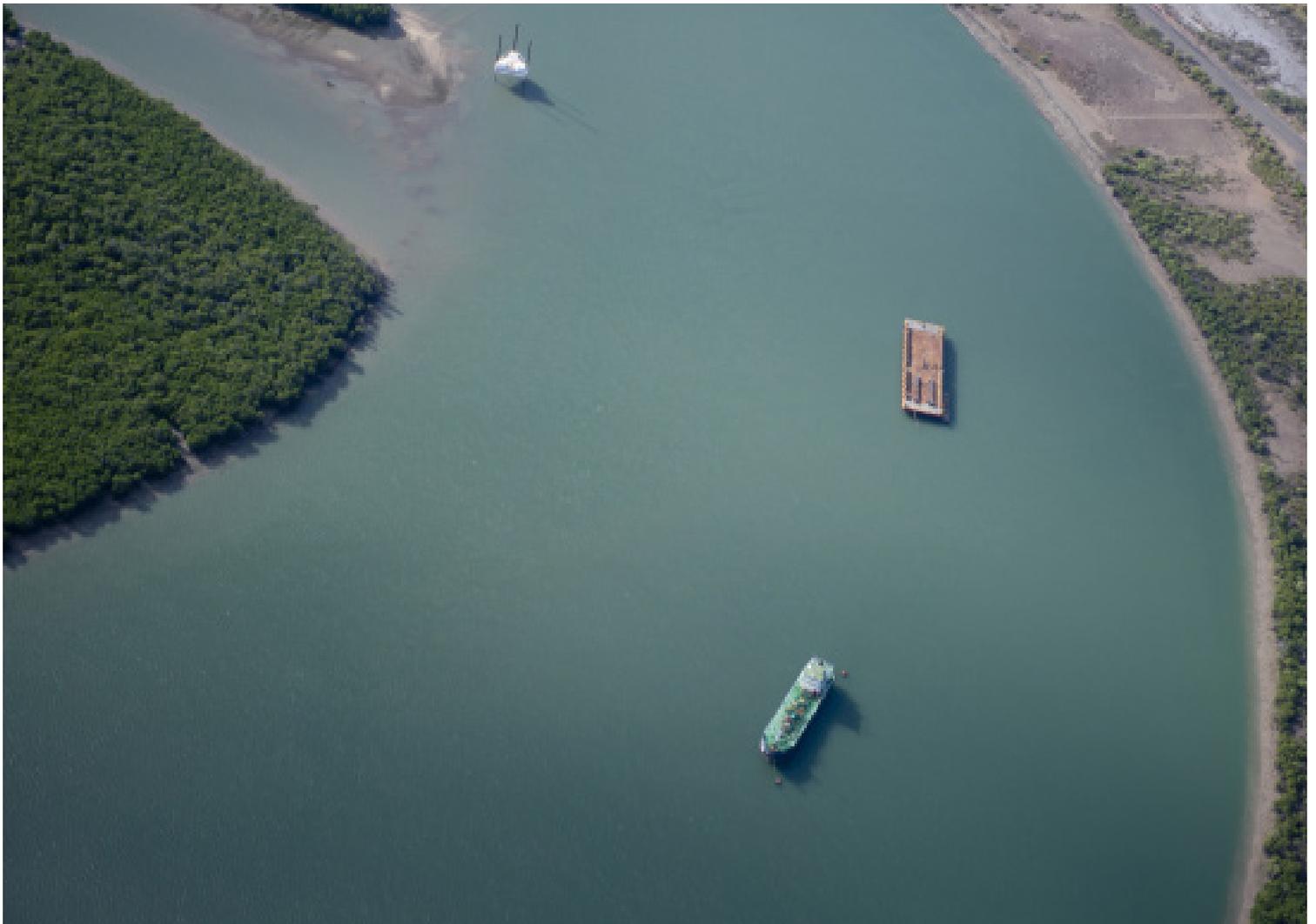


Securitization for Sustainability

Does it help achieve the Sustainable Development Goals?

By Daniela Gabor



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Gladstone Harbour, Australia

The image shows an aerial view of the Gladston Harbour in Australia. Photo by the Greens MPs taken on June 10, 2013

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EXECUTIVE SUMMARY

The new consensus in international development circles focuses on private finance as the solution to pressing sustainability issues. As Lord Stern, of the influential Eminent Persons Group, put it: “the challenge of achieving the Sustainable Development Goals (SDGs) is in large measure that challenge, of fostering the right kind of sustainable infrastructure,” for which, “you have to have good finance, the right kind of finance, at the right scale, at the right time” (Stern, 2018). The ambition, spelled out in the Billions to Trillions agenda, the World Bank’s new *Maximizing Finance for Development* (MFD) or the G20 *Infrastructure as an Asset Class* agenda, is to create investable opportunities in poor countries that can attract the trillions of global institutional investors (World Bank, 2018).

In turn, institutional investors find themselves at a critical juncture. Environmental, social and governance (ESG) issues are moving from the subfield of impact investment into mainstream investment practice, as climate risks in particular become increasingly apparent. The SDGs, it is often argued in the private investment space, could provide an overarching ESG framework for sustainable investments if and where investable opportunities are found.

The creation of investable opportunities requires *de-risking of development projects* to better fit the preferred risk/return profiles of institutional investors. Securitization is envisaged to become one important de-risking instrument that would successfully crowd in private (institutional) investors and scale up sustainable assets. This is, for instance, the logic of the Asian Infrastructure Investment Bank’s (AIIB) recent *Infrastructure Private Capital Mobilization Platform*.

Thus, securitization is at the core of international efforts to encourage private finance to invest in SDGs and other sustainability-related activities. This paper maps three potential strategies that would guide the agenda of securitisation for sustainability:

- i. securitization of Multilateral Development Banks’ (MDBs) portfolios;
- ii. MDBs support for global banks and shadow banks’ securitization;
- iii. country-level support for securitization.

The paper examines the claims that securitization would create winners at *institutional, market, country and SDG* level. It asks why securitization – a more complex financial instrument than standard fixed income securities like green bonds – has become central to SDG ambitions. It examines the mechanisms through which securitization may dilute sustainability commitments, asking whether securitization could better incorporate sustainability concerns (as for example captured through ESG ratings) than straightforward, simpler financial assets like green bonds? How, if at all, can securitization-based development interventions play to the strength of the instrument? What are the developmental implications of regulatory and market reforms that developing countries will be asked to make in

order to accommodate the new investors under the World Bank’s MFD, or the G20 *Infrastructure as an Asset Class*?

It concludes that the new Wall Street Consensus - that re-imagines international development interventions as opportunities for global finance - will not deliver on its promises to deliver sustainability via securitization. The potential gains from organising development interventions around questions of “how to sell development finance to the market” are overstated, while the costs - in terms of structural changes in the financial sector, (de facto) privatization of public services via Public-private partnerships (PPPs) and the narrowing of policy space for a green developmental state - are downplayed.

At an *institutional level*, it is often argued that securitisation would help MDBs transform into catalysts for private finance. By *de-risking* development projects via securitisation of their loans, MDBs could help mobilise the trillions of global institutional investors for the SDGs.

MDBs’ business model would need to change if ambitions to scale up private finance from *Billions to Trillions* are to be realised. MDBs are more likely to prefer synthetic securitization instruments that allow them to retain loans on the balance sheet – as the African Development Bank did in the 2018 *Room2Run* deal (Chahed 2018) – to “true” securitisation that removes loans from MDB balance sheets. Yet institutional investors with long-term horizons require tailored conditions in order to enter synthetic securitization with MDBs. These investors may demand their own ESG criteria on MDB loans that would be securitized, or cherry-pick loans that are consistent with their ESG framework. The net socio-economic benefits (if any) and the developmental impact of MDBs de-risking for this class of investors needs to be fully transparent.

MDB support for securitization of (global) commercial and shadow bank portfolios would use development resources to subsidise systemic financial institutions, whose overall activities have a doubtful developmental impact. MDBs would have to clearly define the process for monitoring (shadow) banks for their business activities with significant adverse ESG/developmental risks. This would require strong institutional relationships with (global) banks and shadow banks, relationships that call into question the developmental mandate of the MDBs. As the AIIB’s recent *Infrastructure Private Capital Mobilization Platform* suggests, the pressure to leverage private capital will incentivise MDBs to replace their Environmental and Social frameworks with weaker, private-sector designed ESG criteria, without a clear framework for accountability.

The turn to securitization risks mission drift, as it would re-orient MDBs from concessional to commercial lending, and change the terms of the relationship between MDBs and private finance.

At *market level*, it is argued that securitization would accelerate international efforts to create local currency capital markets in developing and emerging countries (DECs). In tandem with the World Bank’s *MFD* agenda

– that envisages a novel strategy for de-risking entitled the Cascade Approach - securitisation would increase the attractiveness of local capital markets for global investors, and thus reduce DEC's reliance on foreign currency (dollar) debt, historically the source of balance of payment crisis.

The structural ambition of the securitization for sustainability agenda is to re-organise DEC financial systems from bank-based to capital-markets based models.

The structural transformation of financial systems towards securities market-based finance is necessary so that the trillions of institutional investors can find their way into sustainable projects. This is, for instance, the first objective of the AIIB's Infrastructure Private Capital Mobilization Platform. This policy-engineered transformation does not resolve DEC's vulnerability to global financial cycles, and volatile capital flows. It also threatens developmental policy space, by seeking a clean break from developmental models reliant on "policy-engineered industrialisation" that traditionally involved developmental banking guided by the priorities of industrial strategies and a closely controlled relationship with global finance (via capital controls and competitive exchange rate management).

The turn to private finance narrows the scope for a green developmental state, that is, a state that designs and implements policies that substantively influence the allocation of resources to low-carbon economic activities. This reduces the prospect for a just transition to low-carbon economies, where the burden of structural change does not disproportionately fall on the poor. It may generate political instability.

At *country level*, it is argued that securitisation would pave the way for a more resilient financial system while allowing countries to re-direct scarce fiscal resources where most needed. Yet the financial stability benefits of organising domestic financial systems around securities markets are doubtful. Furthermore, **the social and developmental impact of the turn to securitization is likely to be negative since it effectively encourages the (indirect) privatisation of public services, necessary to both generate and de-risk cash-flows that can be directed to the owners of securities.**

This is explicit in the World Bank's *MFD* initiative. It holds that developing countries can offer USD 12 trillion in market opportunities to global institutional investors. These opportunities include "transportation, infrastructure, health, welfare, education". Everything can become an asset class, as the *MFD* agenda puts PPPs at the core of efforts to construct "sustainable" asset classes. Development is recast as an exercise in the privatization or commercialization of public services to generate returns for global finance, with state bureaucracies focused on how to sell development finance to the market rather than on how to design green developmental states.

At *SDG level*, it is often argued that sustainability is the big winner of the new push for MDBs to become catalysts for the trillions of institutional investors. These investors increasingly view SDGs as an overall framework to incorporate ESG criteria in their portfolios. Securitization is

one key vehicle for aligning private finance with SDGs. In the optimistic scenario, the MDBs' involvement would accelerate the realignment, as MDBs would draw on the Environmental and Social frameworks guiding their lending to set standards that can overcome the misincentives that underpin the use of private ESG ratings.

This optimism appears misguided.

The history of green bonds points to trade-offs between achieving scale and enforcing strict environmental/social safeguards. The same trade-offs characterise securitization. The imperative of selling development finance to the market, and scaling up "sustainable" assets, increases the chances of "sustainability" washing. Sustainability in securitization will be determined in part by the sustainability of underlying loans that are pooled together, and by the degree of societal impact from the basic structure (on financial stability, on financial system structure, on developmental model). Where MDBs are prepared to accommodate private ESG criteria to assess sustainability, as is the case for the AIIB's Infrastructure Private Capital Mobilization Platform, loans/assets would be chosen through some green or ESG screen, none of which has any universality, and is applied inconsistently from issue to issuer of ESG ratings.

In turn, *public ES(G)* frameworks have been diluted (e.g. the World Bank's new *Environmental and Social Framework*) or are politically negotiated with little attention paid to the particular context, or needs, of emerging and poor countries (as for instance the European Union's Sustainable Finance initiative).

The MDBs' turn to securitization may further dilute accountability, by increasing intermediation chains and reducing the (already weak) incentives for continuously enforcing ES(G) compliance. Private ESG criteria are likely to become the norm in sustainability-oriented securitization. The "ESG evangelism" at the core of the global policy agenda downplays the fickleness of this indicator, and the potential for SDG-washing inherent in the private and this far unregulated ESG provision.

MDBs should work with national authorities for a universal public ESG framework or sustainability taxonomy for private finance. Such a taxonomy should be enforced without prioritising the development of asset classes that meet the profitability requirements of institutional investors. A public ESG taxonomy, mapped onto the SDGs, and mandatory enforcement in sustainable securitization is necessary if the turn to securitization is to live up to its SDG promises.

ABBREVIATIONS

AfDB	African Development Bank
AIIB	Asian Infrastructure Investment Bank
CLO	Collateral loan obligation
DECs	Developing and emerging countries
ESG	Environmental, Social, and Governance
E&S	<i>Environmental & Social Framework</i>
G20	Group of 20
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IMF	International Monetary Fund
MFD	<i>Maximising Finance for Development</i>
MDB	Multilateral Development Bank
MPCC	IFC's Managed Co-Lending Portfolio Program
PPP	Public-private partnership
PSW	Private-sector window
SDG	Sustainability Development Goal
SPV	Special Purpose Vehicle
STS	Simple, Transparent and Standardized

1. INTRODUCTION

“The United Nations’ SDGs are exciting interest and passion as an overarching ESG framework that can guide investments to achieve returns while delivering positive societal impact.”
Gavin Power, PIMCO, 2018

The global development policy community, from multilateral development banks (MDBs) to the Group of 20 (G20), have recently articulated a new vision of international development focused on private finance. From the *Billions to Trillions* agenda underpinning the adoption of the Sustainable Development Goals (SDGs) to World Bank’s (2017) *Maximizing Finance for Development (MFD)* initiative, to the G20 *Infrastructure as an Asset Class* agenda, the ambition is to turn development finance into profitable business that can attract the trillions of long-term institutional investors with deep pockets.

The efforts to attract institutional investors to poor countries are typically premised on the idea that institutional investors are diverse and therefore often expect some de-risking of development projects to better map onto their risk/return preferences.

Securitization is such a *de-risking* instrument. It transforms non-tradable loans, extended by MDBs or private banks, into a range of tradable securities with distinctive risk/return profiles that can be sold to institutional investors. Take infrastructure. Around 60 percent of infrastructure projects in emerging countries are not fundamentally *investible/bankable* without government or multilateral bank support (Oliver Wyman 2017). Given their underlying risks, such projects do not create the cash flow characteristics that institutional investors prefer or are inscribed in their mandates¹. The securitisation of infrastructure loans would create both highly-rated, low return tranches suitable for conservative pension funds/asset managers and lower-rated, higher return tranches suitable for investors with higher risk appetite such as hedge funds (see Box 1). It would also accelerate lending to infrastructure projects, now constrained by Basel III rules for banks. Banks can sell infrastructure loans to platforms such as the Asian Infrastructure Investment Bank’s (AIIB) Infrastructure Private Capital Mobilization Platform, which in turn would package and securitize them for distribution through capital markets. The Platform would “mandate purchase infrastructure loans from financial institutions and distribute them to institutional investors through securitization or other formats. This will support private capital mobilization and build infrastructure as an asset class” (AIIB 2019a, p. 1).

Box 1. An example of securitization of World Bank loans to the private sector

The World Bank would take a portfolio of loans it originated, or pool loans across MDBs. In a true securitisation, it would sell the rights to the loans to a Special Purpose Vehicle (SPV), a separate legal entity that should not be affected by the insolvency of the originator. The SPV issues a tradable security or several tradable securities (by tranching²) that receive credit ratings, can be traded in secondary markets and sold to investors with different risk appetites. The cash flows from the underlying loans are directed to the owners of the new securities. Tranches establish the priority of payment of principal and interest from the underlying loans, and therefore carry different interest rates. The AAA rated tranche has priority of payment over mezzanine and junior tranches, and yields a lower interest rate to match its (relatively) safer profile.

In a synthetic securitization, the World Bank retains the portfolio of loans on its balance sheet, and instead buys protection against the possibility that a tranche of that portfolio defaults. This de-risks the remaining tranches that receive a higher credit rating. With a de-risked balance sheet, the World Bank can extend new loans and preserve its own AAA rating (see Claessens and Ratnovski 2014; Segoviano et al 2015).

The turn to securitization has been further energized by geopolitical considerations. At the end of 2018, China announced that it would join the global race to securitize infrastructure loans to solve the Belt and Road financing gap over the next five years (Liu and Ng 2018). The Hong Kong Mortgage Corporation has been mandated to pool infrastructure loans – such as those extended by the China Development Bank – and channel funds into China’s Belt and Road Initiative. Concerns about China’s growing geopolitical influence also prompted the Trump administration to approve a new bipartisan push to increase US foreign aid into infrastructure projects (FP Staff 2018).

It is often assumed by those promoting securitization in developmental circles that the MDB’s support for securitization would provide “proof of concept” that securitization and sustainability are natural bedfellows.³ The push for securitization emphasizes its winners at *institutional, market, country and environmental* level.

1 For instance, a common rule of thumb is that pension funds need a minimum 4 percent return plus inflation.

2 Tranching also allows the issuance of new securities known as Collateralized Debt Obligations. These are structured products that purchase and pool tradable assets (as opposed to illiquid loans) such as the riskier tranches of asset and mortgage backed securities, to then issue securities in tranches that can be in turn repackaged. The aim is to recycle those tranches that cannot be easily sold to investors into higher-rated products, with the help of credit rating agencies.

3 For a review, see Humphrey (2018) and the Eminent Persons’ Group (2018).

At **institutional** level, the winners include multilateral development banks, institutional investors and traditional banks constrained by Basel III rules. As the Eminent Persons' Group (2018) advice to the G20 put it, Securitization would enable MDBs to achieve their new ambitions as catalysts for greater involvement of private finance in the achievement of the SDG. Securitization would increase the mobilizing capacity of MDBs, freeing up balance sheets while preserving their high credit ratings. For institutional investors, sustainability could become a profitable business, in line with their greater appetite for impact investment and increasing pressure to include ESG risks in their operations. Commercial banks constrained by Basel III rules to lend for infrastructure projects would also benefit, as securitization allows them to offload loans to platforms such as the AIIB's Infrastructure Private Capital Mobilization Platform

At **market** level, securitization would accelerate international efforts to create local currency (green) capital markets in developing and emerging countries (DECs). In tandem with the World Bank's Maximising Finance for Development agenda, securitisation would increase the attractiveness of local capital markets for global investors, thus reducing countries' reliance on external debt and vulnerability to sudden stops.

At **country** level, securitisation holds promises for both DEC and high-income countries. By drawing on private financing via securitisation markets, DECs would be able to preserve limited fiscal resources for other pressing developmental needs, while accelerating the pace of SDG implementation. In turn, high-income countries could reduce their official development aid in the age of tighter fiscal constraints, while simultaneously ensuring that institutional investors headquartered there and catering to the needs of their citizens re-orient towards sustainable finance (see European Commission 2018).

At **SDG** level, the turn to securitization would accelerate the transition to a world where private investors can integrate ESG risks across the investment process, and asset classes. MDBs with lending activities governed by well-defined Environmental and Social frameworks would play the role of catalysts to encourage private finance to adopt faster a framework for re-orienting their portfolios towards sustainable activities.

The paper explores these claims. It asks why securitization - a more complex financial instrument than standard fixed income securities like green bonds - has become central to SDG ambitions. It outlines three key avenues through which securitization of sustainable projects could be promoted – by MDBs themselves, by global commercial and shadow banks with support from MDBs, and by developing countries themselves. It then examines the mechanisms through which securitization may dilute sustainability commitments, asking whether securitization could better incorporate sustainability concerns (as for example captured through ESG approaches) than straightforward, simpler financial assets like green bonds? How, if at all, can securitization-based development interventions play to the strength of the instrument? What are the developmental implications of regulatory and market reforms that developing countries will be asked to make in

order to accommodate the new investors under the World Bank's Maximising Finance for Development, or the G20 Infrastructure as an Asset Class? It concludes with a reflection on the financial stability aspects and the kinds of development models promoted by the turn to securitization and international interventions oriented to selling development finance to the market.

Table 1 on the following page provides an outline of the critical issues that development organisations should consider carefully, and plan for, when contemplating the use of securitization to target SDG outcomes. It details (a) the exact mechanics of securitisation in each of the three scenarios, (b) the impact on sustainability and the accountability of multilateral development organisations; (c) the potential financial stability spillovers; and (d) the developmental implications of placing institutional investors at the centre of development finance.

Table 1. The impact of securitization on sustainability - a summary

	MDB Securitization	MDB support for (shadow) bank securitization	Country-level securitization
Pathways to securitization	Balance sheet (funding) vs synthetic securitization (capital relief) options *AfDB <i>Room2Run</i> Synthetic Securitization*	MDBs to help structure risk-return profile demanded by private investors directly by purchasing bank loans / guaranteeing tranches or indirectly by promoting financial market structures supportive of securitization markets *AIIB Infrastructure Private Capital Mobilization Platform*	Re-orient financial systems towards market-based finance, with liquid (SDG-backed) securities financed via wholesale money and derivative markets *G20 Infrastructure as an Asset Class*
Sustainability and accountability	Weak(er) incentives for continuously enforcing ES(G) performance, on tranches and loans in the securitization pool	Trade-offs between achieving scale (market depth) and enforcing strict ESG/sustainable taxonomies	Trade-offs between achieving scale (market depth) and enforcing strict ESG criteria/ sustainable taxonomies
		Sustainability washing: lack of ESG universality leads to ESG ratings shopping, misalignments between SDGs and ESG, ongoing ESG compliance for tranches.	
Financial Stability	Limited systemic impact from synthetic securitization	Systemic fragilities characteristic to shadow banking and market-based finance	Systemic fragilities characteristic to shadow banking and market-based finance
Developmental Impact	Privatization/PPP (social) infrastructure to generate cash flows for institutional investors	Privatization/PPP (social) infrastructure to generate cash flows for institutional investors	Privatization of social and other infrastructure to generate cash flows, fiscal resources to de-risk "bankable" projects
			Shrinking space for green developmental state

2. THE TURN TO SECURITIZATION IN THE INTERNATIONAL DEVELOPMENT AGENDA

Securitization markets played a central role in the global financial crisis. These are markets where banks and shadow banks package illiquid loans (such as mortgages) into securities that can be sold to investors with different risk appetites (Claessens and Ratnovski 2014). While regulators encouraged the growth of securitization markets by pointing to their potential for de-risking before the Lehman crash, the global financial crisis prompted intense

regulatory scrutiny. The Financial Stability Board, the global body mandated with designing a regulatory framework for shadow banking, identified securitization markets as one of the two systemic shadow markets alongside repo markets (wholesale money markets where banks and shadow banks lend to each other against collateral securities), reflecting an ample consensus that securitization activities required not only more transparency, but

a well-designed framework that would strictly regulate banks and shadow banks' involvement.

Box 2. The role of securitization in the global financial crisis

It is broadly agreed that securitization markets – particularly of subprime mortgages in the US – made an important contribution to the fragility of the global financial system that became explosive with the collapse of Lehman Brothers.

There are several reasons why securitization exacerbated systemic fragilities:

- *Aggressive loan origination practices:* banks and shadow banks pursuing an “originate to distribute” business model that targeted new borrowers aggressively without due diligence procedures.
- *Aggressive securitization issuance practices:* (shadow) banks engaged in complex and opaque financial engineering of loans into securitization issues, driven by high fees.
- *Aggressive credit rating agencies' search for profit:* “ratings shopping” created misincentives to award high ratings that poorly reflected the credit quality of the underlying loans.
- *Aggressive search for yield:* leveraged investors demanding securitisation (tranches) to increase profits.

(See Segoviano et al. (2013) for further details.)

It is somewhat paradoxical that 10 years after Lehman, global policy forums have again turned to securitization as a financial instrument that can support the global efforts to re-orient finance towards more sustainable activities. These include the OECD's low-carbon infrastructure push, the MDBs plans to optimize balance sheets, or the G20 to promote *Infrastructure as an Asset Class* as a pilot sector for the new, finance-driven development agenda.

Across these forums, the understanding of the links between securitization and sustainability varies significantly, from a *narrow* understanding of “sustainable” loans – green mortgages, electric vehicle loans, green technology corporate lending, sustainable mass transport, electric storage technology or sustainable agriculture – that can be securitized to *broader* claims that securitization of development-oriented loans can help achieve the SDGs.

In the more modest proposals, securitization can improve sustainability understood through low-carbon infrastructure (renewable energy, energy efficiency and low-emission vehicles). The OECD (2016) argues that “revitalising the concept of securitization, which was tarnished during the 2007-2008 financial crisis is important to the scaling up of low-carbon infrastructure finance”.

The Sustainable Finance Working Group working under Argentina's presidency of the G20 proposed a broader definition (IIF 2019). It spelled out three priority areas for voluntary adoption: creating sustainable assets for capital markets; developing sustainable private equity

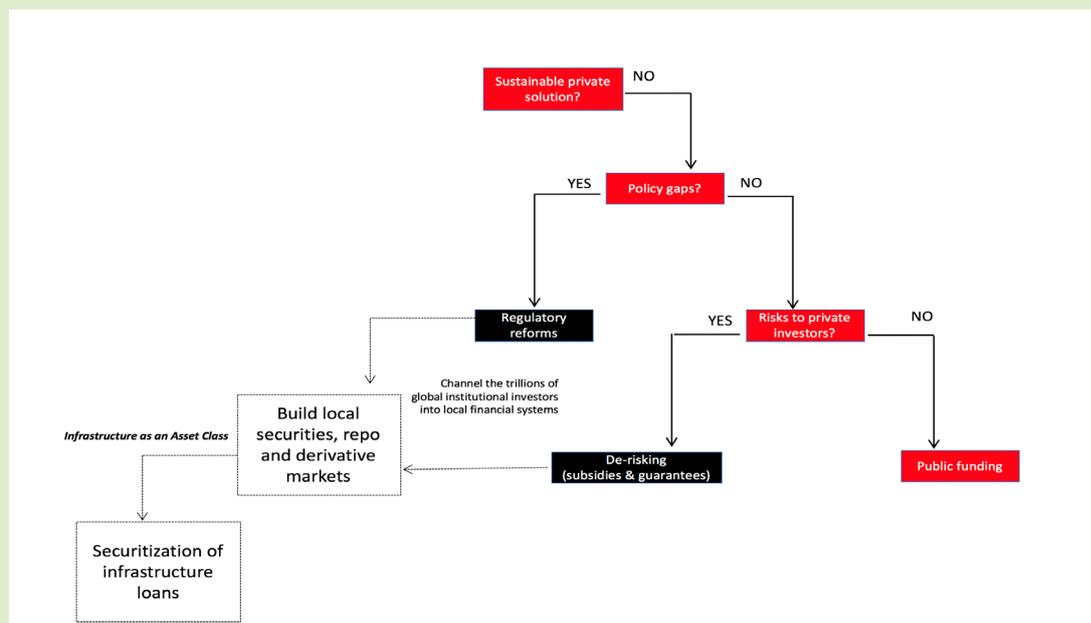
and venture capital, and applying digital technologies to sustainable finance. The area of sustainable assets for capital markets envisages “sustainability-targeting” securitization, including asset-backed securities, mortgage backed securities and collateralized debt obligations. In this understanding, sustainable securitization captures a “new” breed of asset-backed securities that pays distinctive attention to sustainability of the assets backing the securities, the use of the proceeds and the constituents of the investor base (McGarry, Dey and Hauman 2018).

The turn to securitization in international development echoes similar initiatives in the European Union. The European Commission played midwife for the re-birth of securitization markets in Europe since 2015. As part of its Capital Markets Union initiative, it developed a framework for Simple, Transparent and Standardized (STS) securitization that benefits from regulatory relief (European Commission 2015). STS securitization, it argued, would connect institutional investors with firms and households across Europe while avoiding the fragilities of the pre-Lehman opaque and complex products aggressively promoted by financial institutions with little skin in the game (see Finance Watch 2015 for a critique). By 2017, the Capital Markets Union agenda explicitly incorporated concerns with sustainable finance in line with global commitments like the Paris Agreement and the 17 SDGs (European Commission 2018). The Commission understands sustainability as improving the contribution of finance to long-term sustainable and inclusive growth.

2.1 The MDBs' turn to securitization: leveraging private finance

The MDBs' turn to securitization can be traced back to the 2013 G20 calls for MDBs to optimize their balance sheets. The ensuing Action Plan to Optimize Balance Sheets identified securitization as one of the avenues that could support MDBs in their efforts to catalyse private finance (G20 2015). It called on MDBs to increase lending to infrastructure investment, climate change or other pressing areas without damaging credit ratings. The ambition is to increase lending in lower income countries or to riskier activities, ambition that is capital intensive. For this, the Action Plan noted five measures: (a) higher risk and leverage; (b) synthetic securitization for MDBs working in poor regions to gain capital relief without affecting debtor-creditor relationships or preferred creditor status; (c) leveraging equity in concessional windows; (d) synthetic securitizations of non-sovereign portfolios; (e) net income transfers. For instance, the African Development Bank's first securitization deal, *Room2Run*, was announced as a “direct response to G20 action plan for MDB balance sheet optimisation” (Mizuho 2018).

The Eminent Persons' Group (2018) report to the G20 Ministers of Finance meeting in Argentina pushed the securitization for international development agenda a step further. It advised the use of system-wide securitization across MDBs so as to mobilize institutional investors on a significant scale. It also stressed that data initiatives need to accompany the process of incentivizing securitization

Figure 1. The World Bank's *Maximizing Finance for Development* agenda

Source: adapted from World Bank (2017)

markets. It proposed shared, locally owned country platforms to develop the supply of bankable projects and share knowledge/data, thus considering advice that institutional investors require comprehensive data to identify, quantify and manage risks. Data sharing would further support infrastructure data platforms that are critical for the process of securitizing MDB loans.

The G20 *Infrastructure as an Asset Class* agenda calls on DECAs to policy-engineer new financial markets that can attract global institutional investors to finance the infrastructure investment gaps in energy, water, communications, and transport, estimated by McKinsey Global Institute (2016) at USD 800 billion annually (see also OECD 2018). These plans, outlined in the “Roadmap to Infrastructure as an Asset Class” or in the Eminent Persons Group proposals, envisage that securitization could effectively crowd-in institutional investors (see Alexander 2018, also Ketterer and Powell 2018).

The MDBs’ plans to optimize balance sheets and the G20 *Infrastructure as an Asset Class* plans overlap in the aim to promote securitization and to create the **financial market structures** that can enhance institutional investors’ appetite for infrastructure-backed securities. The aim to re-engineer financial systems —by organising them around securities, derivative and wholesale money markets that can support **liquid infrastructure/SDG asset classes** —is an important albeit underappreciated element of the new global push for maximising private finance for development.

Consider the World Bank’s *MFD* agenda, to date the most concrete MDB proposal to align international development interventions with the preferred risk/return profiles of institutional investors. The Cascade Approach at the core of the *MFD* agenda guides the World Bank’s efforts to leverage the private sector for growth and sustainable development (World Bank 2017). It outlines a series of steps that MDBs and country-level authorities should follow in order to remove the barriers to “sustainable private” investments in SDGs (see Figure 1). If

barriers are regulatory, the World Bank suggests addressing them, either by creating rules to enable the private sector to enter new sectors or by deregulating. Alongside regulatory measures, the World Bank envisages new instruments that can “de-risk” projects with high developmental impact but low “bankability”.

Traditionally, MDBs provided de-risking by straightforward guarantees. But guarantees would not go far enough to successfully mobilize the trillions of institutional investors, since the process involves “high costs, complexity of the products’ structure and conditions, lengthy negotiation and approval processes, limited risk coverage, low flexibility, and slow speed to claim payments” (Dos Santos and Kearney 2018, p. 7). This is why guarantees constitute a small proportion of MDBs portfolios – the highest, for the International Finance Corporation (IFC), reaches 10 percent of the overall portfolio (Humphrey 2018). In contrast, securitization can be harnessed to create financial products of varying risk profiles, to create “sustainable assets for capital markets” (OECD 2018b).

Thus, while the World Bank does not explicitly tie securitization to the *MFD* agenda, the two go hand in hand. *MFD* will create the conditions for MDBs’ balance sheet optimization via securitization, and for MDB support for global and local bank securitization efforts. In an effort to promote local capital and financing markets, *MFD* envisages the creation of derivative markets where foreign institutional investors can hedge currency and other risks attached to holding securitization tranches, and of wholesale funding markets that provide the “plumbing” for liquid securities markets (see Chapter 5 for further details).

Other MDBs are already following suit. Against the background of the trade war between the United States and China, the AIIB announced in June 2019 that it would pilot financing in local currencies in response to demand from member countries, demand reflecting in part the pressing necessity to move away from US dollar financing (Yu 2019).

2.2 Sustainable Finance - the turn to ESG Criteria

The ESG framework was born out of the United Nations Global Compact ambitions to provide a framework under which equity owners could influence the behaviour of corporations in relation to sustainability. The ESG framework emerged in response to concerns with responsible investment (PRI 2016, P 4)⁴ from decades-long development of various practices under the umbrella of socially responsible investing.

The shift to ESG has been promoted by international development agencies in cooperation with global institutional investors⁵, with ESG ratings provided by private companies and in-house ESG offices. Competition between providers has resulted in often conflicting ESG ratings for corporations.

Public authorities are increasingly willing to provide public taxonomies for sustainable activities, as a voluntary – rather than mandatory – alternative for disclosure of ESG performance. For instance, the European Commission produced the first proposals for a public taxonomy for sustainable activities in June 2019 that it expects, after negotiations and possible redrafting, to become the benchmark for European finance in the near future (European Commission 2019).

The ESG approach emerged as a *privately-provided, corporation-focused, equity-tailored, activist/impact investor* system of rating environmental, social and governance practices. It is now evolving rapidly, as climate change generates public pressure for regulators and the private sector to act.

Privately provided: the proliferation of ESG providers reflects the growing importance of environmental risks for institutional investors. Indeed, the E reigns supreme in the incentive structure. Investors now face threats of legal action for failing to hedge against climate risk, both physical risk that climate events would affect the performance of their assets, and transition risks⁶ that climate regulation may reduce their profitability or increase exposure to financial stability issues (Mooney 2018). Conversely, the IFC (2016) estimated that national plans would collectively generate USD 23 trillion in opportunities for climate smart investment in emerging countries.

From corporation-focused to all issuers: initially, ESG data were used to compile ratings for corporations, and to encourage corporations to engage more systematically in ESG disclosure. More recently, private providers have begun to provide ESG ratings for countries, so that these can be applied to government bonds. ESG ratings for countries involve monitoring the rules, laws and policies that promote or impede sustainable development. For example, INRATE provides an ESG rating scale for countries from A+ (very good performance on most ESG topics) to D- (low performance) (Reutimann, Wani and Hurst

2019).

From equity-tailored to fixed income instruments: originally, activist investors adopted ESG ratings as a vehicle to influence corporations in which they held equity. This resulted in a large body of research on the link between ESG investing and financial performance, alongside benchmarks and indexes (for instance, for ESG funds).

More recently, the World Bank and the largest Japanese pension fund have explored ways to incorporate ESG considerations in fixed income instruments (bonds, securitization tranches etc), recognizing that ESG investment is no longer simply about impact investment but about material credit risks to portfolios that include equities and securities (Inderst and Stuart 2018).

From opportunity (impact investment) to material credit risk factor: The ESG framework traditionally catered for demand for impact investment or for generating social and environmental benefits alongside financial returns. As climate change gains political salience, so have calls to mainstream ESG factors as material credit risks factors, that is, factors that may affect the borrowers' capacity to repay loans. Put differently, it is increasingly recognized that ESG criteria are no longer a subset pertaining to impact investment, but should be viewed as a critical component of any financial investment decision.

This far, the consensus emphasizes voluntary adoption of ESG frameworks or other taxonomies, but this may change towards mandatory adoption as climate events become more violent, and as central banks recently recognized climate risk as material financial stability risks to be addressed within their financial stability mandate (Cœuré 2018).

What does mandatory adoption imply? Regulators – central banks and governments – are increasingly concerned about the implications of climate change on economic activity and financial stability. If countries wished to regulate businesses and finance for climate change, the ESG framework would provide the metrics for the new regulatory regime. In finance, central banks could impose a green supporting factor that would provide regulatory relief to assets with ESG ratings above a certain threshold. Conversely, central banks could impose a brown penalising factor that would make brown assets more expensive in regulatory terms (additional capital requirements for instance).

The brown-penalizing factor would correct a market failure, as financial markets do not price climate risks adequately. For instance, in a ground-breaking study, Blackrock calculated that several US asset classes that do not price in extreme climate events, including municipal bonds, commercial estate-backed securities (manufactured through securitization) and utility stocks (Riding 2019), would experience significant losses over a long horizon. Yet private finance is resisting the brown-penalizing approach, since it would provide a more systematic,

4 Responsible investment was understood as 'an approach to investing that aims to incorporate ESG factors into investment decisions, to better manage risk and generate sustainable, long-term returns'

5 The United Nations Environment Program – Finance Initiative and an asset management coalition, including Blackrock, PIMCO, Alliance Bernstein, that signed the Principles for Responsible Investment.

6 For details see Bank of England (2016).

and therefore costlier, approach to dealing with climate risks.

In their resistance, private investors may find an unlikely ally. Central banks in the growing Network on Greening the Financial System conceptualize the immediate impact of tighter climate rules under the heading of transition risks. These are risks that the transition to a low-carbon economy would increase the cost of funding or change dramatically asset values for financial institutions. The faster the transition to a green economy, the higher the potential that transition risks affect financial stability.

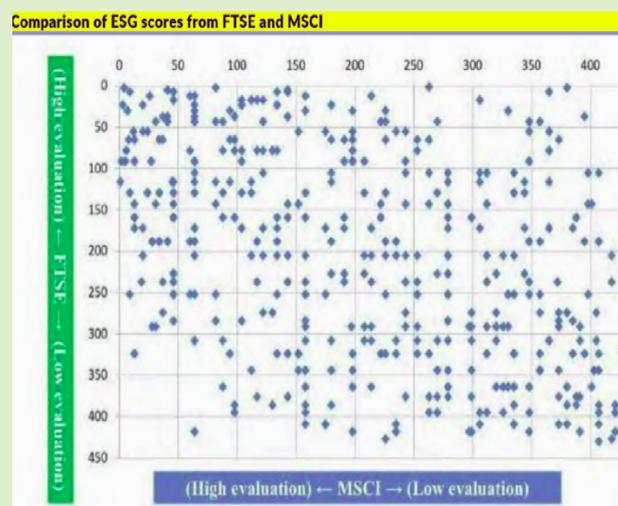
This renders visible the importance of a green development state that can effectively provide a buffer against transition risks through Green New Deal type of programs.

Private vs public ESG frameworks: the potential shift from voluntary to mandatory also renders the question of whose ESG metrics' is relevant. One possibility, supported by public and private actors, is to better align private ESG metrics with the SDGs, "mapping impact using the Sustainable Development Goals" (PIMCO 2018). This is often suggested in the global debates on sustainable infrastructure. According to United Nations Environment Programme, "sustainable and resilient infrastructure – defined as infrastructure that integrates environmental, social and governance (ESG) aspects into a project's planning, building and operating phases while ensuring resilience in the face of climate change or shocks – is capable of making the difference" (Egler and Frazao 2015).

The incorporation of private ESG criteria in regulatory frameworks suffers from significant pitfalls that raise the distinct possibility of SDG-washing. Consider two examples: shopping for preferable ESG ratings, and bespoke screening.

Private providers quantify the ESG performance of a company or country. This typically involves a large number of ESG criteria, chosen and assessed on *discretionary* and proprietary basis. Hence, ratings are often conflicting. For instance, a recent report by the Asian investment bank CLSA and the Asian Corporate Governance Association compares two popular ESG rating methodologies, by the Financial Times Stock Exchange and MSCI Inc. (Allen 2018). The report provides a powerful picture of the inconsistency in ratings: Tesla's global auto ESG for instance, was rated first by MSCI, last by the Financial Times Stock Exchange, and mid-range in Sustainalytics. Tesla is not the exception, but rather the rule (see Figure 2 in the following column). This suggests it would be easy for investors to shop around for high ESG ratings in a future where ESG ratings anchor mandatory climate rules.

Figure 2. Shopping for high ESG scores?



Source: Financial Times Alphaville (2018)

The possibility that financial institutions would engage in ESG shopping is real. Indeed, one of the reasons why securitization exacerbated financial fragility, as discussed above, was the behaviour of credit ratings agencies, which responded to ratings shopping by awarding high ratings to securitization issuances without due diligence into the credit quality of the underlying loans. ESG providers face the same problematic incentives.

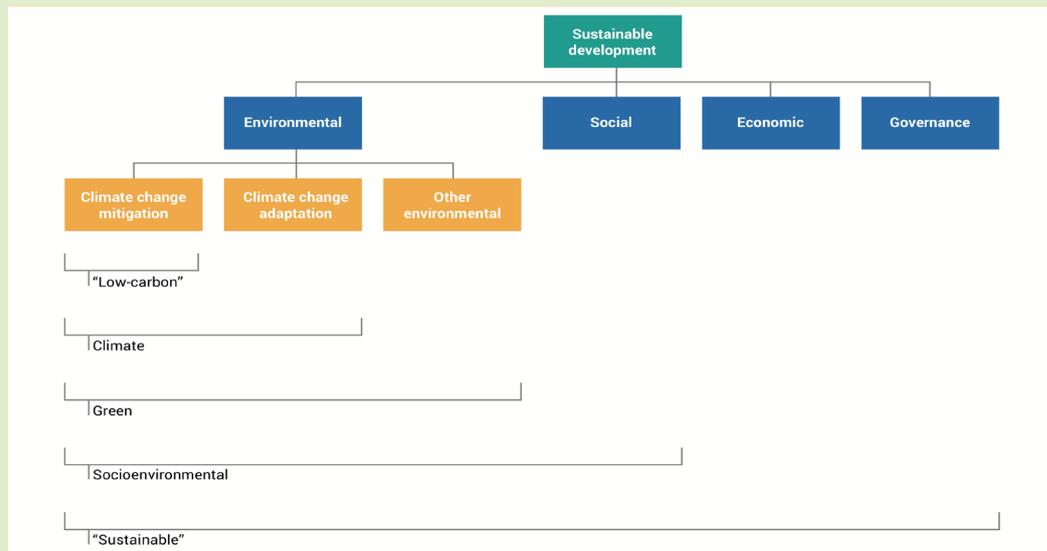
Bespoke screening allows ESG providers to screen out issuers whose business lines are inconsistent with the investment policies, values or social norms of investors. For instance, MSCI provides bespoke screening for "Catholic values" like anti-abortion legislation (Inderst and Stewart 2018). This would allow institutional investors to claim SDG outcomes when their investment decisions are in fact directly conflicting with women's rights agendas.

The alternative, a sustainability framework constructed by public bodies for private finance, has yet to emerge. At first glance, the World Bank Group's new *Environmental and Social Framework*⁷ would be a good starting point. The World Bank's safeguards have long been seen as "gold standard in development finance", as it was the first MDB to adopt mandatory safeguard policies to prevent and mitigate environmental and social harms (Bank Information Center 2016). The World Bank's *Environmental & Social Framework* was recently updated to balance environmental (resource efficiency and pollution prevention and management; and biodiversity conservation and sustainable management of living natural resources) and social issues (labour, community health and safety, land acquisition, Indigenous Peoples; cultural heritage).

However, the recent reform of the World Bank's *Environmental & Social Framework* opens the door further to SDG-washing because it embraces, rather than clarifies, the ambiguity of private ESG approaches. The new *Environmental & Social Framework* replaces the mandatory environmental and social safeguards with a "risk-based,

⁷ Other MDBs use a similar framework, with varying degrees of credible commitment to the Environmental & Social framework principles (see for example Chow (2017) for the AIIB)

Figure 3. The Sustainable Finance plans of the European Commission



Source: European Commission (2019)

outcome focused, tailored and proportionate approach". It accepts the use of borrowers' *Environmental & Social Frameworks* that are "materially" close to the World Bank's own, without clearly defining "materially close" in terms of thresholds, without mechanisms for transparent consultation before approval, without specified mechanisms for monitoring changes in borrowers' frameworks. Furthermore, the World Bank shifted to *adaptive risk management* that replaces pre-project risk assessment before Board approval with "risk-based management" (Oxfam, 2015). Both borrowers' frameworks and risk-based management put a *private ESG a la carte* logic at the core of World Bank Group operations.

The other public initiative on the table, the European Commission's Sustainable Finance initiative, develops "an EU system of classification of financial products that captures all acceptable definitions of 'sustainable'" and to establish "credible EU labels and quality standards" (see Figure 3).

The Commission published a draft taxonomy in June 2019, that establishes a detailed classification system for sustainable activities, and EU labels for green financial products. This is a different approach from ESG: it starts from identifying taxonomy-eligible activities, taxonomy to then be deployed in the service of reorienting the financial sector towards sustainable investments. For now, the taxonomy is voluntary and only targets disclosure. However, as climate events increase in regularity, it is likely that the taxonomy would be used to design a mandatory regulatory framework that rewards 'green' (taxonomy eligible) investments and penalizes 'brown' investments.

In sum, it is often assumed by those promoting securitization in developmental circles that the MDB's promotion of securitization would provide 'proof of concept' that securitization and sustainability are natural bedfellows. It is this assumption that the paper turns to critically examine.

3. PROMOTING SECURITIZATION MARKETS: A THREE PILLAR APPROACH

The global promotion of securitization as financial instrument that can reorient investors towards sustainability can take three distinctive avenues (see Humphrey 2018):

- (i) MDB securitization of their own loans
- (ii) MDB support for (shadow) banks' securitization
- (iii) Country level promotion of securitization

3.1 A MDB Securitization: mobilizing private finance for the private sector

In search for mobilizing private finance, the MDBs can in theory choose to securitise both their concessional and private sector loans. In 2017, the outstanding portfolio of all MDBs amounted to USD 630 billion, with the International Bank for Reconstruction and Development and the International Development Association accounting for roughly half of that figure (Engen and Prizzon, 2018). The MDBs' portfolios are dominated by infrastructure loans, with the largest MDBs allocating as much as half of their disbursements to infrastructure (Engen and Prizzon, 2018).

The securitization of MDB loans can take two forms, true-sale or synthetic, each with their advantages and drawbacks (see Table 2). While both would create additional lending capacity for MDBs, the structure of incentives and political economy factors suggest MDBs will prefer synthetic securitization of their private sector loans.

The securitization of MDBs' concessional loans raises technical and political obstacles (Humphrey 2018). MDBs extend loans to sovereigns at subsidized rates. MDBs have low funding costs and high credit ratings, while the risk premiums MDBs calculate for sovereign borrowers rarely incorporate political risk. The terms of the lending relationship the MDBs have with sovereign borrowers thus constrain the shift to securitization. The "magic" of securitization does not extend to creating high-yielding securities from low yielding loans, while also covering the costs of issuing securities. Put differently, the securitization of sovereign MDB loans would not generate attractive risk-return incentives for institutional investors without additional financing from MDBs. MDBs would have to commit own resources to yield enhancement.

Table 2. MDB loans - true sale vs. synthetic securitization

	MDB public sector loans	MDB private sector loans
Pricing	Subsidized terms	Commercial terms
De-risking	MDB subsidies for yield enhancement	Less yield enhancement than on concessional loans
True sale securitization	Pooling loans (across MDBs) to sell to SPV ? own resources for yield enhancement?	Pooling loans (across MDBs) to sell to SPV ? Weakening of developmental impact, environmental and social safeguards? <i>Example: Green Asset-Backed Securities (IDB)</i>
Synthetic securitization	Benefits of achieving capital relief lower than costs of securitization	On balance sheet; buying credit protection for synthetic tranches ? Weakening of developmental impact, environmental and social safeguards? <i>Example: Room2Run (AfDB)</i>

In contrast, the securitization of MDB's private sector loans has the potential to both meet the ambitions of scaling up billions into trillions and the preferred risk-return profile of institutional investors. This would shift the financing landscape for MDBs. Whereas MDBs typically rely on member governments to finance their concessional windows and on financial markets for non-concessional windows⁸, the turn to securitization would allow donor countries to scale back their official development support for MDBs and subsequently incentivise MDBs to increasingly focus on private sector loans financed via securitization and other capital market instruments. The turn to non-concessional is implicit in the G20 (2015) call to increase "the risk-bearing capacity by the MDBs".

Mission drift: securitization would shift MDB lending priorities from concessional loans to high-risk commercial loans to the private sector if ambitions to scale up private finance investments are to be realised.

True sale securitization: scale or incentives?

True sale securitization would in theory allow MDBs to achieve the scale necessary to mobilize the trillions of institutional investors (see Table 3 on the following page). Typically, true sale securitization occurs for funding purposes. Once legal frameworks are adapted, MDBs could, individually or collectively, sell their private sector loans to an SPV, which in turn would issue several tranches to pay for the underlying loans. These tranches would receive different credit ratings, and be marketed to investors with different risk profiles. De-risking works both for MDB balance sheets and for institutional investors.

⁸ Member countries increase their 'callable capital' contributions in order to allow the MDBs to increase market financing (see Nelson, 2018).

Table 3. True sale vs. synthetic securitization

	True securitization	Synthetic securitization
Purpose	Funding and capital relief	Regulatory capital relief
Underlying loans	Sold to special purpose vehicle (SPV)	Remain on balance sheet of originator, who buys credit protection for a/ several tranches
Ownership of assets (loans)	SPV	Originating bank
Mechanism for risk transfer	*Ownership of underlying exposures with SPV and tranching *mechanisms of support from originator for SPV	Balance sheet securitization vs arbitrage synthetic
Payment flows for issuer	SPV passes cash flows from underlying assets to investors according to tranche hierarchy	Originator compensates investors for assuming the credit risk of one/ several tranches
Leverage	Generates additional leverage	Balance sheet sec: introduces leverage in the originator's balance sheet, as capital requirements are reduced without commensurate reduction in securitized exposures
Investors	Purchase rated tranches according to risk appetite	Sell credit protection to originators (MDBs)
Risks for originators	SPV failure	Effectiveness of credit risk transfer depends on the creditworthiness of the protection seller
Developmental risks	Financial performance versus developmental impact	Financial performance versus developmental impact

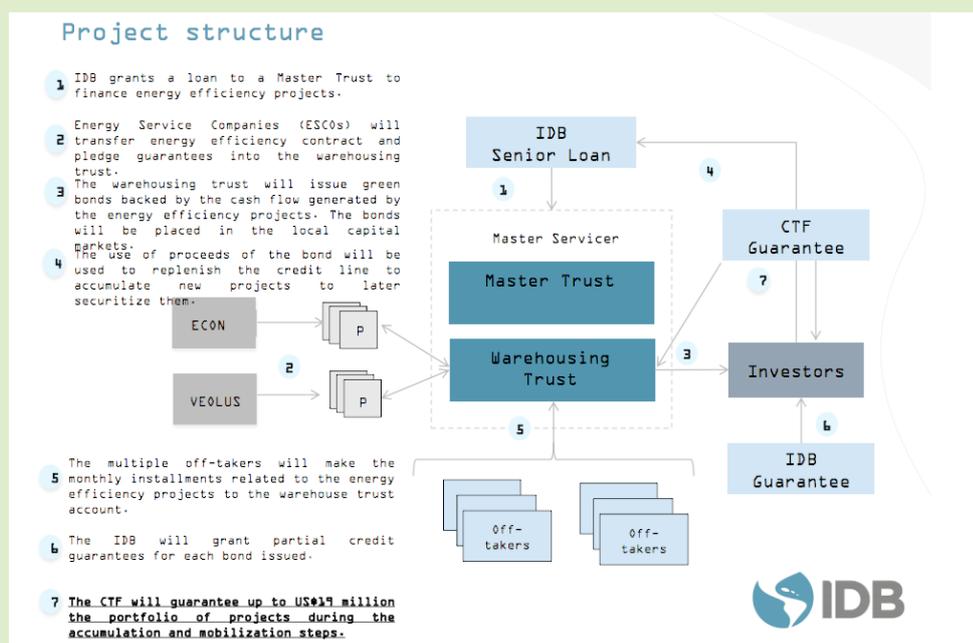
For instance, a pool of MDB private sector loans would be transferred to an SPV. The SPV issues three tranches worth USD 100 million to fund that acquisition. The senior tranche, rated A, is worth USD 60 million, the mezzanine tranche, rated B, is worth USD 30 million and junior tranche, rated C, is worth USD 10 million. The transaction documents specify that as loans are repaid by borrowers, the proceeds (cash) are first used to pay the owners of the A tranche, then the owners of tranche B, and finally the owners of the junior tranche C. By ordering the transfer of the underlying debt service, the junior tranche takes the first loss on the pool (that is, any losses up to and including 10 percent would result in holders of the junior tranche losing out without affecting the mezzanine and senior tranche investors). Losses in the pool between 10 and 30 percent would affect the holders of the B mezzanine tranche, and the holders of the senior tranche would be affected once 40 percent of the entire pool is experiencing defaults. Because the senior tranche has less risk attached than the junior tranche, it will pay less yield to holders.

The legal and administrative steps can pose significant costs. The MDB would have to sell and transfer, in an insolvency-proof manner, the underlying loans and associated collateral; it would also have to enter an administration agreement with the SPV to collect interest payments. MDBs may have to provide liquidity and credit support to the SPV to protect against fluctuations in the cash flow and deterioration in the pool of underlying loans/assets.

Consider the experience of the Inter-American Development Bank (IDB) with Green asset-backed securities. In 2015, the IDB announced plans to support the issuance of energy efficient asset-backed securities under its *Scaling Up Capital Markets Solution for Financing Energy Efficiency in LAC* program, approved by its Board in 2015. This involves a two-step financing mechanism: (1) *Accumulation*: IDB provides up to USD 50 billion loans to SPV that accumulates loans for Energy Service Companies (ESCOs) operating in Mexico, for energy efficiency projects (2) *Mobilize*: IDB provides guarantees for junior tranches in order to align risk-return profiles with investors' appetite, for an overall issuance of MXN 700 million of 8-year asset-backed securities. The IDB would thus use true-sale securitization to mobilise capital markets financing for energy efficiency projects that were not funded by local Mexican banks and institutional investors (see Figure 4). Furthermore, the IDB would monitor the environment and social impacts and risks (IDB, 2016).

By mid 2019, no asset-backed securities had been issued. The IDB explained the limited success of the Accumulation phase through drops in electricity prices and the devaluation of the Mexican peso (IDB, 2017) that creates currency risk exposure for (foreign) investors. While the exact terms of the ESCO loans are not publicly available, the lesson is that MDB involvement in true securitization of green projects in developing and emerging countries (DECs) requires significant own or public resources to mitigate demand fluctuations and meet the risk-return profiles of institutional investors. This is precisely what the World Bank Group's *MFD* agenda aims to achieve, by committing MDB and public resources to de-risking.

Figure 4. IDB plans for securitizing energy efficiency projects



Source: IDB (2017)

The downside of true-sale securitization is the alignment of incentives with the MDBs mandate (Humphrey 2018). True securitization is attractive because it provides funding and capital relief, that is, it typically accommodates highly leveraged, aggressive expansion business models in private finance. True sale securitization fundamentally engenders the perverse incentives of the “originate to distribute” model that prevailed in the United States before the Lehman Brothers, that is, incentives to generate securitizable loans and move them off balance sheet. This model saw commercial banks and shadow banks aggressively extending mortgage (and other) loans with limited due diligence since they were assuming no risk once the loans were transferred to the SPV. Similar incentives may be at play for MDBs, particularly when these are guided by the imperative of selling development finance to the market.

The mission drift would likely accelerate were MDBs to follow the IFC’s Managed Co-Lending Portfolio Program. If MDBs would allow investors to pick and choose the assets they want, as it occurs with IFC, this might put in place behavioural incentives for MDBs to extend the kind of loans that meet the sectoral or financial criteria of private investors, without a clear framework for ensuring developmental outcomes.

To avoid such detrimental outcomes, MDBs may want to follow the practice of European Union regulators. After the collapse of Lehman Brothers, regulators there identified the revival of securitization markets as an important initiative to connect institutional investors to borrowers. Critically, regulators put in place a clearly defined set of rules for simple, transparent and standardized securitization that enjoys regulatory benefits, including risk retention rules for originators that mandate originators to retain a share of the credit risk of the securitized

products. MDBs could mirror the Simple, Transparent and Standardized process by defining what SDG securitization means, and the retention rules that would align closer the interests of originators (MDBs) with the investors (see Finance Watch 2015) – say a 20 percent vertical retention rule that mandates MDBs to retain 20 percent of each securitization tranche. This would ensure that MDBs can continuously monitor SDG tranches for compliance with safeguards or other sustainability criteria.

Synthetic securitization: high-risk assets

Synthetic securitization would circumvent some of the downsides and perverse incentives associated with transferring loans off-balance sheet. MDBs would engage in synthetic securitization as originators, *buying credit protection* from investors (*credit protection sellers*). Through synthetic securitization, MDBs can transfer the credit risk associated with a tranche of their loan portfolio with the aim of receiving regulatory capital relief. Loans remain on the balance sheet of the MDBs, and a part of the associated cash flows is paid to the investors willing to assume the credit risk. The MDB takes protection against loan default. Critically, synthetic securitization does not generate *funding* for MDBs.

Synthetic securitization can take two forms: balance sheet and arbitrage synthetics. Balance sheet synthetics provide MDBs with credit risk protection for a tranche of loans that *remain* on balance sheet. In contrast, arbitrage synthetics do not require the originator to own the underlying loans. Rather, the two parties engage in complex financial engineering to create bets on default of the underlying loan. It allows financial institutions to create an unlimited number of bets and securitizations referencing specific loans. As Finance Watch (2015, p. 4)

puts it, arbitrage synthetics “are equivalent to letting all your neighbours buy a fire insurance policy on your house. Not only might it give the wrong incentives, but it also dramatically amplifies the financial impact of your house burning, just as synthetic securitizations enabled the creation of many more subprime loan securities than there were subprime loans”. Arbitrage synthetics are bets that amplify market cycles.

The African Development Bank’s (AfDB) Room2Run Synthetic Securitization

The most exalted accounts described Room2Run as follows, “AfDB has announced the securing of USD 1 billion to enable investment in infrastructure development across the African continent” (Amaefule, 2018). This is misleading. The deal does not secure any funding for AfDB. Instead it generates significant interest rate costs to achieve capital relief.

The Room2Run deal works as follows. The AfDB pooled together USD 1 billion of its non-sovereign loans with an average rating of B+, denominated in a variety of African currencies along euros and dollars, with an average maturity of 6 years. This is half of the AfDB’s USD 2 billion portfolio of outstanding loans to the private sector. The underlying portfolio comprises around 40 loans to power, transport, manufacturing and finance projects.

The average size of the loans in the AfDB pool is USD 25 million, suggesting that MDBs securitization will likely require large “bankable” projects.

Mizuho, the structuring bank, then created four different tranches: an USD 20 million equity tranche, a mezzanine tranche worth USD 152.5 million, a senior mezzanine tranche worth USD 100 million, and a senior tranche worth USD 727.5 million. It then agreed with Mariner Investment and Africa50⁹ that the latter would assume the risk of default for the mezzanine tranche, and with the European Commission that it would guarantee the senior mezzanine tranche.

The AfDB pays Mariner Investment & A50 an interest rate of at least 10 percent on the mezzanine tranche, and a very low rate to the European Commission for guaranteeing the senior mezzanine. As protection against the risk that Mariner & A50 defaults during the life of the contract, Mariner & A50 agreed to provide cash collateral worth USD 152.5 million. In return, the AfDB pays interest on this cash collateral, set at 3 months USD Libor. Throughout the life of this synthetic security, the AfDB pays at least 13 percent interest rate (the credit protection rate and interest on cash collateral) to Mariner. It would recover some of the interest costs by lending the cash collateral. It also pays Mizuho for the costs of structuring (undisclosed). In exchange, the senior tranche is rated A- (by Standards and Poor). Effectively, AfDB pays Mariner Investment & A50 around USD 100 million for capital relief via ratings “upgrade”.

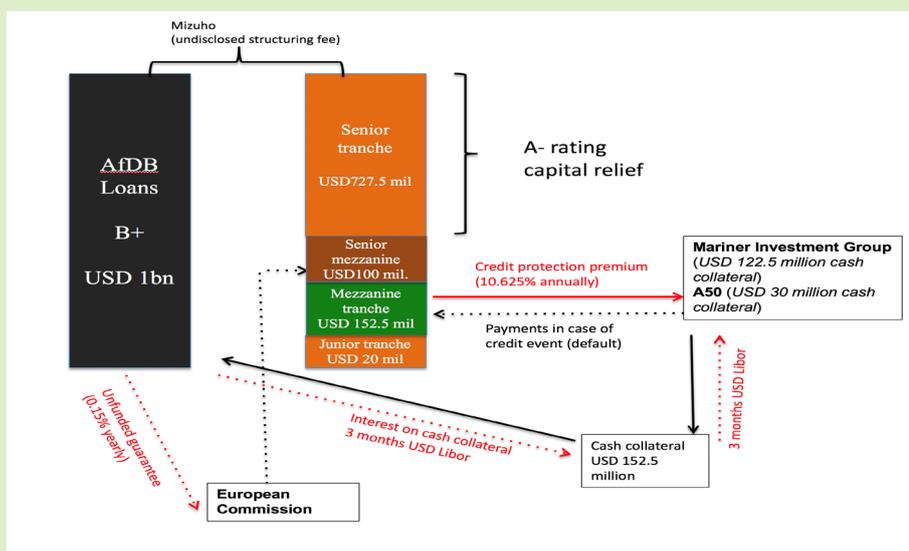
The distinctiveness for MDBs’ synthetic securitizations is that MDBs enjoy Preferred Creditor Status, and are therefore in a privileged position to recover losses. The Room2Run deal does not specify the conditions under which the AfDB could trigger default on Environmental and Social Framework (E&S) criteria.

The AfDB has its own framework for assessing E&S risks. It provides a template for borrowers to draft E&S risk assessment, on the basis of which loans conditions and covenants are agreed (AfDB 2011).

Projects are then classified into categories, including those with important adverse and irreversible E&S impact (Category 1) to detrimental but manageable E&S impact (Category 2). The Room2Run deal does not specify the number of Project 1 and 2 types in the securitization portfolio.

Does this deal place the AfDB in a position of conflict of not wanting to call default on a loan in the securitization pool due to borrower’s breach of E&S safeguards? In theory, it does not. The AfDB remains in control of the underlying assets, and can dispose of these as it wishes.

Figure 5. The Room 2 Run Synthetic securitization deal



Source: own elaboration

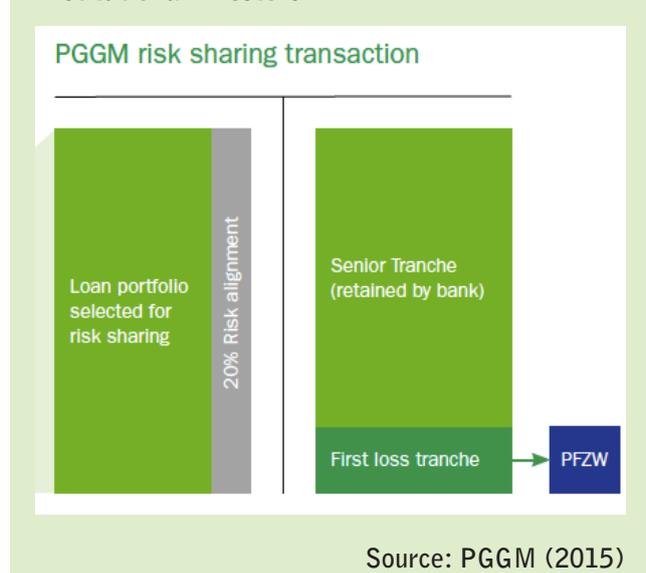
⁹ Africa50 is an infrastructure investment platform that seeks to accelerate the emergence of bankable projects, catalysing public sector capital, and mobilizing private sector funding. A50 is designed as an independent infrastructure fund that focuses on high-impact national and regional projects, mostly in the energy and transport sectors, with a particular emphasis on increasing the pipeline of investment-ready projects.

Credit protection in the *Room2Run* structure works like this: assume a USD 25 million loan defaulting on E&S criteria is the first in the securitization reference portfolio. AfDB absorbs the first USD 20 million of losses (the equity tranche, or 2 percent of the overall USD 1 billion reference portfolio), and will be compensated on the remaining USD 5 million by the investor, Mariner Investment. If this is not the first loan to default, Mariner would compensate AfDB for the entire USD 25 million losses. However, this requires that AfDB calls default on E&S basis. Unless this default is specified in the securitization contract – unclear from the public information available – it is unlikely that the investor would accept the breach of E&S safeguards as default event. The incentives, particularly since these are large loans, would be for AfDB to avoid triggering E&S default.

Notice the complex ecology of public and private actors necessary to make this deal viable. It involved a financial institution with high risk appetite, guarantees from an official actor (the European Commission) and a structuring bank (Mizuho). It failed to involve directly the class of investors that is central to the *MFD* narrative – patient institutional investors. One such investor (P+ Pension) that administers the funds of two Danish occupational pension schemes, reportedly dropped out because the return offered by the AfDB did not match its expectations, raising critical questions about the costs of de-risking for long-term institutional investors.

The experience of European institutional investors provides some insights into the conditions that long-term investors typically require. Compare the AfDB deal with the model of the Dutch pension fund company PGGM (2015), the first institutional investor in Europe to be involved in synthetic securitization, and still the largest institutional investor in the synthetic securitization market. PGGM has a mandate to invest 2.5 percent of the assets it manages on behalf of pension funds in synthetic securitization. PGGM typically invests in the first loss tranche, in contrast to the AfDB deal where the hedge fund sold credit protection on the mezzanine tranche.

Figure 6. Synthetic securitization practices of institutional investors



Given the structural complexity of synthetic securitization, PGGM requires the following conditions to be met:

- long-term partnership with the originating bank that allows them to closely monitor the loans subject to synthetic securitization;
- that these loans reflect bank's core business in which the bank has a significant market position;
- the cash collateral it provides to be held with custodian and invested in highly rated short-term securities such as government bonds;
- strong alignment of interests whereby the bank holds at least 20 percent exposure to the same credit risk. With this, both PGGM and the bank are exposed to the risks of default in the pool.

To attract patient institutional investors, MDBs may have to develop long-term partnerships ridden with two sets of potential conflicts between (i) enforcing safeguard policies and prioritizing the financial performance of the underlying assets and (ii) MDB's environmental & social frameworks and the ESG approach of institutional investors with long-term horizons, who require specifically-tailored synthetic securitization deals (see chapter 4).

3.2 MDB support for (shadow) banks' securitization

With the exception of a few middle-income countries (India, Indonesia, China, see next section) with local capital markets, commercial banks in low and middle-income countries have little if any experience with securitization. Given the growing financialization of banking activity in these countries, loan portfolios are concentrated in housing, consumer and auto markets. These banks do not extend the long-term infrastructure or other large-scale loans on a sufficient scale to create the volume that would justify costs and align with the portfolio practices of local and foreign institutional investors. In turn, global banks often invoke the new Basel III rules on liquidity and leverage, rules seeking to contain their capital markets activities, to explain why MDB supported securitization would increase banks' ability to extend infrastructure loans.

MDB efforts, it is argued, could be directed towards encouraging *local* banks to securitize their loans. These could target credibly green activities – as for instance defined by the OECD Green Growth strategy, including energy-efficient projects, renewable energy, renewable energy, carbon capture and storage, nuclear power, smart grids and electricity demand side-management technology, new transport technologies (electric vehicles), floodplain levees and coastal protection, sustainable agriculture and water infrastructure. For this approach to achieve scale, it would require a significant change in banks' business models, and significant MDB resources deployed for de-risking.

For instance, the International Finance Corporation (IFC) recently helped scale up renewable portfolios by de-risking loans made by Chinese banks to finance the implementation of energy efficiency improvements and

renewable energy projects (the CHUEE program). Since over half of the IFC projects are in the financial intermediary sector, MDBs could adopt the IFC’s business model (again raising questions of mission drift).

MDBs could also support the securitization activities of global banks or shadow banks with significant exposures to emerging and low income countries (see Humphrey 2018). For instance, the IFC provided a USD 90 million guarantee to Credit Agricole’s synthetic securitization of private loans to emerging countries. The MDBs have other modalities of supporting securitization: (a) partial guarantees on the senior/mezzanine tranche, (b) partial guarantee on the underlying assets, or (c) outright purchase of mezzanine or senior tranche of securitization (IFC 2017).

The MDBs support for local or global banks’ securitization efforts mirrors the IFC’s Managed Co-Lending Portfolio Program (MCPPI). The MCPPI is a new development financing initiative through which the IFC offers its balance sheet as a vehicle for connecting institutional investors¹⁰ with emerging or poor country borrowers. The MCPPI investors agree with IFC on a loan portfolio that they invest in through structures similar to an index fund. The MCPPI has three large components, the MCPPI Trust Funds for sovereign investors (SAFE, HKMA), a dedicated MCPPI Infrastructure facility (by 2019, a third of the overall MCPPI portfolio), and MCPPI Financial Institutions, targeting developing countries’ banks. These relationships are organised around *de-risking* for institutional investors: for instance, global insurance companies take credit risk for a part of the MCPPI portfolio (IFC 2018), allowing the IFC in turn to expand lending capacity.

Another, more recent initiative is the AIIB Infrastructure Private Capital Mobilization Platform. The Platform will:

“purchase infrastructure loans from financial institutions and distribute them to institutional investors through securitization or other formats. This will support private capital mobilization and builds infrastructure as an asset class. The purchase of such loans is predicated on the hypothesis that

financial institutions that currently originate and hold such loans to maturity will increasingly be constrained from doing so with the advent of Basel III regulations” (AIIB 2019).

Through securitization, the AIIB would help banks recycle their infrastructure loans into new investable securities for institutional investors. Securitization is particularly important in Asian jurisdictions, the AIIB claims, as “institutional investors typically do not invest directly in infrastructure loans as they are bespoke in nature, illiquid and are, for the most part, domiciled in sub-investment grade jurisdictions”. AIIB would rely on securitization to de-risk infrastructure investment in countries with lower credit ratings.

MDBs would have to clearly define the process for monitoring banks and shadow banks for substantial business activities with potential significant adverse ESG risks and sustainability effects that are diverse, irreversible, or unprecedented.

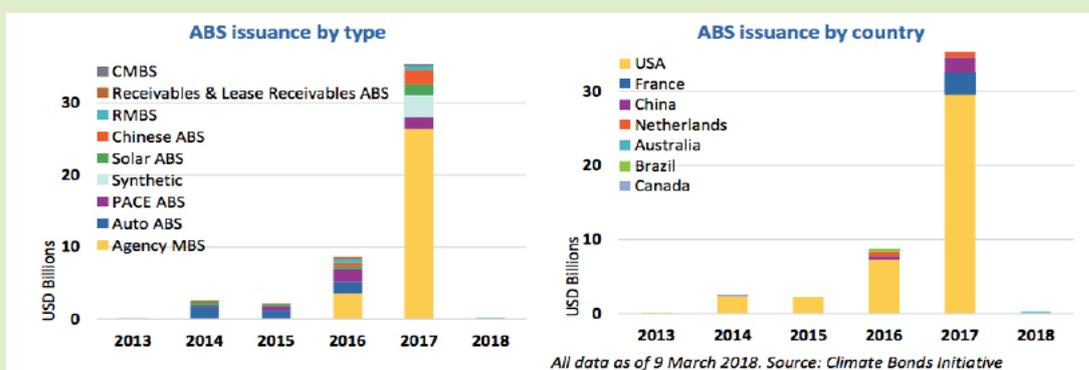
The experience of the IFC, the AIIB and of other MDBs with financial intermediaries’ portfolios is instructive in this respect and will be explored in depth in chapter 4.

3.3 Country level securitization: from low-carbon to infrastructure securitization

In both the United States and Europe, it is widely expected that the issuance of asset-backed securities will significantly increase. The OECD has stated that a third of the outstanding low-carbon bonds sector could be asset-backed securities by 2035 (TMF Group 2018).

Data from the Climate Bonds Initiative suggests that green securitization issuance has rapidly increased in volumes, albeit still on a small scale compared to the ambitions to capture the trillions of institutional investors. The underlying asset pool includes mortgages on certified buildings, mortgage financing for energy efficiency upgrades, loans/leases on electric vehicles and hybrids, loans/leases on solar and wind assets, loans/leases on

Figure 7. Green asset-backed securities issuance by underlying pool and country of issuance



¹⁰ IFC first partnered with China’s State Administration of Foreign Exchange sovereign wealth-type fund. The MCPPI partners in April 2019 included several global institutional investors (Allianz Global Investors, AXA, Eastspring Investments, Hong Kong Monetary Authority, Liberty Specialty Markets, Munich Re, Swiss Re (see IFC 2017).

equipment, e.g. electric vehicle charging stations, loans for energy efficiency improvements and loans to green small and medium-sized enterprises (see Figure 5). The largest issuer so far, the US government agencies Fannie Mae and Freddie Mac purchase a significant volume of mortgage pools from originating lenders and refinance them in the mortgage-backed securities market. Fannie Mae's Multifamily Green Initiative Program targets mortgages to certified low-carbon buildings and financing for energy and water efficiency improvements of at least 20 percent. Notably, China is the first country to issue a green commercial mortgage backed securities, a three-tranche deal secured on a LEED Gold certified office building owned by China Energy Conservation and Environmental Protection Group.

The Sustainable Finance Study Group report to the Argentinian presidency of the G20 called for securitizing "sustainable assets" in both high-income and DECs. It noted that local currency bond markets are growing in emerging countries, and could provide long-term financing to sustainable infrastructure and other low-carbon sectors. It advises G20 countries to promote *sustainability-targeting collateralised loan obligation (CLO) bonds* issued by a CLO vehicle. Asset managers would issue sustainability-targeting bonds to purchase sustainable loans, manage the loans and pay the bond coupon with proceeds from the pool of loans. A CLO would purchase sustainable debt directly from banks, involving a true sale and a reduction of risk exposure from the banks' balance sheet.

Beyond these relatively small-scale issuances targeting green sectors, MDBs are increasingly promoting the securitization of infrastructure loans. For instance, the Asian Development Bank (Romero-Torres, Bhatia, and Sural 2017) and the AIIB (Passi 2018)¹¹ have sought to "create depth in domestic debt and capital markets", that is, to provide a range of financial services that can support local banks' and shadow banks' infrastructure backed securitization. These include currency instruments (fx swaps that can provide foreign investors local currency to purchase infrastructure-backed securities), loans in local currency that could fund securitisable assets, and refinancing of infrastructure assets (AIIB 2018). Put differently, the AIIB is proposing to help build the "plumbing" for infrastructure-backed securitization by deeply changing the financial structure of emerging and poor countries. For instance, the first objective of the AIIB's Infrastructure Private Capital Mobilization Platform is to help develop infrastructure capital markets as an asset class through the creation of investable debt securities (AIIB 2019a). In so doing, the AIIB is paving the way for a the G20 objectives to promote sustainable assets for capital markets.

The G20 *Infrastructure as an Asset Class* sets out "policies, frameworks and mechanisms to increase investment, including through initiatives such as the high-level principles on long term investment financing by institutional investors; investment strategies; the guidance note on diversification of instruments and incentives for infrastructure financing; and the principles of corporate governance" (G20 2018, p. 2). These plans, outlined in

the "Roadmap to Infrastructure as an Asset Class" or in the Eminent Persons Group proposals, and supported by MDBs, central banks and international financial institutions, envisage that securitization could effectively crowd-in institutional investors.

It is easy to underestimate the structural implications of the G20 sustainable infrastructure agenda. At first sight, it appears similar to the MDBs' securitization of their loans. But the G20 agenda goes beyond promoting changes in the laws governing DEC's securitization markets. It promotes structural reform for local financial systems: a wholesale re-organisation that would accommodate the investment practices of global institutional investors. This is a project of policy engineering a shift from traditional bank-based to market-based financial system. It seeks to accelerate the global diffusion of the architecture of the US securities markets, securities financing markets (repurchase markets) and derivative markets (see Gabor 2018).

The starting point is that most emerging and low-income countries face a series of constraints to securitization, including "the need to establish a legal/regulatory framework, upfront costs, shallow local capital markets and small portfolio sizes" (OECD 2018a). The *Roadmap for Infrastructure as an Asset Class* proposes to remedy these issues via three pillars: Improved Project Development, Improved Investment Environment and Promoting Greater Standardization. These together encourage countries to policy-engineer a shift of their financial systems towards securities markets-based finance, where securitization of capital-intensive (green) infrastructure projects can attract foreign and local institutional demand. The Improved Investment Environment Pillar identifies three work streams: Financial Engineering, Risk Allocation and Mitigation, Regulatory Frameworks and Capital Markets, and Quality Infrastructure.

These work streams seek to transport the market architectures for producing liquid capital (securities) markets from high-income countries, in particular the US (Gabor 2018). Global institutional investors' demand for "sustainable" infrastructure-backed securities depends on their ability to (a) hedge currency risk via currency markets; (b) finance and hedge securities positions via repo and derivative markets designed according to the legal framework of high-income countries, (c) exit securities positions by selling in liquid markets.

The ambition of the Infrastructure as an Asset Class agenda, closely aligned with the Cascade Approach of the World Bank, is to re-organise developing countries' financial systems from bank-based to capital-markets based models.

At the forefront of such initiatives, Indonesia introduced an ambitious investment in infrastructure agenda that has dedicated between 15-20 percent of annual budgets to investment in infrastructure between 2015 and 2020. Additionally, it encourages state-owned companies to turn to securitization in order to finance this ambitious expansion plan. Jasa Marga, the state-controlled toll road operator (operating around 70 percent of toll roads in Indonesia), state-owned electricity company PLN and

¹¹ AIIB approved 31 infrastructure development projects in 18 countries worth USD 6.3 billion since 2016.

state-owned lender PT Bank Tabungan Negara all made recourse to securitization since 2017.

“We can’t just sit back and wait for people to come because competition to attract capital flows is ferocious Everything from toll roads to power plants to airports to ports should be securitized to capital markets”

(Tomas Lembong in Silviana and Danubrata 2017)

In order to win the competition for capital flows, Indonesia aligned its securities financing markets framework with international standards (ADB 2017) – and in so doing, it opened up its economy to new sources of financial instability (see Chapter 5).

Equally important, the turn to securitization at country level has been energized by geopolitical considerations.

4. SECURITIZATION AND ACCOUNTABILITY: DILUTING SUSTAINABILITY COMMITMENTS?

It is often claimed that the growing reliance on private finance in international development can accelerate the achievement of the SDGs. This is a partnership between institutional investors that are increasingly mainstreaming ESG risks in their frameworks, and public authorities. As one of the largest global institutional investors, PIMCO, put it:

“SDGs are exciting interest and passion as an overarching ESG framework that can guide investments to achieve returns while delivering positive societal impact. To be sure, the 17 SDGs [...] can be seen as a comprehensive and thorough elaboration of ESG, with the added benefit of targets and even indicators [...] The long-term nature of the SDGs – with its arc to 2030 – and the fact that much of the financing, especially on the sovereign side (but not only), will need to relate to long-horizon social and environmental projects and investment means that debt instruments could be ideally suited.”

(Amey and Power 2018)

Would securitization succeed in incorporating sustainability concerns? Institutional investors such as PIMCO seem to believe so, as long as there is a voluntary move towards ESG frameworks guided by the SDGs.

Sustainability in securitization will be determined in part by sustainability quality of the underlying assets that are pooled together. Sustainability will be also determined by the degree of external/societal impacts from the basic structure and the characteristics of securitization, be it true sale or synthetic.

One straightforward approach would be the securitization of low-carbon assets, as proposed in the OECD work of low-carbon infrastructure or the G20’s Sustainable Finance Working Group. But the ambitions of the *Billions to Trillions* agenda would not materialize given the small

China announced that it would join the global race to securitize infrastructure loans to solve the Belt and Road financing gap over the next five years (Liu and Ng 2018). The Hong Kong Mortgage Corporation has been mandated to pool infrastructure loans – such as those extended by the China Development Bank - and channel funds into China’s Belt and Road Initiative. Concerns about China’s growing geopolitical influence also prompted the Trump administration to approve a new bipartisan push to increase US foreign aid into infrastructure projects (Thrush 2018). The geopolitical struggle over the Global South (broadly defined) will also be fought on the terrain of securitization markets, with little scope for scrutiny and accountability from other developmental actors.

pace of low-carbon assets generation. There are three alternative pathways for capturing the sustainability quality of assets to be securitized: (a) private ESG ratings, (b) “public-private” ESG ratings designed by MDBs together with private finance or (c) the MDBs’ own Environmental and Social Frameworks.

4.1 Sustainability via private ESG ratings

The recent global embrace of securitization rests on bold claims about sustainability in private finance. For instance, the G20’s Sustainable Finance Working Group cites statistics from the 2016 biennial Report that estimates that USD 23 trillion of assets are professionally managed globally under sustainable investment strategies, a 25 percent increase from 2014 estimates. The sustainability impact is measured through ESG criteria.

ESG criteria is likely to become the norm in sustainability-oriented securitization, with or without the direct involvement of the MDBs in the process of creating sustainable asset backed securities.

In the case of MDB support for local/global banks’ securitization and in the case of private securitization oriented to sustainability, it is likely that the underlying assets would be chose through some kind of private ESG screen. For MDBs’ synthetic securitization of own portfolios, it is likely that MDBs would have to develop long-term partnerships with patient institutional investors. Since these typically require specifically-tailored synthetic securitization deals, it is likely that MDBs would have to accommodate the ESG framework of those investors. The World Bank has already taken steps in this direction by introducing “borrowers” framework’ and risk-based management in

its revised Environmental and Social safeguards policies.

The “ESG evangelism” at the core of the global policy agenda downplays the fickleness of this indicator, and the potential for SDG-washing inherent in the private and this far unregulated provision of ESG frameworks. There are several issues that amplify the potential for sustainability washing: ill-fitting ESG criteria for fixed income securities such as asset-backed securities or infrastructure bonds, lack of ESG universality, the misalignments between SDGs and ESG in terms of sustainable impact, and ensuring ongoing ESG compliance for tranches.

- **ESG criteria for tranches:** the ESG approach is an imperfect fit for securities, including for securitization tranches. While the fixed income universe is significantly larger than equities, the incorporation of ESG criteria is far more complex. Challenges include weaker rights of bondholders compared to shareholders, liquidity and relationship with credit ratings. Indeed, credit rating agencies are beginning to formalise structures that integrate ESG risks in ratings (Thompson 2019).

Perhaps the most important challenge is what Mark Carney, the governor of the Bank of England, described as the “tragedy of the horizon”. Securities mature before ESG risks mature, rendering the quantification of those risks particularly difficult (Inderst and Stuart 2018).

- **Lack of ESG universality:** the assets to be securitized would be chosen through some kind of a green screen or a private ESG screen, neither of which has any universality, and both are inconsistently applied from issuer to issuer. ESG is interpreted narrowly by investors in comparison to the way MDBs deal with ES(G). ESG screens give signals to the market players – the issuers and buyers- all of whom have strong incentives to deceive themselves that they are buying into sustainability, in the same way that investors “bought” into the AAA-rated awarded to tranches of securitised subprime mortgages. The implication is that MDBs, country authorities and investors could easily shop around private providers to purchase the highest ESG rating for assets into the “sustainable” securitization pool.

The historical experience of green bonds suggests that the trade-offs between achieving scale (market depth) and enforcing strict criteria will also be relevant for sustainability-targeting securitization. The ambitions of rapidly tapping into the trillions of institutional investors, combined with the sense of urgent action necessary to address climate change, raise concerns that regulators and the (finance)

industry may collude on ESG shopping/SDG washing. Such questions are often asked about the industry-led Green Bond Principles developed by the International Capital Markets Association together with market participants, principles to which most MDBs – including the IFC – subscribe (IFC 2017).¹²

- **ESG not easily mapped onto SDG:** institutional investors assume that ESG can adequately capture the relevant aspects of sustainability. For instance, E3G (2018) argues that institutional sustainability should be a critical component of any sustainable infrastructure agendas, as it captures the importance of “robust institutional capacity and clearly defined procedures for project planning”. This would ensure long-term planning that explicitly incorporates safeguards and performance criteria upstream (earlier in the project cycle). Similarly, ESG ratings do not account for the social impact of securitization that involve the privatization/PPP provision of public services necessary to generate cash-flows for buyers (institutional investors) of securities.
- **Ongoing ESG compliance:** after issuance, it is important that securitization tranches are monitored for deteriorating ESG performance. Assuming a robust ESG framework, securitization that is strictly guided by sustainability concerns would additionally involve:
 - borrowers have instruments to report ESG ratings on a regular basis, and that a threshold rating is agreed for ESG default
 - for true-sale securitization, that tranches have clearly specified mechanics of enforcing ESG responsibility
 - a transparent default mechanism that spells out who has access to the asset in case of default, and how ESG criteria would continue to be enforced
 - that financial considerations (cash flow) do not take precedent over sustainability considerations in the underlying pool
 - that financial instability risks are minimized by strong retention rules

MDBs would have to clearly define the process for monitoring banks and shadow banks for substantial business activities with potential significant adverse ESG risks and sustainability effects that are diverse, irreversible, or unprecedented.

The challenge for international development initiatives is to ensure that comprehensive set of criteria combining

¹² For instance, the green bond investment company Affirmative Investment Management described the Climate Bonds Initiative certified green bonds issued by the Chinese state-owned Three Gorges Company as greenwashing. The A+ rated green bonds meet the Climate Bonds Standard Wind Criteria, and CTG has also complied with other requirements from the Climate Bonds Standard on project selection and evaluation process, use/management of proceeds, and regular reporting. While CTG plans to allocate proceeds from the bonds to two power projects (offshore wind project in Germany and onshore wind farms in Portugal), the CTG Dam has been identified as a significant threat to biodiversity and environmental sustainability in China. Similarly, Poland was the first sovereign to issue green bonds in 2016, with a second issuance in 2018, although its national energy strategy is focused on an increasing role for coal.

environmental, social and governance concerns under the umbrella of measurable “developmental impact” can be enforced without prioritising the development of financial instruments that meet the profitability requirements of institutional investors and support SDG-washing.

One corrective solution would be for global regulators to agree on a public ESG scoring methodology/sustainable finance taxonomy, as for instance that currently developed by the European Commission, and to institutionalize it across the MDB universe. In this public-only scenario, two questions remain: the relevant aspects of sustainability and the particular challenges of enforcing sustainability criteria in securitization.

4.2 Private-Public Partnerships for ESG frameworks: the case of AIIB

The AIIB approved an *Infrastructure Private Capital Mobilization Platform* in June 2019. Over five years, it will provide USD 54 million of equity capital to the platform, to complement another USD 126 million financing from other investors. The Platform will purchase infrastructure loans for securitization, with a threefold objective: develop infrastructure capital markets as an asset class for institutional investors, mobilize new pool of institutional capital for Asian infrastructure, and support the recycling of infrastructure loans for banks constrained by new Basel III rules. The platform promises to gradually develop environmentally and socially “sustainable” securitizations or equivalent as a new asset class.

Sustainability is understood and approached in this infrastructure as an asset class project through a “public-private” ESG framework. This will replace the AIIB’s Environmental and Social framework used for project loans, although it intends to continue following its spirit. The AIIB (2019b) claims that an ESG framework is better for the following reasons:

- **The Environmental and Social Framework is not fit for application to securities markets** - although it fails to mention that neither are ESG ratings, as the World Bank recognizes (Inderst and Stuart 2018).
- **The management of environmental and social risks for loans to be purchased in secondary markets for securitization is “only feasible” through an ESG framework** – although it fails to mention the reasons for this, particularly since AIIB envisages the purchase of loans to projects that have already reached completion
- **An ESG framework would provide the kind of transparency that institutional investors require to scale up this new asset class** – although it fails to consider instruments for resolving potential inconsistencies between the AIIB ESG framework and investors’ in-house ESG metrics.

This last reason illustrates well the political economy of sustainability metrics: MDBs may be pressured to accommodate the preferences of institutional investors without paying due considerations to questions of sustainability washing.

Indeed, the AIIB is the forefront of private-public partnerships for ESG frameworks. Its *Asia ESG Enhanced Credit Managed Portfolio* seeks to launch an ESG Markets Initiative in partnership with an appointed asset manager, to demonstrate “an AIIB ESG Framework that is consistent with the spirit and vision of the AIIB’s Environmental and Social Framework” (AIIB 2019b, p. 3). It proposes product and norms-based exclusion, and an ESG assessment that may include controversies screening based on third-party data services, internal socially responsible investing score based on third-party ESG data and Internal ESG risk score, that ‘reflects the potential for ESG risks to lead to financial impacts’.

Put differently, the AIIB ESG framework puts private ESG ratings at its core, and a private asset manager in the driving seat for designing, monitoring and enforcing ESG criteria. The asset manager is tasked with reporting ESG performance on annual basis, and implementing the so-called Escalation Process that specifies the process through which deteriorating ESG performance would lead to exclusion of issuers. Issuers would be “flagged for observation and quarterly review when they have (1) deteriorating ESG performance, or (2) allegations of conduct that may be in violation of international norms, including activities specified in the Product Exclusions”. Issuers will be placed on an AIIB ESG Focus List in the absence of a corrective action plan, and excluded once the manager judges that no progress can be made that there is no “adequate” response or that there are material risks. Without clearly specified thresholds for each of these scenarios, the asset manager has full discretion in the process.

4.3 A MDB ES(G) framework for sustainable securitization?

Alternatively, MDBs could use their own Environmental and Social Frameworks to set the standards on sustainable securitization. This is how green bonds started, issued by the European Investment Bank in 2007, followed by the World Bank in 2008. MDBs promised to integrate environmental concerns in standard financial instruments, thus supporting the financing of climate-friendly projects. Investors, such as the Scandinavian pension funds that were involved in the World Bank’s green bonds, would be able to purchase high-rated bonds that financed projects selected according to World Bank’s environmental and social safeguards, reassured that the World Bank had in place processes for carefully assessing environmental and social risks for projects.

The track record of MDBs is not encouraging. The latest Independent Evaluation Group (2018) monitoring report notices uneven progress on the World Bank’s pledge to strengthen monitoring, evaluation and reporting systems for the E&S framework.

- **No instruments for borrowers to report compliance:** while the Environmental and Social Commitment Plan requires the World Bank to ensure that borrowers monitor environmental and social performance and provide reports on project implementation at least annually, the World Bank has

not provided instruments that do so.

- **No integration of safeguard indicators within the results framework of projects**
- **No guidelines on monitoring and evaluating safeguards performance** in supervision and completion reports, despite World Bank commitments to do so by end of 2011.

Precedents exist where MDBs did indeed terminate loans on sustainability grounds. The Independent Evaluation Group (2018) identified a small number of cases in which the IFC used loan covenants to enforce compliance with environmental and social requirements and reporting, and withdrew from four loans on such grounds since 2010. Yet the turn to securitization would make such practices even more difficult, since the MDBs would effectively have to enforce the default of the underlying assets.

Furthermore, the MDBs record of supporting financial intermediary lending is patchy at best. For instance, the China-led AIIB has committed funds for India's National Investment and Infrastructure Fund, without adequate systems in place to ensure consistency with its Environmental and Social Framework. Such safeguards and transparency throughout all funding levels are critical given that India's National Investment and Infrastructure Fund may revive large infrastructure projects with serious environmental and social risks (Geary and Munshi 2018). Similar critiques have been levelled at the private sector arm of the World Bank Group, the IFC.

The recent reform of the World Bank's *Environmental and Social Framework* opens the door further to SDG-washing because it embraces, rather than clarifies, the ambiguity of private ESG approaches. It may also pave the way for other MDBs to change their environmental safeguards. The new *Environmental and Social Framework* replaces the mandatory environmental and social safeguards with a "risk-based, outcome focused, tailored and proportionate approach". It accepts the use of *borrowers' Environmental and Social Frameworks* that are 'materially' close to the World Bank's own, without clearly defining "materially close" in terms of thresholds, without mechanisms for transparent consultation before approval, without specified mechanisms for monitoring changes in borrowers' frameworks. Furthermore, the World Bank shifted to *adaptive risk management* that replaces pre-project risk assessment before Board approval with "risk-based management" (Oxfam 2015). Both borrowers' frameworks and risk-based management put a *private ESG a la carte* approach at the core of World Bank Group operations.

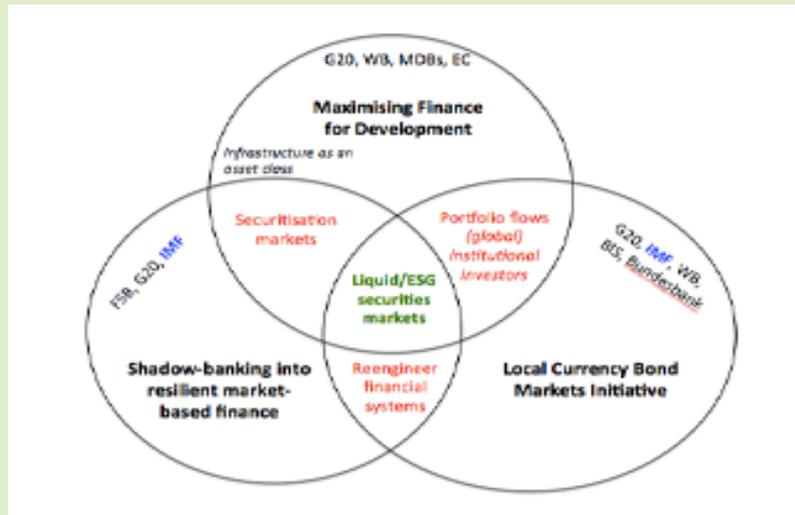
5. THE FINANCIAL STABILITY ASPECTS OF THE SECURITIZATION FOR SUSTAINABILITY PROPOSALS

The turn to securitization as a vehicle for sustainable development requires a change in the structural characteristics of developing countries' financial systems. This involves a shift from bank-dominated financial systems to market-based financial systems where global and domestic institutional investors can easily purchase local securities, including infrastructure-backed securities, finance and hedge their securities positions via repos and derivative markets.

It is important to note that the *MFD* agenda converges with several other global initiatives to restructure financial systems in DECs towards market-based finance, initiatives discussed in G20 and other global policy spaces (see Figure 8). Two are worth mentioning. The Local Currency Bond Market Initiative seeks to encourage the entry of foreign investors – such as global institutional investors – into local currency debt markets of DEC. It was originally introduced under the leadership of the German Central Bank, the Bundesbank, with cooperation from the World Bank and the International Monetary Fund (IMF), at the G8 meeting in Germany in 2007 (G8 2007). For the G8, well-developed local securities markets would reduce dependency on external financing and improve DECs'

ability to withstand volatile capital inflows. While acknowledging capital flow volatility, the ensuing Action Plan called for carefully phasing out capital controls, eliminating first those capital controls that hamstring local securities markets such as withholding taxes on foreign investors' bond earnings (IMF et al 2013). Domestic institutional investors were also to be encouraged, by privatizing pension funds and encouraging the emergence of mutual funds and insurance companies. Similarly, the Financial Stability Board announced in 2015 its new priority, to transform shadow banking into resilient market-based finance, understood as the development of securities, derivatives and repo markets that would allow the real economy to tap credit from institutional investors.

Figure 8. The turn to securities markets in international



Source: own elaboration

The financial stability consequences of re-engineering domestic financial systems towards market-based finance are rarely examined in policy documents celebrating securitization as the instrument of the *Billions to Trillions* agenda.

The securitization of MDB loan portfolios

The securitization of MDB portfolios can take two forms: balance sheet and synthetic. The first generates additional funding for MDBs, the second results in capital relief. The two raise distinctive financial stability issues, rarely discussed in the global policy circles that seek to deploy securitization as an instrument to better structure the risk-return profile demanded by institutional investors. It is important to note here that institutional investors include a wide range of financial institutions with distinctive business models, from pension funds and insurance companies to hedge funds notoriously associated with aggressive risk taking.

The MDBs' turn to synthetic securitization, as illustrated by the AfDB's *Room2Run* deal, raises financial stability issues in as far as the private counterparties selling credit protection may themselves be operating with high-leverage business models.

Indeed, the institutional investor world that the global policy discourse references in the *Billions to Trillions* agenda is composed of investors with distinctive business models: from pension funds to insurance companies to asset managers and hedge funds. Because of their use of securitization, repo and derivative markets, the Financial Stability Board treats these investors as shadow banks. By choosing asset managers or hedge funds counterparties, as the AfDB did, MDBs are effectively promoting fragile business models characteristic to shadow banking. For instance, the Financial Stability Board identified several structural fragilities related to asset managers, linked to leverage and liquidity (FSB 2017). However, there is no global regulatory regime that deals with these structural fragilities.

Beside the issue of counterparties, the MDBs' use of true-sale securitization raises additional financial stability

issues. Consider for example the proposals of the influential *Centre for Global Development* for implementing the *MFD* agenda, entitled "More mobilizing, less lending". While silent on the potential financial stability issues, it proposes an MDB shadow bank (Lee 2018). The MDB private sector windows (PSW) would be upgraded with a special purpose vehicle (SPV), shifting to a new financial model that "facilitates more risk tolerance, increased mobilization of private finance and greater development impact". The SPV arm would be guided by two priorities:

- To support infrastructure and other investable by taking the junior or equity tranche, and moving the senior tranches to global investors
- Early stage projects to support the development of local securities markets (see next section).

For these efforts to be effective, the Center for Global Development calls on MDBs to use their sovereign lending in order to promote "well-targeted policy and institutional reforms that makes projects financially viable and for helping to finance the public share of public-private partnerships" (Lee 2018, p. 3). This may generate conditionality and/or MDB political pressure on low and middle-income countries to put their fiscal resource in the service of the de-risking architecture envisaged by the MFD approach as for example guarantees/subsidies for demand risk or political risk (see Griffith and Romero 2018).

The paper proposes that MDBs' shadow bank (the SPV) play a critical role in re-engineering financial systems around securities markets in low and middle-income countries. The SPV would be an opportunity to "strengthen a culture of openness to innovation and push out the risk tolerance frontier within the PSW as a whole" (Lee 2018, p. 4). Such celebratory rhetoric downplays the systemic vulnerabilities associated with market-based finance (see next section).

Another detail worth considering in the Center for Global Development proposal is the organization of the SPV. One variant could be a single SPV for the entire MDB world, managed by the World Bank given its global mandate, with a global portfolio that would thus multiply the securitizable loans. Another possibility is a private-public SPV, where the MDBs would enter into partnership

with “risk-tolerant impact investors and philanthropists” who would also contribute with “innovations and efficiency gains”. This last scenario is particularly problematic in that it envisages high risk, high leverage financialised investors (with appetite for the junior tranches) as legitimate and entirely beneficial actors in international development. In the process, it exposes the MDB group to the vulnerabilities of the high leverage model of shadow banking.

The securitization of global/local banks loan portfolios

The engineering of securities markets envisaged in the global securitization agenda comes with pressures for DECAs to import the institutional structures for producing liquid securities markets from high-income countries. That ambition is explicitly stated in the World Bank’s (2017, p. 3) documents:

“This approach asks the World Bank Group to help countries maximise their development resources by drawing on private financing ... It also means sustained support at the sector and country level to strengthen the enabling environment for private sector solutions—including in developing domestic capital and financial markets to expand the supply of local currency financing available for development.”

This imposes a structure for generating liquidity that is known to be highly fragile. Central banks in high income countries regularly stress that the repo and derivative markets that the MDBs and G20 view as critical to creating deep capital markets generate cyclical liquidity, and expose countries to fire sales in securities markets and wholesale funding runs (Cunliffe 2015). This new plumbing of securities markets threatens emerging and poor countries with systemic interconnectedness, liquidity risk and pro-cyclical capital flows, potentially undermining the sustainability agenda.

For instance, the IMF and World Bank policy advice on creating local currency bond markets, advice also promoted by the G20 Sustainable Finance Working Group, identified the modernisation of repo markets in emerging and low income countries as immediate priority, to “enhance the money and bond market nexus”. The 2013 Diagnostic Framework identifying the barriers to DEC securities market development provided further detail: “the money market is the starting point to developing [...] fixed income (i.e. securities) markets’, integral to financial stability, and to the emergence of market-makers”¹³(IMF et al. 2013, p. 12).¹⁴

The promotion of “domestic capital markets that are deep and liquid” to support the development of infrastructure as an asset class, and more broadly, to tap into the trillions of institutional investors, appears to be treated as an unequivocally good idea in global policy discourse (see for example the G20 Sustainable Finance Working Group 2018). It can wean poor countries off the dependency on foreign currency debt. Yet the World Bank’s

recipe for engineering liquidity in local securities market, developed together with other international institutions in the Local Currency Bond Market initiative (Gabor 2018), involves the shadow markets (repo and derivative markets) that turned Lehman into a global systemic event. The Cascade’s regulatory reforms and de-risking policies will entrench the kind of financial plumbing that is associated with shadow banking.

Consider India. In a 2016 report (FSB 2016), the Financial Stability Board applauded national regulators for easing repo market restrictions in the effort to create “vibrant secondary market liquidity”. If India wanted to develop local securities markets, it had to redesign repo -securities financing- markets according to “classic” US/European standards (allowing collateral re-use and transfer of legal title) so that foreign investors could easily finance and short securities. The Financial Stability Board extended the same advice to China. Yet elsewhere, the Board’s Mark Carney (2014) warned that:

“Securities financing markets fed boom-bust cycles of liquidity and leverage. Ample liquidity and low volatility drove increasing availability of secured borrowing. That created a self-reinforcing dynamic of more leverage, even greater liquidity, lower volatility and even greater access to secured borrowing.”

In remodelling their financial market plumbing according to the World Bank/Financial Stability Board blueprint, countries render their securities markets more sensitive to global liquidity conditions. They are creating fragile financial structures where fire sales of collateral (Stein 2013), haircuts and liquidity spirals are typical occurrences. The Financial Stability Board’s repo rules and Basel III do not go far enough to contain such dynamics (see Gabor 2018).

Indeed, the celebration of the opportunities that financial globalization creates for poor countries is strangely quiet on its downsides. This is not for lack of research. Elsewhere, the IMF recognizes that financial globalization has generated a global financial cycle (Rey 2015): securities and equity markets across the world, capital flows and credit cycles increasingly move together, all in the shadow of the US dollar. The global financial cycle confronts poor countries with a dilemma, named after the French economist H el ene Rey: there can be either free institutional flows into securities markets or monetary policy independence.

The MFD agenda – *development aid is dead, long-live private finance!* – will make it more difficult for poor countries to choose monetary policy autonomy and actively manage capital flows. In choosing to surrender to the rhythms of the global financial cycle, DECAs surrender their ability to influence domestic credit conditions, and therefore autonomous greening strategies.

¹³ In securities markets, market-makers, usually banks, stand ready to buy and sell, thus making a market in that debt instrument.

¹⁴ Indeed, asset managers have absorbed a growing share of the rapidly expanding DECAs’ local currency securities since 2008 (Feroli et al., 2014). Foreign holdings of DECAs’ local currency bonds doubled from 12.7 percent in 2008 to 30.1 percent in 2015, as DECAs local currency debt increased fourfold to USD 17.2 trillion in that period (Gabor, 2018).

6. WHAT KIND OF DEVELOPMENT WOULD SECURITIZATION FINANCE?

In 2015, international financial institutions alongside G20 announced that a paradigm shift was necessary to achieve the UN-mandated SDGs. The *Billions to Trillions* agenda “is shorthand for the realization that achieving the SDGs will require more than money. It needs a global change of mindsets, approaches and accountabilities to reflect and transform the new reality of a developing world.” (World Bank and IMF 2015, p. 4) The institutions were transparent that the new mind set meant countries should aim for the trillions institutional investors and asset managers. They were less transparent about the overall strategy. Tapping the trillions of global institutional investors requires poor countries to reengineer their financial systems around market-based finance on the terms of those investors and to create investible projects – via de-risking – that can generate returns for those investors.

The turn to securitization would pave the way for the commodification or privatization of public utilities, social and other types of infrastructure. It would further increase pressure for public-private partnership projects, despite extensive critique from civil society organizations and academia (Bayliss and Van Wayenberge 2018). If infrastructure projects are to become bankable, they need to generate predictable cash flows that can in turn be securitized.

Consider for instance the G20 Compact with Africa. It calls on African states to “commercialize” public utilities: “Reforming public utilities and commercializing them will shift their borrowing and performance risks off the public balance sheet, thereby creating fiscal space for non-commercial public infrastructure. It will also help level the playing field for private enterprises, whether in accessing finance, attracting investment, or ensuring the necessary environment for business development. By issuing non-guaranteed debt on domestic markets, state-owned enterprises (SOEs) can scale up finance for public infrastructure and build a domestic constituency supporting financial viability. Another way of introducing commercial discipline and market oversight is through partial stock exchange listings of SOEs, as has been done for the Kenya Power and Light Company.”

(AfDB, IMF and World Bank Group 2017, p. 23)

In principle, there can be positive effects from commercializing public utilities. It would enable these to access international capital markets and transition to disclosure practices and ESG reporting. As ESG reporting goes mainstream, this would help public companies in emerging and low-income countries to tap sustainable financing. However, it is doubtful that public utilities can function on market terms without impeding their ability to supply public goods, particularly in poor countries. For instance, Kenya Power was forced to renegotiate debt covenants in late 2018, due to lower profits and reliance on short-term debt.

Indeed, commercialising public utilities effectively implies imposing and/or hiking user fees at or above cost recovery. In so doing, the *MFD* echoes the structural adjustment era of the IMF and World Bank. Then, the Washington Consensus set of policies advising privatization, stabilization and liberalization in developing countries severely eroded the institutional capacity of poor countries (E3G 2018). It reduced the scope for a developmental approach that prioritized upward movement in global value chain by effective structural change of countries productive structure.

This new Wall Street Consensus re-imagines international development interventions as opportunities for global finance (see Gabor 2019). Through MDBs, global (shadow) banks will be able to influence, if not altogether shape, the terms on which poor countries join the global supply of securities. Poor countries will have less room to define what is a “bankable” project, and have to accept large PPP infrastructure projects at the expense of smaller projects with more developmental potential. The World Bank will lead the efforts to design the “de-risking”/subsidies measures that will seek to protect global investors from political risk, or the demand risk associated with privatized public services. As Jim Yong Kim (2017), the former World Bank’s president put it: “We have to start by asking routinely whether private capital, rather than government funding or donor aid, can finance a project. If the conditions are not right for private investment, we need to work with our partners to de-risk projects, sectors, and entire countries.”

But there is a real danger that low income and emerging countries will come under pressure to pay for de-risking (see Griffith and Romero 2018) in the name of aligning sustainable projects with the preferred risk/return profile of institutional investors. There is already evidence in the World Bank’s promotion of PPPs in infrastructure that poor countries will be expected to assume demand, political and climate risks via PPP contract (Gabor 2019). Middle-income countries with a rising middle class will be pressured into adopting the US model of private pensions in order to create local institutional investors. The tendency toward concentration in the asset management sector (to exploit economies of scale and scope) may result in US-based asset managers absorbing DECs’ institutional investors, and making allocative decisions on a global level.

This is not just a technical question of finance. The architecture of securitization markets, and the plumbing that supports them (repos and derivative markets) changes the structural features of the financial system, and in so doing, the type of development model that can be financed. The old developmental banking model that put finance in the service of well-designed industrial strategies becomes increasingly out of reach.

This is a *political choice*. Developmental banking can

arguably better serve a sustainability agenda because banks can easier include, monitor and enforce safeguard policies in long-term relationships with customers. Most countries with a successful experience of industrialization (Korea, Japan, China, India, Brazil, the United States and France) relied on public development banking as a critical pillar of industrial policies (Naqvi et al. 2018). Public development banking allowed the developmental state to provide subsidized long-term loans to industrial sectors identified as strategic by an industrial policy aimed at promoting the international competitiveness of local firms. Developmental banking would be central to a green developmental state, a state that carefully designs a just transition to a low carbon economy.

But the ambition to attract institutional investors structurally requires a financial system where credit creation occurs via securities (capital) markets, with longer intermediation chains, banks whose business model involves complex market-making activities in securities, derivative and repo markets, and complex requirements of tracing and regulating these markets. Historically, the only country

that has successfully grown with a financial system organized around securities markets was the United States in the 19th century, in a unique set of circumstances that are unlikely to occur in developing/poor countries.

In this re-engineering of financial systems in the Global South, the space for alternative development strategies, and for a green developmental state, shrinks further. Government capacity, in many poor countries severely eroded by structural adjustment, will be further pressured to allocate scarce resources to creating the conditions for, and then monitoring and enforcing sustainability-oriented securitization. Public resources have to be dedicated to de-risking “developmental” assets, to identifying “bankable” developmental projects that can easily be transformed into tradable assets, to mopping up the costs of the financial crisis inevitable with this more fragile model, all the while dismantling the financial infrastructure that might support a green developmental state (including developmental banking by state-owned banks).

7. CONCLUSION

In sum, there is a significant distance between the ambitious rhetoric of the securitization for sustainability agendas and the institutional, political and practical challenges of creating processes through which securitization can channel the trillions of institutional investors into projects that are environmentally and socially sustainable, that create the types of structural change of the productive and public sectors in emerging and poor countries that is necessary to achieve the SDGs.

Rather, the securitization for sustainability agendas will accelerate the structural transformation of the financial system in emerging and poor countries. This new financial structure with securities markets at its core means a more fragile (global) financial system, one that is cyclically vulnerable to swings in securities prices, to changing risk appetite of global institutional investors. The fragility reduces the space for autonomous developmental strategies.



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