The case of missing middles:

Gaps in the development finance landscape, and UNCDF's positioning in it

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About ISF Advisors

ISF Advisors is the leading strategic and financial advisory group committed to mobilizing capital for more sustainable, equitable, and productive rural economies. Building on a decade of industry research, the ISF Advisors team combines experience from top-tier strategy, investment banking, and corporate finance firms to help the public and private sector develop more practical, profitable, and sustainable financial solutions. This combination of expertise allows us to analyse problems with a systems lens and structure investment solutions that mobilize different forms of investment and philanthropic capital.

Executive summary

Global development finance is facing a twin crisis: the regression of progress on key development indicators, and the declining availability of affordable finance to address them.

The poorest and most vulnerable countries—Least Developed Countries (LDCs), Small Island Developing States (SIDS), and Fragile and Conflict-Affected States (FCS)—face disproportionately severe financing gaps, yet remain largely excluded from private investment and underserved by traditional Development Finance Institutions (DFIs). While DFIs have made important strides, structural constraints—such as the need for fund reflows, creditworthiness, high deal sizes, and limited flexibility—undermine their ability to act catalytically in the most high-risk, low-income contexts.

This paper identifies these persistent "white spaces" in the development finance ecosystem and argues that bridging them requires a distinct institutional approach—one that embraces patient, risk-tolerant, small-ticket, and blended capital; is embedded in local ecosystems; and invests not just in deals but in market systems. The United Nations Capital Development Fund (UNCDF) is uniquely positioned to play this role.

With its flexible toolkit, in-country presence, and catalytic mandate, UNCDF can act as a first-mover and last-mile financier in frontier markets. It can demonstrate financial viability where markets fail, build pipelines of investable opportunities, and create the conditions for additional development finance and private capital to follow. Crucially, UNCDF's operations are designed not as one-off interventions, but as foundational steps toward larger market transitions. By embracing this catalytic, complementary role, UNCDF fills a critical niche in the development finance architecture—helping to close the gap between the ambition of global development goals and the ground-level realities in the world's most underserved markets.

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List of abbreviations

AIIB	Asian Infrastructure Bank
ARIA	Africa Resilience Investment Accelerator Program
BII	British International Investment
CASA	Commercial Agriculture for Smallholders and Agribusiness Programme
DAC	Development Assistance Committee
DFC	United States Development Finance Corporation
DFI	Development Finance Institutions
DPI	Digital Public Infrastructure
EDA	Federal Department of Foreign Affairs, Switzerland
EIB	European Investment Bank
FASA	Financing for Agricultural SMEs in Africa
FCDO	Foreign, Commonwealth & Development Office
FCS	Fragile and Conflict-Affected States
FDI	Foreign Direct Investment
FMO	Dutch Entrepreneurial Development Bank
GCF	Green Climate Fund
GDP	Gross Domestic Product
GEF	Global Environment Facility
GNI	Gross National Income
HDI	Human Development Index
IFC	International Finance Corporation
ISF	Initiative for Smallholder Finance
ITU	International Telecommunications Union
LDC	Least Developed Countries
LICs	Low Income Country
LMICs	Low and Middle-Income Country
MDB	Multilateral Development Bank
MICs	Middle Income Country
SMEs	Small and Medium-sized Enterprises
NORAD	Norwegian Agency for Development Cooperation
ODA	Overseas Development Assistance
OECD	Organization of Economic Cooperation and Development
PDBs	Public Development Banks
SDG	Sustainable Development Goals
SIDA	Swiss International Development Cooperation Agency
TA	Technical Assistance
USAID	US Agency for International Development
WASH	Water, Sanitation, and Hygiene

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Background & context

This position paper investigates UNCDF's positioning in the development finance landscape by assessing needs, defined in terms of investment requirements to solve the most critical development challenges in the most underserved markets, and mapping them against existing and historical focus of development finance.

Together, these give us a rapid measure of the blank spaces left for UNCDF to fill with its strategy and toolkit, and its positioning in this area. These are complex questions to answer in one attempt, given the vastness of development challenges in the world and the global geographies in which they are expressed, the sheer number of multilateral, bilateral, and national DFIs, and the variety of strategies at their disposal. Answers can - and should - vary based on the person or institution asking it; influenced by their vision of the world and its priorities, and their role in addressing these. For this reason, the findings in this paper should not be considered exhaustive or representative of the views of all actors.

While this paper represents an independent view, it makes its arguments from the point of view of an impact-first, high-risk, catalytic[1] investor in the landscape asking itself: 'what part of the landscape has the most acute needs, where can we be most additional and have the greatest impact given our size and capabilities?' For us, this means focusing on

[1] We use the term "catalytic" across this paper to refer to capital that takes the form of debt, equity, or other investments that accept disproportionate risk and/or concessionary returns compared to conventional investments. The objective of catalytic capital is to generate positive impact and enable third party investment that would not be possible with higher return expectations, lower risk tolerance, or less flexible/patient investment terms. We take this definition from the Impact Finance Research Consortium.

opportunities in the most underserved markets considered to be the "frontier," or too risky, by both private and DFIs. This does not mean that geographies and sectors not highlighted in this paper are not essential for development finance or are considered "problem solved"; it means they're well understood and included in the investment strategies of leading institutions, and hence excluded from the scope of this paper, which focuses on areas overlooked, as a guiding principle.

Given this, a compelling rationale exists to prioritize scarce resources towards the poorest and most vulnerable nations, such as Least Developed Countries (LDCs), Small Island Developing States (SIDS) and Fragile and Conflict-Affected States (FCS), over many Low-Middle Income and Middle-Income Countries (LMICs/MICs). LMICs/MICs generally possess greater capacity for domestic resource mobilization, attract the bulk of Foreign Direct Investment (FDI) flowing to developing regions, and have comparatively better access to commercial finance markets, even if challenges remain.

DFIs and Multilateral Development Banks already channel significant financing and private capital mobilization efforts towards these economies. In contrast, LICs/LDCs and many FCS face the most profound structural impediments, the largest relative SDG financing gaps (estimated at US$462 billion annually for LDCs alone), extreme poverty concentration, minimal FDI attraction (LDCs receive less than 3 percent of global FDI), and severe limitations on domestic resource mobilization. Critically, private finance mobilization by DFIs remains disproportionately low in these contexts, with LDCs receiving only 6 percent of such mobilized funds between 2012-2023.

Therefore, fulfilling the core DFI principle of additionality—intervening where markets fail most acutely—necessitates a strategic focus on these most vulnerable countries. This includes deploying catalytic capital (risk-tolerant, patient, and often concessional instruments like guarantees and first-loss protection) to de-risk investments, build nascent markets, and address the deep-seated financing needs largely bypassed by commercial capital.

Importantly, this is not solely a humanitarian and altruistic goal. Proactive investment in sustainable development, peacebuilding, and resilience in these vulnerable states represents a cost-effective strategy for high-income countries to mitigate future risks and external shocks, thereby enhancing their long-term safety and stability, while generating large-scale social and economic impact in countries that need it the most.

Introduction

Current context of global development priorities and challenges

Global development progress has encountered a significant setback, reversing a two-decade trend where inequalities between wealthy and poor nations were narrowing. After declines in 2020 and 2021, the global Human Development Index (HDI) – measuring health, education, and standard of living – is rebounding unevenly. High-income countries have reached record levels of human development, while half of the world's poorest nations, including many Least Developed Countries (LDCs) and Fragile and Conflict-Affected States (FCS), remain below their pre-crisis levels.[2] This divergence risks entrenching permanent losses in human development. For LDCs specifically, their combined GDP in 2023 was 10 percent below pre-pandemic projections, and over half of the 35 LDCs that saw HDI declines in 2020/2021 had not recovered by 2023. FCS also suffered severe economic impacts from recent crises, with a slow per capita income recovery.[3]

This stagnation is starkly reflected in key socio-economic indicators. Global extreme poverty reduction (living on less than $2.15 per day) has nearly halted, affecting almost 700 million people worldwide.[4] Poverty rates in low-income countries are now higher than before the pandemic, and extreme poverty is increasingly concentrated in Sub-Saharan Africa. LDCs saw at least 15 million more people fall into extreme poverty between 2019 and 2023.[5] Education has also suffered, with a pre-existing learning crisis worsened by the pandemic[10]; in 2022, nearly 22 percent of primary-aged children in LDCs were out of school.

Furthermore, debt burdens are escalating, particularly in LDCs where the median debt-to-GDP ratio hit 55.4 percent in 2022 – the highest since 2005 – and rising debt service payments consume resources needed for essential services like health and education.

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Addressing global development challenges is not merely an altruistic endeavour but a critical imperative for countries seeking to safeguard their self-interest and maintain domestic safety. Nearly half of the world's extreme poor reside in countries affected by fragility, conflict, and violence.[6] Given the interconnectedness of the global economy and security landscape, instability and underdevelopment in these vulnerable regions generate significant and far-reaching negative externalities. For instance, protracted conflicts and economic stagnation often drive forced displacement and irregular migration flows, straining resources and potentially exacerbating social tensions in destination countries. Weak governance and lack of economic opportunity in conflict-affected countries can create fertile ground for transnational organized crime, terrorism, and illicit trade networks, directly undermining the security and economic stability of developed nations. Prolonged

[2] Least Developed Countries (LDCs) - TWAS, accessed May 7, 2025, https://twas.org/least-developed-countries-ldcs

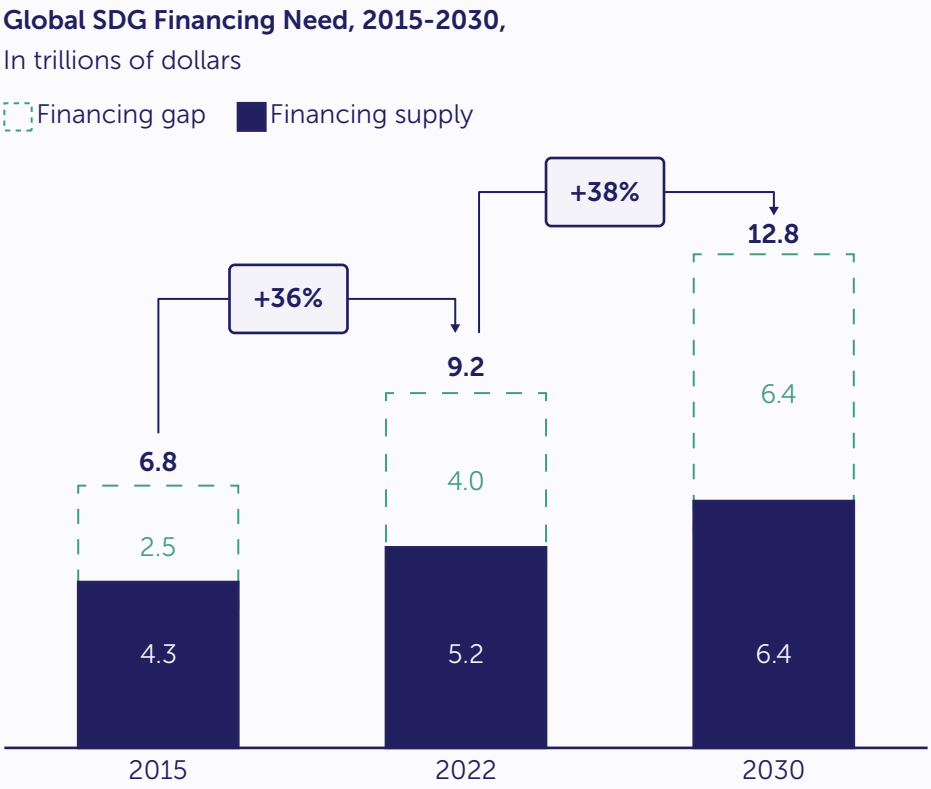
[3] Four key challenges facing least developed countries - UNCTAD Video | LDC Portal, accessed May 7, 2025, https://www.un.org/ldcportal/content/four-key-challenges-facing-least-developed-countries-unctad-video

[4] Ibid.

[5] Fragile States Need Customized Support to Strengthen Institutions, accessed May 7, 2025, https://www.imf.org/en/Blogs/Articles/2023/09/21/fragile-states-need-customized-support-to-strengthen-institutions

[6] UN News, accessed May 10th 2025, https://news.un.org/en/story/2024/10/1155821#:~:text=Nearly%20half%20the%20world's%201.1,in%20conflict%20settings%20%7C%20UN%20News

Figure 1: SDG Financing Gaps



Source: OECD Global Outlook on Financing for Sustainable Development, 2025

underdevelopment also increases the risk of infectious disease outbreaks, as evidenced by recent pandemics, posing global health risks that transcend national borders.

Conversely, persistent underinvestment in human capital, infrastructure, and innovation in these regions represents a substantial lost opportunity for global investors and the international private sector. Despite their vulnerabilities, many LDCs possess abundant natural resources, and SIDS offer unique opportunities in the blue economy and renewable energy sectors. However, systemic deficiencies in critical infrastructure, such as reliable energy, transportation, and digital connectivity, coupled with human capital deficits and limited access to finance, act as significant barriers to productive investment. For instance, an ITU study shows that increased broadband penetration in LDCs and SIDS yield a higher economic impact on GDP per capita compared to higher-income countries, suggesting substantial returns on digital infrastructure investment.[7] Investment in education, healthcare, vocational training, and robust physical and digital infrastructure – alongside enabling environments conducive to innovation and private sector growth – could unlock new markets, diversify global supply chains, and expand emerging consumer bases. The current "debt trap" faced by many LDCs, where a significant portion of export revenues are allocated to debt servicing rather than development, further highlights the need for a paradigm shift from aid-centric approaches to sustainable, investment-driven growth models that foster local economic resilience and create mutually beneficial economic partnerships.

[7] Economic impact of broadband in LDCs, LDCs and SIDS: An empirical study – ITU, accessed May 29th, 2025, https://www.un.org/ohrlls/sites/www.un.org.ohrlls/files/19-00328_1h_economic_impact_of_broadband.pdf

Addressing the deep-seated challenges outlined above requires financing on an unprecedented scale. The estimated annual SDG financing gap for all developing countries has widened to $4.2 trillion.[8] For LDCs alone, achieving seven percent annual growth requires an estimated $462 billion in annual investment, a 55 percent increase over 2019 levels.[9] These financing gaps appear in the backdrop of a challenging domestic and international financing environment, as summarized below:

Domestic public resources are insufficient to finance in-country needs: The capacity for low-income countries to raise domestic funds is severely constrained. LDCs, for example, exhibit low tax-to-GDP ratios (average 13 percent in 2021 vs. 15 percent global average), stemming from narrow tax bases, large informal sectors (where 60-80 percent of the labor force operates untaxed),[10] weak tax administration capacity, and significant losses to illicit financial flows. This is worse in fragile states that face additional challenges due to conflict disrupting economic activity, weak institutions and governance eroding state capacity and public trust, and lack of transparency. Small island developing states, despite often having higher national tax-to-GDP ratios, struggle with domestic resource mobilization due to small, undiversified economies, high per capita costs for public services, reliance on volatile revenue sources (tourism, remittances, fishing licenses), eroding trade tax bases, low domestic savings rates, and extreme vulnerability to economic and environmental shocks. As a result, countries have gotten stuck in debt-traps, borrowing ever more money at increasingly unfavourable terms to finance expenditure: 20 out of 43 LDCs tracked were either in debt distress or high risk of distress in 2024, and median public debt as a percentage of GDP peaked at 55.4 percent in 2025 in developing and LDC countries.[11]

Overseas development assistance (ODA) is in decline: ODA remains a critical lifeline, particularly for LDCs where it constituted 13 percent of GDP on average in 2020.[12] However, it is plagued by insufficiency. Over a 10-year period from 2013-2023, ODA (minus humanitarian aid) has actually decreased in real terms, (from $36 billion to $31 billion), as aid budgets have come under pressure from geopolitical challenges and new emergencies, leading to shifts in allocation away from traditional development needs towards in-donor refugee costs or specific crises like Ukraine. This has resulted in declining ODA to regions like sub-Saharan Africa. Overall donor commitments, including the 0.7 percent GNI target and the specific 0.15 percent -0.20 percent GNI target for LDCs, remain largely unmet.[13] In 2022, only three Development Assistance Committee (DAC) donors met the LDC target, and overall DAC ODA was only 0.33 percent of GNI in 2024.[14] In light of the latest global trade upheavals and its impact on the growth prospects of tariff-impacted high-income countries, donor commitments are expected to continue down this trend in the near future, offering little relief to LDC countries expecting an increase in ODA.

[8] New UN report calls for trillions more in development investment to rescue Sustainable Development Goals | United Nations, accessed May 7, 2025, https://www.un.org/en/desa/trillions-more-development-investment-rescue-sustainable-development

[9] The Least developed Countries Report 2023 (Overview) - UNCTAD, accessed May 7, 2025, https://unctad.org/system/files/official-document/ldc2023overview_en.pdf

[10] LDCs - Financing for Sustainable Development Office, accessed May 7, 2025, https://financing.desa.un.org/sites/default/files/2024-10/LDCs%20inputs%20for%20the%20Elements%20Paper-final.docx

[11] FSDR 2024, accessed May 30th, 2025, https://desapublications.un.org/publications/financing-sustainable-development-report-2024

[12] Country classification - the United Nations, accessed May 7, 2025, https://www.un.org/en/development/desa/policy/wesp/wesp_current/2014wesp_country_classification.pdf

[13] Financing for Sustainable Development Report, 2024, United Nations, accessed May 30th 2025, https://desapublications.un.org/sites/default/files/publications/2024-04/2024_FSDR_ChIIIA.pdf

[14] International aid falls in 2024 for first time in six years, says OECD, accessed May 7, 2025, https://www.oecd.org/en/about/news/press-releases/2025/04/official-development-assistance-2024-figures.html

It's important to take note of one financing flow that bucks the above trend: international remittances by migrant workers back to their home countries. At a time when ODA is shrinking and export revenues are constrained, remittances inflows to LDCs countries now exceed both ODA and foreign direct investment ($67 billion remittance inflow vs. $33 billion FDI, 2023), serving as a financial lifeline that underpins macroeconomic stability and household resilience. Unlocking this capital through the lending portfolios of domestic financial institutions where most of these remittances are saved in home countries, is a powerful opportunity to go beyond the usual suspects of international development finance.

Foreign Direct Investment (FDI) is risk-averse and seeking safe harbor: Global FDI flows have been declining and flows to developing countries fell by seven percent in 2023.[15] LDCs attract only a marginal share of global FDI (around 2.4 percent in 2023, totaling $33 billion), a share that has stagnated or decreased over the past decade. FDI in LDCs is often concentrated in extractive industries with limited positive spillovers or diversification effects. Furthermore, FDI is significantly deterred by regulatory barriers (cumbersome approvals, operational restrictions) and political risks (expropriation, policy instability, currency restrictions) prevalent in many developing countries, particularly those at the lowest end of the income ladder. Blended finance, while promising, has mobilized very little private capital in LDCs (only six percent of the total between 2012-2018), concentrated in a few sectors like energy and finance.[16] Scaling up requires strategic support for domestic market development, the de-risking and pipeline-building of bankable projects, and crucially patient capital, and strong government partnerships anchored through a local presence.

This situation reflects a "great finance divide", where countries most in need face the greatest barriers to accessing affordable and appropriate finance[17]. It stems not just from a lack of funds but from a systemic misalignment of the international financial architecture. Unmet ODA commitments, pro-cyclical private flows, inadequate debt relief mechanisms, and the limited voice of vulnerable countries in global financial governance all contribute to this divide. Furthermore, the insufficiency of grants and highly concessional finance, particularly for climate adaptation, forces LDCs and SIDS into taking on more expensive debt, risking a climate debt trap, where addressing climate impacts further undermines fiscal stability[18].

Future development financing strategies must address key market failures in these regions and respond to the unique needs of private and public clientele within countries. Any development finance institution looking to work in these spaces cannot go at it alone: they need the volume and scale of private capital, and the political mandate and distribution networks of public financial institutions. This means creating enabling conditions that facilitate reinforcing partnerships between public and private financing actors. This means investment strategies that can tolerate (and improve) structural weaknesses of underdeveloped markets, that can de-risk and catalyse domestic and international private capital, and that can work together with domestic public banks to finance businesses and public institutions delivering essential goods and services to citizens. In the next section, we review some of these investment opportunities, and the challenges in addressing them with traditional strategies.

[15] Bridging the financing gap to achieve SDGs requires mobilization of ..., accessed May 8, 2025, https://sdgpulse.unctad.org/investment-flows/

[16] Blended Finance in the Least Developed Countries 2020 - OECD, accessed May 7, 2025, https://www.oecd.org/en/publications/blended-finance-in-the-least-developed-countries_57620d04-en.html

[17] Financing for Sustainable Development Report 2022 - the United Nations, accessed May 7, 2025, https://www.un.org/ohrlls/content/financing-sustainable-development-report-2022

[18] The Least developed Countries Report 2023 (Overview) - UNCTAD, accessed May 7, 2025, https://unctad.org/system/files/official-document/ldc2023overview_en.pdf

Understanding the need:

Key investment opportunities and challenges in frontier, underserved markets

Understanding the investment landscape in the most underserved markets with last-mile delivery gaps begins with recognizing their distinct yet often overlapping vulnerabilities. There are three country classification frameworks that can help identify countries that are the hardest to reach and serve for private and development investors: Least Developed Countries (LDCs), as defined by the United Nations, are nations with low levels of income and severe structural impediments to sustainable development. Their classification hinges on an average annual per capita income below $1,018, a low Human Assets Index (reflecting poor health and education outcomes), and a high Economic and Environmental Vulnerability Index.[19]

Small Island Developing States (SIDS) constitute a distinct group of 39 States and 18 Associate Members of UN regional commissions, predominantly located in the Caribbean, Pacific, and Atlantic, Indian Ocean, and South China Sea regions[20]. These nations contend with unique social, economic, and environmental vulnerabilities stemming from their small size, geographic remoteness, narrow resource and export bases, and high import and export costs. SIDS are acutely exposed to the climate crisis, yet many are also at the forefront of adopting digital technologies. Fragile and Conflict-Affected States (FCS), while lacking a universally agreed definition, are generally characterised by a fundamental failure of the state to adequately meet citizens' basic needs and expectations[21]. These environments are frequently under civic and political discord, marked by high unemployment, dilapidated infrastructure, and pervasive economic uncertainty, often resulting in forced displacement. A stark illustration of their profound vulnerability is that half of the world's extreme poor currently reside in FCS, a proportion projected to increase to nearly 60 percent by 2030[22].

A critical observation is the significant interconnectedness among these categories, with 67 percent of FCS-affected settings also categorized as LDCs and SIDS. This overlap is not coincidental; it signifies a compounding of challenges, or a "vulnerability multiplier." When a country is simultaneously an LDC, a SIDS, and conflict-affected, its inherent structural impediments, unique environmental exposures, and political instability intertwine. For instance, climate change impacts, a primary vulnerability for SIDS, can exacerbate resource scarcity, potentially fueling conflict in FCS. Concurrently, the low income and structural weaknesses characteristic of LDCs severely limit their capacity to address these multifaceted issues. This deepens the complexity for investors and underscores the necessity of integrated, holistic development and investment strategies, rather than siloed approaches based on single classifications.

The main opportunities for development-enhancing investments – while numerous and varied – in these regions can be broadly categorized into three main buckets: (a) strengthening domestic financial markets by building the capacity of, and catalysing investment from local financial institutions with a development agenda, (b) expanding climate-resilient rural and urban public infrastructure to deliver to last mile customers, and (c) scaling locally founded enterprises, particularly micro, small, and medium enterprises.

[19] UN LDC category. Retrieved from https://www.un.org/ldc5/content/ldc-category

[20] UN About Small Island Developing States. Retrieved from https://www.un.org/ohrlls/content/about-small-island-developing-states

[21] IFC. (2025, February). Fragile and conflict-affected situations. Retrieved from https://www.ifc.org/en/what-we-do/sector-expertise/fragile-and-conflict-affected-situations

[22] Ibid

Strengthening local financial markets and financial intermediaries: Unlocking domestic capital and strengthening local financial markets are pivotal for sustainable development in frontier, underserved markets, complementing international finance and fostering greater self-reliance. The immense pools of capital held within domestic financial institutions in developing countries – it is estimated that national public development banks (PDBs) have combined assets of nearly $20 trillion, dwarfing the assets of multilateral development banks that manage around $3 trillion[23] – represent a largely untapped resource for financing local development priorities. National and subnational public development banks have mandates that align with national development goals and a long-term investment horizon, making them ideal partners for DFIs. They have a local presence and networks, including with urban local municipal bodies and SME ecosystems, the capacity to lend in local currency, and can effectively bridge public and private finance, making them essential for implementing national development plans and accessing global concessional finance streams.

Despite this immense potential, the local financial sector in most frontier markets remains significantly constrained by a confluence of systemic issues. High perceived risk and inherent instability often lead to risk aversion between domestic and international co-investors, limiting the flow of capital to and together with national public banks. This is compounded by a lack of adequate risk sharing mechanisms available to PDBs (such as guarantees), which would otherwise allow them to increase allocations to riskier, high-impact sectors within the country. Pervasive financial and institutional capacity gaps, such as insufficient technical resources for project preparation, inadequate project management capabilities, and the struggle of local firms to meet increasing disclosure requirements, further impede the effective mobilization and deployment of domestic capital through national and subnational PDBs.

Very few international DFIs have an explicit mandate of working alongside national and subnational public development banks in frontier markets, and typically consider this process to be too resource-intensive and full of regulatory and political complexity that they do not have the capabilities to navigate. However, a development actor with institutional ties to national governments and their finance ministries, and knowledge of financial rule-making and best practices, can address these barriers. This can be achieved primarily through: (1) risk mitigation pathways - deploying guarantees, first loss capital, and other blending approaches together with domestic banks, and (2) technical assistance and capacity building to domestic financial institutions, covering project origination and structuring support, risk management tools, and (3) capital market development including local bond issuances, securitization assistance, and improved financial rule making together with ministries of finance and central banks. Done right, unlocking capital from and building distribution partnerships with national and subnational public development banks can be highly effective ways of bridging the "missing-middle" finance gaps for the sectors mentioned below.

Building climate-resilient rural and urban public infrastructure (built, and digital): Bridging the vast local public infrastructure deficit in the least developed economies is a necessary precondition for broader economic transformation in the Global South. Rural populations in low-income countries, for example, experience access rates approximately 30 percent lower than their urban counterparts across key services[24]. Deficiencies in energy, water, sanitation and hygiene (WASH), transport, and digital connectivity undermine basic service delivery, hinder economic activity, and limit human development. For example, nearly 700 million people lacked electricity access in 2022, with 85 percent of those residing in sub-Saharan Africa. Only 67 percent of citizens of LDC have basic drinking water, 39 percent basic sanitation, and

[23] Peking University. Global Database on PDBs and DFIs worldwide. Retrieved from http://www.dfidatabase.pku.edu.cn/

[24] World Bank. (2004, December). Infrastructure services in developing countries: Access, quality, costs, and policy reforms. Retrieved from https://documents1.worldbank.org/curated/en/476891468782346365/pdf/wps3468.pdf

32 percent with basic hygiene facilities. Eighty percent of people residing in these regions had low or no internet connectivity. Without these basic conditions in place, populations in these countries are unlikely to become more productive, or build long-term revenue generating assets for their communities.

Large-scale public utilities are often prohibitively expensive and struggle to serve last mile and rural populations in low-income and fragile contexts. In contrast, decentralized small-to-medium scale models, such as clean energy mini-grids, microgrids and community-based fresh water distribution systems like rural water kiosks, offer more context-appropriate solutions that align with customer needs and the operating realities of constrained markets.

Urban infrastructure deserves equal, if not greater, focus. While LDCs currently have lower urbanization levels (around 30 percent), they are experiencing high urban growth rates (close to four percent annually), adding millions to urban centres each decade. This rapid growth, particularly prominent in Africa and Asia, often outpaces the capacity of municipalities to plan, finance, and deliver essential services and infrastructure. In LDCs, over 60 percent of the urban population resided in slums in 2022. Sub-Saharan Africa faces the highest prevalence (53.6 percent) and is projected to see the largest increase in slum dwellers if current trends continue[25].

This situation creates an urbanization paradox: Cities are potentially powerful engines of economic growth and innovation, yet in LDCs, FCS, and SIDS, rapid and unplanned urbanization often deepens inequality and overwhelms municipal capacity, leading to deteriorating living conditions and service deficits, particularly for the poor. The potential economic benefits are undermined by the negative social and environmental consequences of inadequate investment and management. Extreme weather events, especially in low-lying cities (particularly in SIDS), further exacerbate service delivery failures as systems become overwhelmed dealing with flooding, sewage ingress, and grid failures during heat waves.

Central to this paradox is the critical sub-national finance gap. City municipalities in most LDC countries, responsible for delivering essential urban services, are financially constrained. The gap between their financing needs – driven by population growth and service demands – and the resources available to them is vast. Their ability to mobilize domestic resources is often limited by narrow local tax bases, dependence on central government transfers, and the difficulty of taxing the large informal economy. Accessing external finance is equally challenging. Municipalities often struggle to borrow from commercial markets due to perceived high risk, lack of creditworthiness, small project sizes unsuitable for large investors, and insufficient capacity for financial management and project preparation. Climate change and disaster recovery costs place additional, often crippling, financial pressure, particularly on SIDS municipalities, diverting scarce resources from long-term development and resilience building towards immediate response. This directly translates into inadequate infrastructure, poor service delivery, and heightened vulnerability, especially in informal settlements. Bridging this sub-national finance gap is paramount for achieving sustainable and inclusive urbanization.

Digital Public Infrastructure (DPI) represents another critical investment area. DPI encompasses "foundational, digital building blocks designed for the public benefit," enabling public and private service providers to innovate and deliver services more efficiently. Despite its transformative potential for financial inclusion and broader digital transformation, a massive global investment gap persists, estimated at least $1.6 trillion, with the majority concentrated in developing countries[26]. LDCs have the lowest connectivity rates,

[25] unstats.un.org, accessed May 8, 2025, https://unstats.un.org/sdgs/report/2024/extended-report/Extended-Report_Goal-11.pdf
[26] ITU. (2025, January 17). Digital infrastructure investment: USD 1.6 trillion to close the gap. Retrieved from https://www.itu.int/hub/2025/01/digital-infrastructure-investment-usd-1-6-trillion-to-close-the-gap/

with only 19 percent internet access in 2019, far from the goal of universal access[27].

Financing these vast infrastructure needs presents a formidable challenge: the annual gap exceeds $1 trillion for LDCs, LDCs, and SIDS combined.

The persistent deficiencies in infrastructure, coupled with the disproportionate vulnerability of LDCs and SIDS to climate change, create a reinforcing "infrastructure-poverty trap." Deficient infrastructure directly impedes economic development and entrenches poverty, while simultaneously diminishing a country's capacity to withstand external shocks. Climate change then acts as a powerful accelerant, disproportionately impacting already weak infrastructure and leading to immense damage costs – estimated at $700 billion per year globally and up to 10 percent of SIDS' GDP annually28. This necessitates costly reconstruction efforts and escalates national debt burdens, diverting scarce resources from new development initiatives into perpetual recovery and debt servicing. This cycle perpetuates underdevelopment. Therefore, investing in resilient infrastructure is not merely a development imperative but a critical preventative measure against future economic shocks and escalating debt. Such investments must be intrinsically climate-resilient and viewed as strategic long-term commitments to fiscal stability and sustainable development.

Financing locally-owned micro, small and medium private enterprises in key sectors: There is a pressing need to empower Micro, Small and Medium-sized Enterprises (SMEs) in frontier markets – the backbone of their economies – operating in vital sectors such as agriculture, renewable energy, digital services, and tourism. In emerging markets, SMEs generate 7 out of 10 formal jobs, and are both founded by, and large-scale employers of youth, the largest and arguably most important demographic group in most LDCs. However, SMEs in these vulnerable contexts face a crippling finance gap, estimated globally at $5.7 trillion29. In Africa alone, the gap is estimated at $331 billion30. Access to finance is consistently cited as the most significant constraint for SMEs, particularly in LDCs where 41 percent report it as a major barrier compared to 15 percent in high-income countries. Rejection rates for SME finance requests globally exceed 50 percent, compared to just seven percent for multinational corporations31. Reasons include informality of SMEs (lack of financial records, registration), lack of collateral and credit history, weak domestic financial infrastructure, and limited technical, managerial and financial capacity of SME operators themselves. Aside from access issues, there is also a consistent product-market mismatch between financial instruments and the needs of early-stage enterprises. Capital that does reach SMEs can often be prohibitively expensive, short-term, and/or misaligned with sector-specific cash flows. Financial intermediaries, such as sub-national public banks, that are meant to service the needs of the SMEs tend to be risk-averse, can lack incentives to serve smaller-ticket sizes, and operate in environments where risk sharing mechanisms are either missing or underutilized.

These barriers contribute to the "missing middle" phenomenon, where SMEs struggle to grow beyond the micro-level, hindering job creation, productivity gains, and economic diversification. The prevalence

[27] Infrastructure and Industrialization - United Nations Sustainable ..., accessed May 8, 2025, https://www.un.org/sustainabledevelopment/infrastructure-industrialization/

[28] UN. (2024, March). Infrastructure connectivity: A pathway to sustainable development. Retrieved from https://www.un.org/pga/wp-content/uploads/sites/108/2024/03/SW-ID-Infrastructure-Connectivity-.pdf

[29] SME Finance Gap | SME Finance Forum, accessed May 8, 2025, https://www.smefinanceforum.org/data-sites/SME-finance-gap

[30] Closing Africa's SME Finance Gap | SME Finance Forum, accessed May 8, 2025, https://www.smefinanceforum.org/post/closing-africa%E2%80%99s-SME-finance-gap?page=55

[31] Challenges of financing SMEs, focus on developing countries | FCI, accessed May 8, 2025, https://fci.nl/en/news/challenges-financing-smes-focus-developing-countries?language_content_entity=en

of informality is a root cause, directly excluding many SMEs from the formal financial system due to their lack of documentation and visibility.

Catalytic capital, strategically deployed by DFIs that have deep in-country networks and partnerships with local governments and national and subnational public development banks, can offer a targeted solution to these financing challenges. Its core function is to use patient, risk-tolerant, flexible, and often concessional instruments – such as guarantees, first-loss capital protection, subordinated debt, targeted grants, and crucial technical assistance – to directly address the specific barriers preventing investment (from private investors, commercially-minded DFIs, and domestic public development banks) in SMEs, local infrastructure, and municipal development.

By de-risking opportunities, enhancing financial viability, building essential local capacity, and demonstrating market potential, catalytic capital acts as a vital bridge. However, as outlined in the next section, the use of catalytic capital by DFIs is yet to reach its full potential - constrained not only by institutional mandates and operating models, but also by structural limitations that restrict their ability to operate intentionally below-market and deploy high-risk capital at scale in the world's most challenging contexts.

Servicing this need:

Landscape of development finance institutions and their limitations in underserved, frontier markets

It's important to note at the outset that multilateral and bilateral DFIs have played and continue to play a critical role in financing development needs across the world, and have been transformative for many countries, assisting them in moving up the income and development ladder. The scale and depth of their impact has been researched extensively, and cannot be covered fairly in the narrow scope of this report. For this paper, we focus on the limits of existing DFI efforts as it relates to catalytic investing in the most vulnerable and high-risk geographies described in earlier sections, in order to understand what more remains to be done, and where other investors can be most additional.

Current landscape of development finance institutions addresses some, but not all of the aforementioned needs, leaving a gap in the market to be filled.

Development Finance Institutions (DFIs) represent a unique category of financial entities, operating at the critical intersection of public policy objectives and market-based financial mechanisms. They are distinct from traditional aid agencies, which primarily disburse grants, and commercial banks, which are driven by profit maximisation. Governments are the majority shareholders in 94 percent of all DFIs, with 75 percent wholly owned by government agencies. Even in the few privately owned DFIs (1.5 percent), government steering is often maintained through other mechanisms, such as debt guarantees[32].

DFIs serve as indispensable instruments for addressing fundamental market failures, proactively filling financing gaps where private capital markets and commercial banks are either unwilling or unable to provide support. Their establishment is a direct response to the inherent limitations of conventional markets in financing socially beneficial projects, particularly those involving long-term investments, high uncertainty, or significant positive externalities such as climate change initiatives.

An overview of DFIs, their investment strategies, and their limitations and constraints is provided below.

The inherent characteristics of high-risk countries, including weak institutions and low or non-existent credit ratings, create significant barriers for DFIs in catalysing private finance. Fundamentally, the inability for existing DFIs to fully meet the financing needs of high-risk contexts comes down to four design limitations:

1. Their investment model based on fund-reflow, which limits their ability to deploy truly catalytic tools that can absorb losses in frontier markets

2. Their fundraising model based on credit-worthiness, which limits the amount of risk they can take, and hence amount of exposure to sub-investment grade markets and assets

3. Their operating model based on adherence to stringent rules and investment criteria that require high overheads to implement, leading them towards bigger deal sizes that can cover their operating costs

4. Their strategy and mandate, primarily focused on investment activities and capital disbursement, keeping market building activities of policy support, institutional capacity building, and patient, multi-stakeholder coordination typically out of scope.

32 Mapping Development Finance Institutions Worldwide, Peking University, accessed on June 1st 2025 at https://www.nse.pku.edu.cn/docs/20190529100907766148.pdf

Figure 2: Key categories of DFIs and operating models

	Description	Examples	Ticket Size (range)	Main capitalization strategy	Risk-return profile	Other operating constraints
Multilateral DFIs	Funded by multiple governments; focus on global/regional, large-scale development interventions	• IFC, MIGA (World Bank Group) • Regional MDBs (AfDB, EIB, EBRD)	**$15-250M**	Multiple member government owners Paid-in capital + Capital markets borrowing + Retained earnings	**Primarily commercial** (market-rates) or slightly concessional	*Prioritize countries with stable governance and financial systems to protect AAA ratings*
Bilateral DFIs	Owned by single countries; focus on "bankable" opportunities aligned with national strategic interests	• BII (UK) • DFC (US) • FMO (Netherlands) • DEG (Germany) • Norfund (Norway)	**$10-100M**	Wholly or majority government-owned Mostly Paid-in capital + Retained earnings Well-established Bilaterals can borrow on capital markets	**Concessional**, sub-market rates but **risk-adverse**	*Align investments with geopolitical priorities of home governments, favoring markets with bilateral trade agreements*
Donor incentive programs / facilities	Blended finance programs primarily funded by donor governments through periodic replenishment cycles, providing de-risking capital to advance SDG-aligned blended finance initiatives.	• GCF • GEF • GAFSP	Not communicated (highly variable)	Capitalized / replenished by direct grants and concessional contributions from donor governments	For non-grant instruments: **typically concessional**, yet non-distortive, financial returns	*Limit scope to 1-2 key themes aligned with global policy framework under which they were created, and must follow rigid screening criteria to show impact*
Foundations	Philanthropies providing flexible, catalytic funding to impact-driven intermediaries	• MasterCard Foundation • Rockefeller Foundation	**$1-15M**	Capitalized / replenished by direct grants from sponsors	For fund investments: **highly concessional**, aiming for capital preservation to low-single digit return (~5%)	*Operate in select, fixed countries; mostly focused on non recoverable grants not used for catalytic purposes*

* With exceptions for DFC (~50B). Source: Climate Bonds Initiative. The Role of Development Finance Institutions in Accelerating the Mobilisation of Green Capital. 2024.

Investment model based on fund-reflow:
DFIs primarily deploy "fund-reflow-seeking financial instruments" as their main products and services. These include various forms of financing such as recoverable grants, sovereign loans, and equity investments. The key characteristic is that these instruments are structured to permit some form of repayment, capital dividends, or risk premium, depending on the nature of the financing. This operational model clearly distinguishes DFIs from institutions that provide pure grants, as grants do not require repayment and are not considered assets of DFIs. The emphasis on fund-reflow-seeking instruments, even with the possibility of concessionality, signals a fundamental

expectation of financial discipline and eventual return (typically respective country's benchmark rate plus 1-2 percent). This theoretical alignment with market logic makes non-grant arms of DFIs mimic private finance, limiting their ability to be truly catalytic[33].

For this reason, DFIs tend to prioritize investment instruments in the order of confidence of guaranteed reflows; first loans, then equity, then, if available, de-risking instruments like guarantees or technical assistance, which come last in the pecking order. They also concentrate their capital in countries and sectors that offer established project pipelines and risk-adjusted returns in line with or above benchmark rates — notably in large-scale infrastructure, energy, and financial services. In 2019, for example, 80 percent of DFI concessional capital went to MICs, citing the scarcity of "bankable" projects in lower income countries, and lack of developed financial markets[34]. These places typically provide more predictable cash flows, better collateralization options, and clearer exits, which align with the institutions' financial and fiduciary requirements. This persistent allocation pattern that prioritizes scale and predictability distorts capital flows away from LDCs and related regions, and reinforces underinvestment in critical sectors and local actors.

Fundraising model based on creditworthiness:
A defining characteristic of DFIs is their ability to finance their operations beyond reliance on periodic budgetary transfers from governments. They achieve this by actively mobilizing resources from capital markets or other financial institutions, often through the issuance of bonds. This market-based fundraising approach typically leverages sovereign creditworthiness and public guarantees, which play an indispensable role in lowering borrowing costs and making their operations financially feasible. When operating through their own balance sheet, many MDBs and DFIs have a credit rating (typically AAA) which enables large-scale deployment and competitive lending terms, but prevents them from entering high-risk markets and non-sovereign lending that can endanger their credit ratings. They tend to use a treasury bill rate plus a risk premium as hurdle rates, and are subject to financial discipline and risk-weighting constraints (e.g., Basel norms). Finally, many MDBs tend to have preferred creditor status, meaning they're the first of the capital stack to get paid back, and do not easily take subordinated positions that can de-risk or improve the return profile of fellow private investors.

This fundraising model has significant bearing on investing in LDCs and FCS countries, a majority of which have (Moody's) sovereign credit ratings of C or below (many unrated), compared to the median exposure of MDB/DFI portfolios, which ranges between Baa1-B3. Assets in these countries, both public (e.g., municipal bonds) and private (equity in SMEs), are inherently riskier as operators can face significant resource constraints and can have technical and managerial capacity limitations, undermining their bankability in initial stages. Given the incentive to maintain their own creditworthiness and limit losses as much as possible, DFIs can find these conditions to exceed their risk appetite.

This is not to say that DFIs do not go to riskier markets; a sizeable proportion of their commitments are in sub-investment grade countries, but a closer look at OECD data reveals that most of these commitments in risky markets are in the form of pure grants (not typically focused on private sector, but rather sovereign grants), rather than concessional loans or equity[35]. Therefore, the goal of using concessional capital in high-risk countries to mobilize private investment remains largely unmet.

[33] Mapping 500+ Development Banks: Qualification criteria, stylized facts and development trends." Research Papers No. 192, Agence Française de Développement (AFD), October 2021
[34] Brookings, Bridging the great finance divide in developing countries, 2022
[35] Creditor Reporting System, OECD Globally, Gross commitments 2013-2022.

Operating model with high overheads and transaction costs:

Due to their explicit focus on impact and the intense scrutiny of these outcomes because of their government sponsorship, DFIs face elevated due diligence requirements and risk assessment processes, incentivizing them to focus on larger ticket sizes (typically $10 million to $50 million) to justify expenses, even when development returns from smaller transactions might be high. For donor incentive programs such as Global Environment Facility (GEF), Green Climate Fund (GCF), thematic rigidness (e.g., climate only), sector-focus (e.g., energy, infrastructure) and/or complex approval excludes small players, and ensures that most capital flows to "safe bets" and relatively more mature asset operators with the ability to meet the high due-diligence and reporting requirements of these funds. In addition, GEF and GCF work mainly with accredited entities, and have to follow 'readiness programmes' with partner countries that can create tensions with inclusion, i.e. a preference for selecting investment partners in LDCs that are big, established "usual suspects" who can corner capital that could be deployed to more catalytic areas of national markets. These cumbersome requirements don't just have an impact on deal size - they also lead to long disbursement periods (exceeding up to 2 years from project origination to approval and disbursement). Given the urgency of the underlying needs that the solutions are solving for, and the costs borne by beneficiaries during the wait period, this is not just an administrative flaw, but an ethical challenge.

Strategy and incentives focus on investments, and not market development

Investing in frontier markets is inherently time-consuming and resource-intensive process, and has long gestation periods till quantifiable results become visible. Identifying fund managers that can meet the diligence requirements and furnish details satisfactorily, scoping the market for opportunities and building a steady pipeline in nascent, untested areas, establishing trust with potential investees where little investment precedent exists and data can be scarce: these activities require specialized capabilities (and hence hiring of teams that have frontier market knowledge). Diverting resources away from much more politically and strategically important portfolios that constitute the bulk of DFI commitments – sovereign loans and big-ticket equity investments in public infrastructure, for example – towards small deals with high transaction costs and long payback periods – can be difficult for management to justify, especially in the context of tightening budgets from donor governments.

In addition, the recurring theme of limited institutional capacity and the challenges in project preparation and management points to a fundamental bottleneck with DFI strategies. Even with increased financial flows, if the underlying institutions are weak, the effective deployment, management, and long-term sustainability of investments are severely compromised. This encompasses the ability to design sound policies, enforce regulations, manage public finances transparently, and coordinate effectively across government ministries and with external partners. Without this foundational capacity, investments risk being inefficient, unsustainable, or even exacerbate existing fragilities. Long-term, sustained investment in strengthening public sector governance, human capital development, and technical expertise within LDCs, SIDS, and FCS governments is as critical as financial capital. This support should be integrated into all development assistance, focusing on areas like public financial management, regulatory reform, and the development of robust project pipelines.

Recognizing some of the challenges described above, several DFIs have established dedicated windows or facilities with a more developmental — and less commercial — investment thesis. Facilities with such catalytic purposes include IFC SME Ventures Program, British International Investment (BII) Catalyst and Kinetic strategies, Africa Resilience Investment Accelerator Program (ARIA) co-run by BII, Proparco, and FMO (Dutch Entrepreneurial Bank), European Investment Bank (EIB,) and African Development Bank's (AfDB) joint Boost Africa program, amongst others. These

are typically smaller, differentiated capital pockets that can accept lower returns or first-loss positions, target underserved geographies or segments, and enable market-building and ecosystem seeding.

Similarly, government aid agencies (including Ministries of Foreign Affairs), having observed the limitations of working only with large, traditional DFIs, are putting grant-based money into catalytic investment structures, either directly or indirectly through their associated DFIs, to leverage private capital (e.g., USAID and Norad in FASA Fund-of-funds, Dutch-MoFA and FMO in Dutch Fund for Climate and Development) and deploying grant mechanisms aligned to their investment funds (e.g., FCDO's Commercial Agriculture for Smallholders and Agribusiness "CASA" TA facility) to de-risk their investments, finance technical assistance to improve project bankability, and improve the capabilities of fund managers to expand to new, riskier markets.

These structures and their strategies are a welcome response to the limitations of DFIs mentioned earlier, and are in most cases led by teams deeply knowledgeable about the problem statements outlined in this paper, and equipped with the ambition and toolkit to solve them. They are, however, small in number, in early stages of implementation, and few have a documented track record (yet) to prove how well or not they have worked. Interviews with managers for these facilities reveal considerable challenges in implementing the vision of these funds in practice. A number of funds struggle with building steady pipelines and disbursing the capital they have in time given the high cost of setting up local presence in operating geographies and the resource heavy nature of building partnerships with local innovation and policy ecosystems[36].

Other challenges include potential for market distortion, scalability challenges, internal debates about capital mandate and risk appetite, and difficulty in relaxing screening criteria and impact evaluation requirements that filter out opportunities in the most vulnerable, nascent operating markets like LDCs. A common ask of investment managers managing these new-age catalytic funds was the support of institutions with "boots on the ground" and trusted relationships with national and subnational governments, that could work with local partners to create bankable projects, have the appetite to experiment and absorb losses to build proof of concepts, de-risk initial investments of other DFIs, and lower barriers to entry for more commercial investors to come in and pool their capital.

36 Source: Confidential interviews with DFI fund managers.

Emerging gaps:

White spaces in development finance

The fundamental challenge faced by these new-age catalytic facilities is their ambition to invest in markets where functioning markets don't yet exist. While sectors like agritech and fintech have shown some success – given the expanding innovation ecosystems consisting of government agencies, entrepreneur support organizations, incubators, and accelerators, that DFIs can tap into and partner with – the same is not true for high-impact/sub-commercial sectors like water and sanitation, education, and civic services. In these sectors, business models are still in very early stages (often pre-revenue, if ever cash-flow positive) and attract far less attention from enabling actors compared to sectors with clearer commercialisation pathways. At best, investment teams at bilateral DFIs can search for investment managers with sound local knowledge and pair them with grant-finance TA facilities to support integral pre-investment, investment, and post-investment activities.

While DFIs remain vital for direct development financing, their catalytic role in high-risk contexts requires a deeper understanding of these inherent limitations. The inadequacy in catalysing private finance is not merely an operational shortfall but a structural reality arising from the very mandate and operating environment of DFIs. Achieving greater private finance mobilization in these challenging settings will likely necessitate more innovative and robust public-private risk sharing models, potentially involving increased public subsidy or more sophisticated de-risking mechanisms, to genuinely bridge the persistent financing gaps and transform commercially unattractive ventures into viable opportunities for private capital.

While the concept of "blended finance" (combining public and private funds) is emerging, its effectiveness in these challenging regions may be constrained by the overall small size and limited number of DFIs available to structure and manage such complex arrangements. The current DFI landscape, particularly its limited capacity in LDCs, SIDS and FCS countries, suggests that while DFIs are crucial for direct financing in high-risk areas, their ability to catalyse significant additional private finance into these same areas is structurally limited. This implies that current models of DFI engagement may need re-evaluation to genuinely unlock private capital at scale in the most challenging contexts, potentially requiring more robust public-private risk sharing mechanisms or greater public subsidy to bridge the gap.

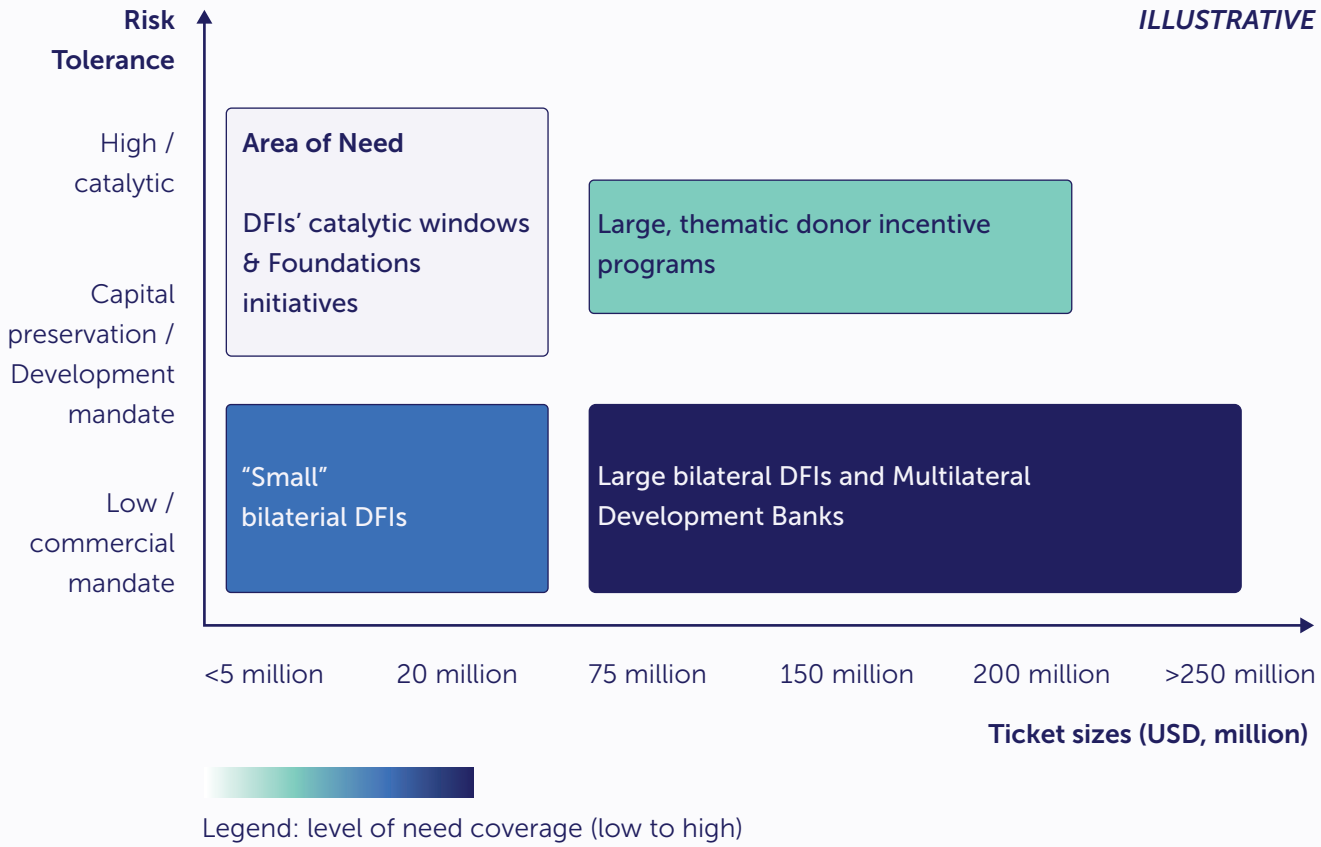
This gap in the market, and the position left open for intentional catalytic strategies to fill is illustrated in the exhibit below.

Mapping the prioritized investment needs in section 3, against limitations in current development finance strategies in section 4, gives us a sense of the market opportunity, phrased in terms of the investment strategy required to tackle it. While the following guidance is directional in nature, and each of its points merit further study (especially its variance from market to market, depending on specific country needs), it incorporates and responds to the needs expressed by UNCDF's peers (in consultations undertaken for this analysis) in the DFI landscape looking for further support in their mission.

1. **A focus on frontier, underserved markets where private capital is most hesitant to enter without the support of a catalytic partner,** and where existing DFIs cannot go alone, due to the limitations of their mandate and structure, e.g., LDCs, FCSs, SIDs.

2. **Investment in market development efforts to create proof of concepts**, providing grant finance and technical assistance to early-scale initiatives alongside local government bodies, incubators,

Figure 3: Illustrative positioning of existing DFI strategies based on size vs. risk tolerance



Note: this is a simplified representation. Many DFIs operate across categories or have specific windows with different risk/ticket profiles. Placement is indicative based on core mandates and typical operations

accelerators, and innovation programs of sister UN agencies. Disseminating case studies with data on viability of assets to fellow DFIs and private impact investors to draw them into frontier markets, illustrating the opportunity of feeding into their future investment pipelines.

3. **Designing catalytic investment tools that draw in additional private and DFI financing to meet the needs of different types of missing-middle (local infrastructure, municipalities, SMEs)**

    - **Flexibility**: employing flexible and unconventional terms tailored to the needs of the investee or project, such as smaller deal sizes (e.g., ranging from $200,000 to $5 million for SMEs, $5million to $20 million for municipalities and small scale infrastructure projects), unique collateral arrangements, and higher tolerance for transaction costs
    - **Patience**: accepting the reality of longer investment horizons and uncertainty regarding exit timelines, recognizing that deep impact and market development take time
    - **Transaction speed:** faster turnaround times to disbursing capital to investees that adjust to the urgency of the problem being solved by co-developing diligence and reporting requirements with local investment partners that strike a balance between rigour and ease of implementation
    - **Focus on risk mitigation** tools like guarantees to portfolios of local lenders, or even incoming DFIs in frontier markets, or subordinate debt to alter the risk-return profile for other (private, and local public) potential investors.

4. **Place-based investment strategies** that respond to the varying needs of countries based on their development priorities, demography, geography, and climate, as opposed to a rigid focus on select sectors and/or themes. This could mean a focus on decentralized energy systems in areas facing rural electricity shortages, urban municipal infrastructure financing in regions with rapid urbanization, and/or SME financing through local banks in entrepreneurship hubs with high supply of talent and skills. Alignment with national and sub-national governments and their policy priorities, should drive investment strategies.

5. **Working with national and subnational public development banks as partners** to reach the last-mile in local currency lending, whether in last mile of SMEs, or last mile of local municipalities, by strengthening the balance sheets with concessional debt/equity and/or targeted guarantee facilities, and improving technical capacity of national and sub-national public banks to service priority sectors.

UNCDF's role and positioning in this landscape

The final question left to answer in this analysis is how a differentiated development financing strategy can fill the gaps left by existing DFIs, and what kind of institution embodies the principles described above.

The United Nations Capital Development Fund (UNCDF) is the UN's dedicated agency for capital investment, primarily serving Least Developed Countries (LDCs). Established by the UN General Assembly in 1966, its mandate is to assist developing economies by supplementing existing capital assistance through grants, loans, and guarantees. UNCDF aims to make finance work for inclusion, focusing on expanding inclusive financial markets and local development finance systems to unlock public and private finance at the local level. As a non-credit-rated UN entity with a unique capital mandate, UNCDF is positioned to act as a catalyst in high-risk markets, deploying blended finance solutions and de-risking investments to mobilize capital where traditional actors are hesitant.

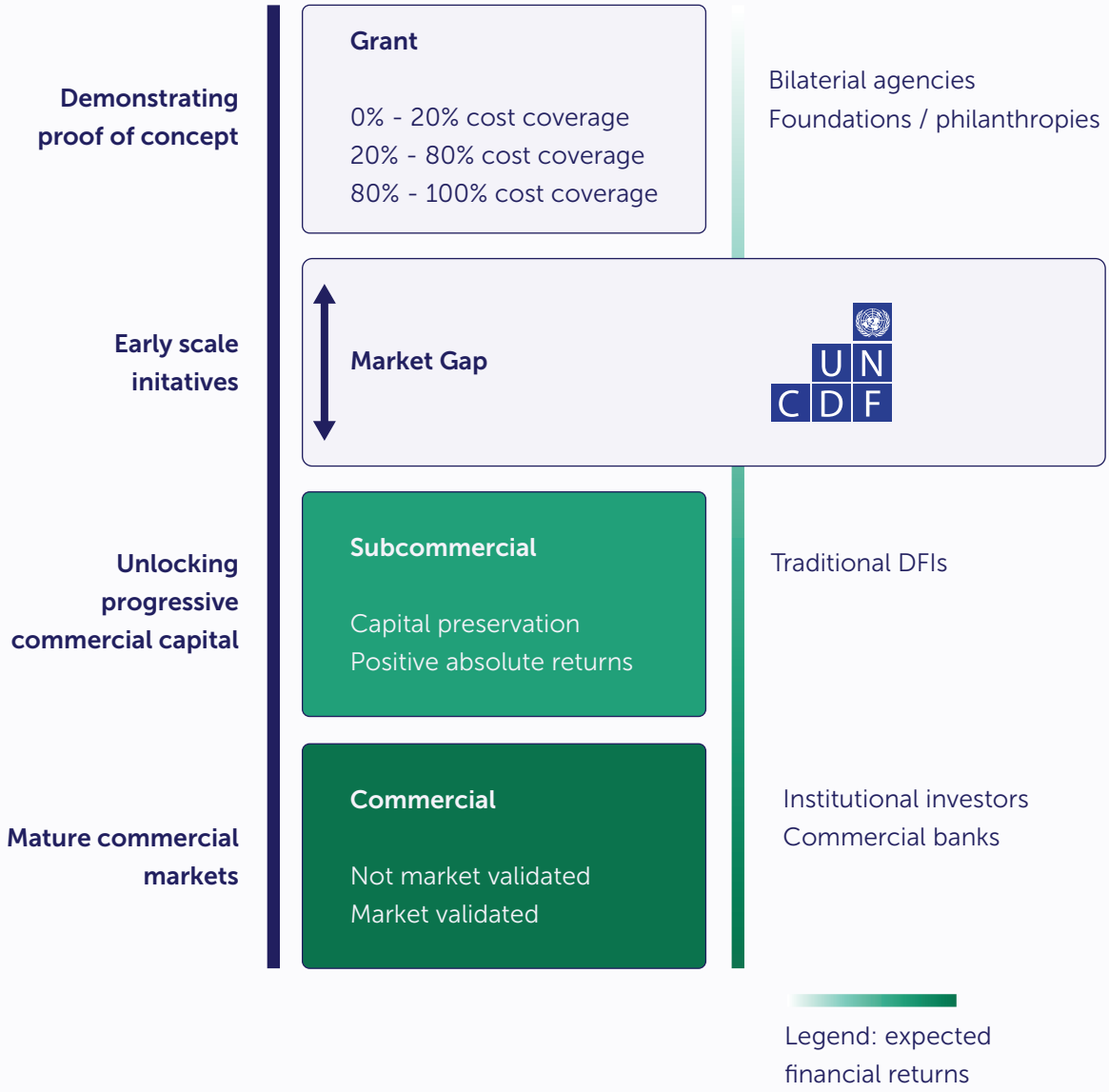
Given its strategy and mandate, structure, and operating model, United Nations Capital Development Fund (UNCDF) appears as a promising candidate to address the critical investment gaps in high-risk frontier markets described in this paper. Unlike traditional multilateral development banks (MDBs) and bilateral Development Finance Institutions (DFIs) constrained by fiduciary duties to ensure fund reflows and minimum shareholder returns, UNCDF's distinct mandate allows it to operate with a higher risk appetite. It explicitly advocates for and deploys localized investments and country-led blended finance solutions, specifically tailored to the complex realities of these geographies. This structural flexibility enables UNCDF to play a catalytic role, directly addressing market failures that deter conventional private capital.

This operational framework permits UNCDF to provide crucial first-loss capital and absorb deal-level losses, thereby de-risking projects for private investors where MDBs and DFIs cannot. Such interventions are vital in environments characterized by high perceived risk, inadequate risk sharing mechanisms, and weak regulatory and financial capabilities. UNCDF's approach can foster an enabling environment by strengthening local financial institutions and enhancing project preparation capacities, which are often insufficient.

Aside from its investment toolkit and strategy, UNCDF's brand occupies a distinct and strategic position in the international development finance landscape, particularly in the context of frontier and high-risk markets where trust, legitimacy, and local access are as critical as capital. As the UN's specialist financing arm, UNCDF leverages the UN's deeply rooted relationships with national and subnational governments in the Global South—relationships built over decades of politically neutral, demand-driven engagement. This embeddedness allows UNCDF to work directly with governments to shape policy, reform regulatory frameworks, and create the enabling environments necessary for sustainable private investment. For donors and investors seeking to catalyse market development in the most challenging contexts, UNCDF offers an unparalleled value proposition: the access and trust of a UN entity, combined with the technical capabilities of a nimble, finance-focused institution.

UNCDF features and characteristics	Implications on filling market gaps/needs
Deal size of $250,000 - $5 million for direct investments	Strong fit with "missing middle" across asset classes, including for off-grid and decentralized public infrastructure, and for private SMEs
Risk Tolerance: Very high (non-credit rated)	Ideal for entry and expansion into high-need, high-risk countries with substantial high degree of underserved beneficiaries such as women and youths, towards nascent but high-impact sectors like agriculture, WASH, decentralized energy, financial inclusion
Patient capital: Time horizon of 10-15 years	Attractive for financial intermediaries like private impact funds looking for investment from LPs with patient return horizons. Suitable for high-risk investment projects with long-term return profile wherein UNCDF's de-risking support could attract commercial and semi-commercial capital
Financial tools including grants, blended finance, and off-balance sheet financing	Attracts a wide range of investment opportunities that need different forms of support, from funds looking for TA, to banks and microfinance institutions in the need of guarantees, to facilitate finance for SMEs looking for patient equity
Partnerships and in-country presence through UN Ecosystem	UNCDF has unique ability to provide on-ground and in-country support to stakeholders (private sector and government) by virtue of partnerships with UN ecosystem actors. Opens up access to consumers and pipelines through existing work of UN agencies in key impact sectors, and access to national and sub-national government agencies critical to create an enabling environment around investments. Further, UNCDF's curated blended financial solutions help amplify the development interventions and efforts by UN partners and local stakeholders.
In-house blending and financial structuring expertise	Provides ability to make direct investments in asset operators if required, and extend TA to intermediaries looking to build their own financial capabilities
System enabler beyond deal-making	Supports long-term market development by strengthening domestic financing ecosystems, enhancing the enabling environment, and building local actors' capabilities and country-owned financing mechanisms that persist beyond individual investments.

Figure 4: Investment continiuum from concessionary to market rate investors, and gaps



Source: Adapted from Omidyar's Investment Continuum

As seen in the figure above, UNCDF's role is fundamentally catalytic – it serves as the first- and last-mile financier in frontier markets, bridging innovative local initiatives to larger DFIs and investors. By deploying small, concessional, early-stage capital (often $0.5 million – 7 million) into unbankable contexts, UNCDF de-risks projects and demonstrates viability where markets have failed or stalled. In effect, UNCDF is an "advance... off-balance sheet, de-risking team" for the multilateral and private sector – it prototypes finance models and builds market scaffolding in overlooked communities so that mainstream investors will eventually say "yes." Its interventions are explicitly designed to be sequenced, and not be one-off: once a proof-of-concept is proven, UNCDF hands these projects over to larger DFIs/MDBs or commercial financiers for scaling. In short, UNCDF deepens local ecosystems through precision finance and then feeds those bankable opportunities into the broader development finance continuum.

To maximize its impact and effectively bridge these critical financing gaps, UNCDF is best placed to follow a narrow but specialized pathway to demonstrating its value. This entails, first, a disciplined focus on delivering a select few high-impact interventions exceptionally well, thereby establishing a distinct niche where its risk-tolerant mandate and blended finance tools can yield the most transformative results. Second, UNCDF must actively complement, rather than duplicate, the evolving efforts of other DFIs.

By providing crucial early-stage support, de-risking nascent projects, and helping to build robust investment pipelines, UNCDF can enable larger DFI and private capital flows into geographies and sectors that would otherwise remain underserved. Finally, leveraging the extensive in-country presence, deep domain expertise, and established policy and institutional connections of other UN agencies will be paramount, ensuring that UNCDF's financial interventions are strategically aligned with broader development objectives and grounded in local realities. This focused, collaborative, and catalytic strategy can enable UNCDF to stand out amongst the crowd of DFIs, helping them close the gap between market need, institutional ambition, and ground realities in frontier markets.

ANNEXURE:

A. Note on country prioritization

This paper uses a combination of three country classification frameworks to define priority areas of development for the development finance community. This is an editorial choice based on the scope of analysis and mandate. We understand that depending on the stakeholder and selected priorities, some readers may prefer one over the other in alternate constructions.

The master set used is the UN's least developed countries (LDCs) covering 44 countries, selected for its comprehensive measure of development challenges and economic constraints in countries, over and above traditionally used indicator of GNI. To this set we add countries that are facing imminent and accelerated risks that are causing shocks to their economies, particularly climate change and civil/political conflict, which in turn threaten global stability through mass-migration and supply chain disruptions. For the former, we use the UN's Small Island Developing Countries (SIDS) (39), many of which are not LDCs, but risk regressing down the income ladder due to their geographic overexposure to sea-level rise and extreme climate events. For the latter, we add the World Bank's list of Fragile and Conflict-Affected States (FCS) (approx. 40 at the time of writing). Most FCS overlap with LDCs barring 15 states, including countries like Iraq, Lebanon, and Venezuela, that are facing or have already reached institutional failure, and are major sources of migration into high-income countries.

B. Infrastructure deficits in select regions of the world (LDCs, FCS, SIDS)

Indicator	LDCs	FCS (Proxy: SSA Avg where specific FCS data unavailable)	SIDS	Global/Other Developing Avg (for comparison)
Electricity Access (%)	56.3% (2021)	~51% (SSA, 2022)	~91% (Avg, 2021)	91% (Global, 2021)
Rural Electricity Access (%)	~33% (Est. based on 2/3 without)	31% (SSA, 2022)	Varies widely (High disparities)	83% (Global Rural, 2020)
Basic Drinking Water Access (%)	67.1% (2022)	---	83.5% (2022)	73% (Global, Safely Managed) / 90% (Global, Basic)
Basic Sanitation Access (%)	39.2% (2022)	---	69% (2022)	65% (Global, Safely Managed) 5/ 81% (Global, Basic)
Internet Users (%)	19% (2019)	37.1% (Africa Avg)	61.8% (2023)	66% (Global Approx.)
Primary Schools w/ Electricity (%)	---	~33% (SSA)	---	---
Health Worker Density (Physicians/10k ppl)	2.7 (2017)	3.7 (FCS Avg, 2017)	Varies (11 SIDS critical gaps)	15.6 (Global Avg, 2017)

C. DFI capitalization structure and impact on risk appetites

DFI Type	Capitalization Structure	Fiduciary Duty to Investors	Why it Prevents Very High Risk / Very Low Return Investments	Examples of Geographies/ Assets Often Avoided (or only engaged with extreme caution/specific instruments)
Multilateral Development Banks (MDBs)	Primarily capitalized by shareholder contributions from member countries (governments - paid-in & callable capital). Raise significant funds by borrowing in international capital markets, leveraging AAA/high credit ratings & preferred creditor status.	To their member countries (shareholders) and critically, to their bondholders. - Shareholders: Expect prudent use of capital for development, and a sustainable institution. - Bondholders: Demand financial soundness, creditworthiness, and timely repayment. The AAA/high credit ratings are paramount.	Constraint: The MDBs' ability to borrow vast sums cheaply in global capital markets relies entirely on their high credit ratings. - Investing heavily in very high-risk geographies (e.g., active war zones, highly unstable states with no rule of law) or assets with inherently very low or negative financial returns would threaten their ability to repay bondholders, leading to rating downgrades. - A downgrade would dramatically increase their borrowing costs, undermining their core model of providing concessional finance and scaling development impact. Their callable capital, while a backstop, isn't intended for routine losses.	- Geographies: Countries in protracted, active civil war with no functional government (e.g., currently, Somalia, Sudan, Yemen for large-scale, direct investment). - Assets: Pure grants (unless explicitly through a separate fund like International Development Association, IDA), or investments where there's no realistic path to financial repayment (e.g., highly experimental, unproven technologies with no market, or social services with no revenue stream).
Regional Development Banks (RDBs)	Similar to MDBs, primarily capitalized by shareholder contributions from member countries within a specific region. Borrow in regional or international capital markets.	To their member countries (shareholders) within the region and to their bondholders. - Shareholders: Expect regional development and financial stability. - Bondholders: Demand financial stability and repayment.	Constraint: While focused regionally, RDBs also need to maintain their creditworthiness to access capital efficiently. - Concentrated exposure to a region with widespread extreme instability or pervasive non-performing assets would jeopardize their financial health and ability to raise funds, hindering their mandate. - Their capitalization may be smaller than MDBs, making them relatively more sensitive to large losses.	- Geographies: Entire regions engulfed in widespread, simultaneous conflicts or systemic economic collapse. - Assets: Infrastructure projects in areas with no security guarantees, or direct equity investments in highly speculative, untested start-ups with no clear path to profitability or social impact in volatile environments.
National Development Finance Institutions (National DFIs)	Capitalized by their respective national governments through direct budget allocations, equity injections, or government-backed debt. Some may also raise funds from domestic capital markets.	Primarily to their national government (sole shareholder) and, indirectly, to the taxpayers of that country. Also, duty to specific national development mandates.	Constraint: While less constrained by international credit ratings than MDBs, National DFIs are ultimately limited by their government's fiscal capacity and political will. - Repeated or significant losses from very high-risk/low-return investments would deplete public funds, lead to calls for recapitalization (a burden on taxpayers), and damage the DFI's reputation and mandate support. - Governments, while willing to take more risk for strategic national development, have budget limitations and accountability to the public.	- Geographies: Extremely remote, underserved areas within their own country if the cost of investment is disproportionately high with no economic viability, or projects with significant political risk within their own jurisdiction that could lead to expropriation without compensation. - Assets: Investing in highly inefficient, non-competitive state-owned enterprises that are perpetual loss-makers, or funding basic social services that are unequivocally the role of the state budget and offer no financial return.

DFI Type	Capitalization Structure	Fiduciary Duty to Investors	Why it Prevents Very High Risk / Very Low Return Investments	Examples of Geographies/ Assets Often Avoided (or only engaged with extreme caution/specific instruments)
Public National Banks (State-Owned Commercial Banks with Development Mandates)	Capitalized like other banks, through equity (from the state), deposits from the public, and borrowing from interbank markets. Operate under banking regulations.	To their shareholder (the government) and, crucially, to their depositors and creditors. - Dual duty: commercial viability and public policy mandate.	Constraint: These entities are bound by banking regulations and capital adequacy requirements designed to protect depositors and maintain systemic financial stability. - Engaging in excessively risky lending or investments with minimal returns would rapidly deplete their capital, violate regulatory requirements, and risk a bank run or collapse, jeopardizing public savings and the financial system. - Their "developmental" role is usually within a framework of financial prudence, not a carte blanche for losses.	- Geographies: Loans to individuals or businesses in highly volatile, unregulated, or unserved regions within the country where default rates are near 100%. - Assets: Providing loans with no collateral or repayment plan to politically connected, non-viable businesses, or consistently making loans that generate returns significantly below the cost of capital, without any other compensatory mechanism.

D. Investment focus of select multilateral and bilateral DFIs

(illustrative, based on ranges. not exhaustive)

Figure 5: Select Multilateral DFIs and investment features

Multilateral DFI	Total asset* size	Total commitment to the private sector	Investment ticket (range)	Main sectors of intervention
African Development Bank (AfDB)	$50.9 billion (AfDB overall)	**$11 billion** total private sector operations approved (2023)	Highly variable, typically **$10 million and above** for NSO	Infrastructure, energy, financial services, agribusiness, industrialization
Asian Development Banks (AsDB)	$271.7 billion (AsDB overall)	**$3.8 billion** non-sovereign commitments (2023)	**$10–250 million**	Renewable energy, infrastructure, financial inclusion, agribusiness, healthcare
Asian Infrastructure Investment Bank (AIIB)	$32 billion (AIIB overall)	*Not communicated*	*Not communicated*	Sustainable infrastructure, renewable energy, digital infrastructure, cross-border connectivity
European Bank for Reconstruction and Development (EBRD)	$85.3 billion (EBRD overall)	**€55.9 billion** total private sector portfolio (2023)	**€5–250 million**	Sustainable infrastructure, financial institutions, agribusiness, manufacturing, green energy

* Refers to total assets as reported on DFIs' balance sheet. It typically includes the current value of investment portfolio, liquid assets and other financial assets | Source: DFI Transparency Index 2023, MDBs' annual reports

Multilateral DFI	Total asset* size	Total commitment to the private sector	Investment ticket (range)	Main sectors of intervention
European Investment Bank (EIB)	$767 billion (EIB overall)	**€14.9 billion** total private sector financing (2023), incl. €0.9 billion outside the EU	**> €25 million**	Climate action and environmental sustainability; technological innovation; security and defense; agriculture and bioeconomy; social infrastructures; cohesion policy and high-impact global investments
Inter-American Development Bank Invest (IDB Invest)	$6.4 billion	*Not applicable*	**$5 to 50 million**	Infrastructures, clean energy, transport and new sectors (e.g., financial technologies)
Islamic Corporation for the Development of the Private Sector (ICD, IsDB Group)	$3.27 billion	*Not applicable*	**$25–50 million**	Energy & Power, Transportation, Water, Waste Management, Extractive Sector, Social Infrastructure PPPs, Petrochemicals, and more
World Bank Group IDA-IFC-MIGA Private Sector Window *Includes Blended Finance Facility, Local Currency Facility, MIGA Guarantee & Risk-mitigation Facility*	$2.5 billion (IDA18)	*Not applicable*	*Provides concessional resources to IFC or MIGA to make specific investment in risky/fragile contexts*	Mainly infrastructures, SME finance and agribusiness
World Bank Group - IFC	$105.3 billion	*Not applicable*	From **$1 million** (some SME programs) **to +$100 million** (large projects)	Infrastructures, Agriculture, Financial Institutions, Sustainable Cities and Manufacturing/ Services
International Fund for Agricultural Development (IFAD)	$0.1 billion (IFAD13 NSO)	*Not communicated*	**$10-20 million**	Rural development, agriculture, and food systems
* Refers to total assets as reported on DFIs' balance sheet. It typically includes the current value of investment portfolio, liquid assets and other financial assets | Source: DFI Transparency Index 2023, MDBs' annual reports				

Figure 6: Select bilateral DFIs and their investment features

Bilateral DFI	Total asset* size	Investment ticket (range)	Risk/return profile	Main sectors of intervention
BII (UK)	$9.4 billion	Direct debt: $10–250 million Funds: up to $150 million	Commercial mandate	Financial services, infrastructure, climate, SMEs, digital, healthcare
BIO (Belgium)	$1.3 billion	€3–20 million	Commercial mandate	Financial institutions, SMEs, infrastructure, renewable energy
* Refers to total assets as reported on DFIs' balance sheet. It typically includes the current value of investment portfolio, liquid assets and other financial assets. | Source: DFI Transparency Index 2023				

Bilateral DFI	Total asset* size	Investment ticket (range)	Risk/return profile	Main sectors of intervention
DFC (USA)	$12 billion	$2 million–$1 billion	Commercial mandate	Energy, healthcare, infrastructure, financial services, agribusiness
FinDev (Canada)	$1 billion	$10–40 million	Development mandate, concessional returns	Financial institutions, sustainable infrastructure, agribusiness, gender finance
Finnfund (Finland)	$0.88 billion	€5–25 million	Commercial mandate	Renewable energy, financial inclusion, digital infrastructure, agribusiness, gender equality
FMO (Netherlands)	$11 billion	Direct debt/equity: €5–50 million Funds: up to €150 million	Commercial (FMO A) to concessional (Dutch Government pockets tolerate capital preservation)	Financial institutions, energy, agribusiness, infrastructure, inclusive finance, climate finance
KfW / DEG (Germany)	$7.8 billion (DEG)	€10–50 million (typical: €20–30 million) €10–50 million (typical: €20–30 million)	Commercial (DEG) to concessional (KfW pockets tolerate capital preservation)	Infrastructure, energy, financial institutions, manufacturing, agribusiness
Norfund (Norway)	$2.9 billion	Typically $5-50 million, median ticket size $15 million	Development mandate, concessional returns	Renewable energy, financial inclusion, scalable enterprises (agribusiness, manufacturing), green infrastructure
Proparco (France)	$7.8 billion	€5–50 million	Commercial mandate	Infrastructure (including renewable energy), financial institutions, health, education, agribusiness
Swedfund (Sweden)	$0.87 billion	~ $5–50 million (SEK 50-500 million)	Commercial mandate	Energy & climate, financial inclusion, sustainable enterprises

* Refers to total assets as reported on DFIs' balance sheet. It typically includes the current value of investment portfolio, liquid assets and other financial assets. | Source: DFI Transparency Index 2023

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United Nations Capital Development Fund (UNCDF) mobilizes and catalyses an increase in capital flows for impactful investments in high-risk markets, especially in Least Developed Countries, Small Island Developing States and countries in special situations. By crowding in capital through the deployment of risk-absorbing financial instruments, mechanisms and structuring advisory, UNCDF contributes to job creation and sustained economic growth in more than 70 countries.

In partnership with UN entities and development partners, UNCDF operates with speed and agility to deliver scalable, blended finance solutions to drive systemic change and pave the way for commercial finance and scale up by development finance institutions and multilateral development banks.

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