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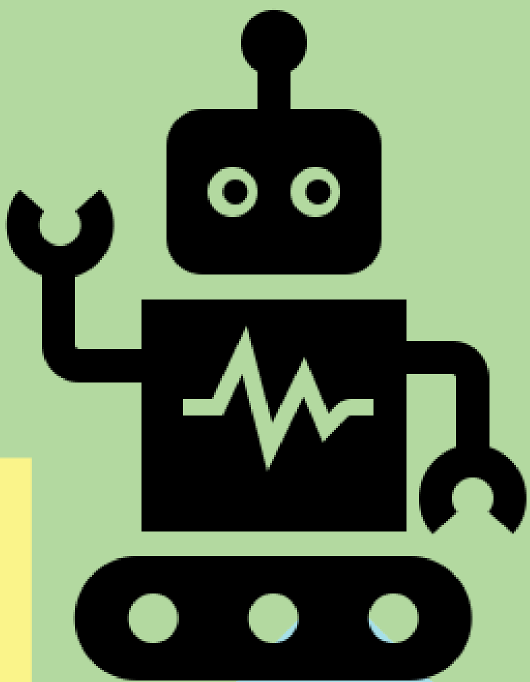

The CDFS Short Read – July 2025

The Case for Actively Embracing Passive Mobilisation

This CDFS Short Read in Brief

Current approaches to private capital mobilisation are struggling to scale and broadly attract institutional capital. To address this challenge, this Short Read proposes an additional "top-down" approach that leverages some of the existing instruments institutional investors are increasingly using to deploy their capital and explores their potential to close the funding gap for sustainable development. By gradually introducing securities aligned with sustainable development objectives into the mainstream indices that Exchange Traded Funds ('ETFs') and other passive funds are benchmarked against, capital mobilisation can be achieved systematically without having to resort to complex fund structures unfamiliar to most investors.

This approach recognises that investors naturally prefer the path of least resistance, beginning with relatively recognised, liquid, transparent instruments associated with lower levels of risk before gradually moving to more complex investment structures as they gain familiarity with a new asset class or geography. Adding a small allocation to frontier markets securities to an existing emerging markets mandate is considerably easier for institutional investors than creating a new standalone private markets allocation requiring a recalibration of their investment process.

With global ETF assets reaching $15 trillion and institutional investors increasingly shifting toward passive strategies, ETFs represent an untapped opportunity to mobilise private capital at unprecedented scale for sustainable development in emerging markets.

Whilst they may not be the elusive silver bullet, ETFs offer unique structural advantages. Their open-ended, regulated structures provide scalability, enhanced liquidity and transparency. They are often passively managed, index replicating funds, purchasing the securities included in the indices they track, systematically creating capital flows in and out of the underlying securities.

They sit at the opposite end of the operational efficiency spectrum from blended finance vehicles that, sometimes justifiably, require lengthy structuring and concessional capital. They can be launched at a relatively low cost while offering enhanced liquidity through a creation/redemption mechanism. They can accommodate low investment amounts, are associated with low costs and relatively undemanding legal structuring and due diligence requirements.

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They can contribute to local EMDE capital markets development and enhance their liquidity. India's inclusion in JP Morgan's Emerging Market Bond Index demonstrates the transformative power of index inclusion. Since the June 2024 announcement, foreign investors have purchased over $10 billion in Indian government bonds. S&P projects initial inflows of $20-40 billion, potentially reaching $180 billion over the next decade, with corporate debt markets expected to triple relative to GDP by 2030.

Current sustainability indices systematically under-allocate to developing countries. The MSCI ACWI Sustainable Impact Index for example allocates over 55% to high-income countries, while many ODA-eligible countries do not feature in emerging market indices at all. This misallocation occurs as passive strategies' holdings in emerging markets have grown aggressively.

Unlocking ETFs' potential requires several key developments. New indices specifically including ODA-eligible countries with meaningful development impact should be created. Market-making support could enhance frontier market liquidity. Coordinated efforts to expand the universe of investable securities meeting index criteria would broaden ODA-countries' access to passive capital flows.

This Short Read will examine the growth of ETFs as a potential market trend worth monitoring that could be critical to close the funding gap in ODA countries. It will assess their potential to mobilise private capital at scale and address legitimate risk perception and liquidity concerns.

By embracing the mechanics of passive investing through ETFs and sustainable development indices, the development finance community can harness a fundamentally different approach to private capital mobilisation, one that works with, rather than against, the prevailing investment industry trends

1. Introducing a top-down approach to private capital mobilsation

ETFs, really?

The introduction of Exchange Traded Funds ('ETFs') in this Short Read, associated as they are with the most liquid end of the capital markets spectrum, to the development finance conversation can appear controversial.

We argue that this is in part because it runs contrary to the development finance system's prevailing approach to private capital mobilisation ('PCM') for private sector developmental investments. With the bulk of institutional investor capital deployed through stocks or bonds listed on the public capital markets of developed economies, and development finance actors justifiably deploying capital through direct lending and private equity to build assets in developing economies, the focus has to date been on convincing the former to start their journey by co-investing with the latter.

Decades of hard learned lessons in capital markets have taught us that this approach is antinomic to a well rehearsed process through which investors enter a new segment through the path of least resistance, lowest risk and highest liquidity, and gradually, as their understanding of the relevant dynamics improves, are drawn to more granular, risky and rewarding propositions.

Put simply, mobilisation should start from the top and work its way down, rather than the other way around. Investors must first be enticed to join the fray through the end of the market spectrum which is closer to their current allocations and portfolio construction approaches, rather than being brought in at the sharp end of things, often by resorting to necessarily finite subsidisation.

Dilutive mobilisation

Another observation borne out of experience is that investors have rightly built processes to implement their strategic asset allocation decisions that make any significant changes difficult to implement. It follows that convincing a risk averse institutional investor to make a new standalone allocation to a niche emerging markets theme that does not neatly fit its current investment process might be an arduous task. For instance, introducing an allocation to sub-saharan private equity SME funds into an institutional client allocation unsurprisingly borders on the impossible.

The inclusion of a Least Devoped Country's sovereign bonds in an already approved emerging markets fixed income investment mandate is comparatively achievable. The level of risk contributed to the portfolio by such a gradual move will not require a significant change to the investment process.

Passive mobilisation: to get the right answer, it is often better not to ask the question

This leads us to the relevance of passive investment to the PCM conversation. The most mechanical route to the gradual inclusion of developing economies assets in the portfolios of institutional investors is through their gradual inclusion in the indices that passive funds (or benchmarked active funds for that matter) are designed to replicate.

This will require some doing but the leverage effect of such an endeavour is of systemic relevance. And whilst it will admittedly initially focus on the most liquid of these assets, there is not only plenty of generic evidence, but also early specific evidence that it will eventually drive capital further down the risk spectrum. As will be discussed below, it is anticipated that the inclusion of India's sovereign bonds in broad emerging market indices will enhance the country's corporates' access to capital.

Why this matters?

'Traditional' PCM asks institutional investors to jump directly into complex, illiquid structures in unfamiliar markets. This new approach works with investor psychology instead of against it, starting with liquid, transparent instruments they already understand before gradually moving to more sophisticated investments. The leverage effect is potentially significant: small allocations in familiar ETF structures can mobilise vast pools of capital blended finance cannot reach.

2. Rendez-vous with capital markets

In a risk-off volatile market environment, and as the pools of concessional capital that most blended finance structures rely on are increasingly scarce, it is more than ever necessary to meet private sector investors where they are to increase allocations to the sustainable investments in Emerging Markets and accelerate capital markets development in this region**.**

Development finance stakeholders should increasingly align their private capital mobilisation (‘PCM’) strategies with the standardised public markets investment approaches widely adopted by institutional investors. Urgent action is needed to embrace observable and accelerating market trends and to adopt well-established tools to fund sustainable investments.

Emerging Markets and Developing Economies (EMDEs) are facing a significant funding gap in their pursuit of the Sustainable Development Goals (SDGs). The United Nations estimates that achieving the SDGs by 2030 requires significant investments with a financing shortfall ranging between $2.5 trillion and $4 trillion annually[1] for developing countries. In a recent report, UNCTAD has projected above $5 trillion investment needed annually to achieve SDGs by 2030.

The same UNCTAD estimates that the sum total of annual private investment mobilisation is equal to only 1% of the $5 trillion. This is all happening as the global asset management industry reached a record $128 trillion in assets under management (AuM) in 2024, up 12% from the previous year. Importantly, the investment landscape is undergoing a massive shift from actively managed funds into passive strategies, a long-term trend which has accelerated as the performance of traditional active mutual funds carrying higher costs lags behind benchmarks. In 2024 alone, active funds saw $0.1 trillion in outflows (excluding money market funds), while $1.6 trillion found their way to passive funds[2], highlighting the magnitude of this phenomenon. This trend is widely expected to continue to reshape the asset management industry.

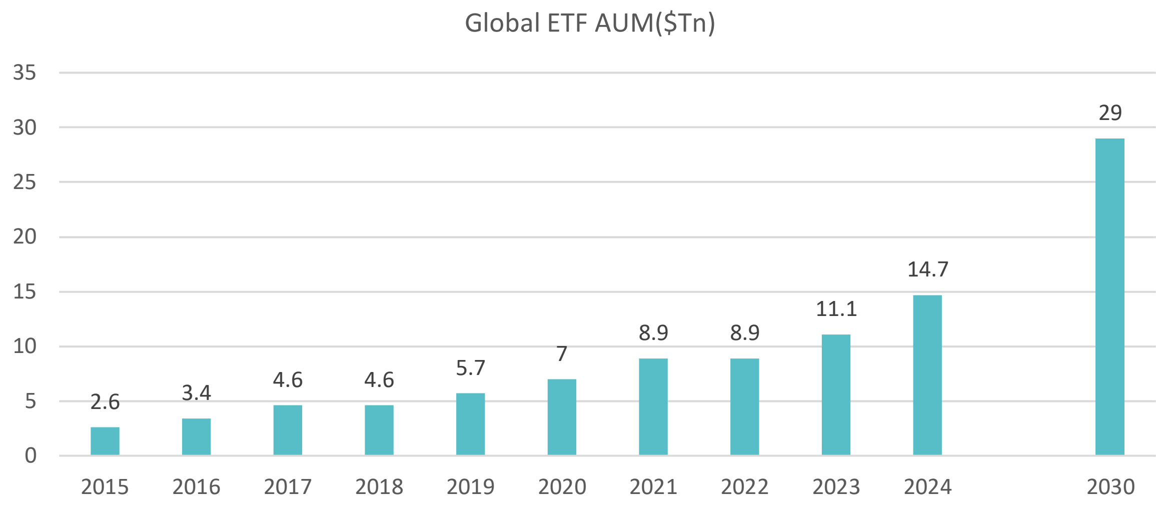
The SDG financing gap will potentially continue to widen with no clear and standardised path to align the official development finance system with the wider capital markets.

Why this matters?
we need $5 trillion annually for SDGs, but current private mobilisation only delivers 1% of that. Meanwhile, $128 trillion sits in global asset management, increasingly flowing towards passive strategies ($1.6 trillion in 2024 alone). Development finance must meet capital where it's going and embrace market trends. The window to harness this adoption of passive investing for development is narrowing.

[1] Financing for Sustainable Development Report 2024

[2] https://www.bcg.com/publications/2025/reinventing-growth-amid-market-volatility

3. ETFs, a scalable solution



3.1. A scalable instrument and a trend set to continue

ETFs constitute one of the fastest growing segments of the investment industry with over $15 trillion in assets under management. This should make them an important option to consider for the purpose of PCM. Among the current range of fund structures, they are comparatively quick to launch, cost efficient, regulated, standardised and offer enhanced liquidity to a wide range of investors.

Liquid
ETFs trade on exchanges just like stocks and have strict risk management and governance regulations
Cost Efficient
ETFs are usually more cost efficient than buying the underlying basket of securities.
Flexible
ETFs are used for strategic or tactical asset allocation, risk and cash management.
Diversified
ETFs track indices comprising a basket containing hundreds or thousands of single securities, insulating investors from idiosyncratic risk of a single asset or market segment.

Their open-ended and transparent nature helps investors make relatively quick decisions and get instant exposure when implementing their short-term asset allocation views or long-term investment and sustainability objectives.

As standardised public markets instruments, they could potentially address some of the challenges facing willing investors, such as due diligence timelines and costs, and deliver PCM at scale through the quick and efficient mobilisation of private allocators to which they are familiar. In stark contrast to bespoke private markets fund structures, ETFs are already adopted by institutional and private investors and widely utilised in the context of their current asset allocation.

There are undoubtedly circumstances where complex structures are necessary to address a specific market segment, and what is suggested here is an additional route to private capital mobilisation. It is further posited that operational efficiency is a key asset management concept that should always inform strategic decisions.

Over the past five years, demand for ETFs has shown no sign of abating thanks to a combination of low investment costs, high liquidity, data transparency, and a growing and diverse universe of investment opportunities. According to a recent JP Morgan report, this trend is set to continue with ETF assets projected to essentially double by 2030 to $29 trillion. Institutional investors are increasingly shifting to passive products with passively managed assets growing from 17% to 20% of total industry assets over the past five years, while their active counterparts shrunk from 44% to 38%[3]. In Europe alone, supported by an established sustainability-driven institutional client base, UCITS ETFs are expected to see a 15% annual growth over the next 5 years, pushing the market past $4.5 trillion in Assets Under Management by 2030[4].

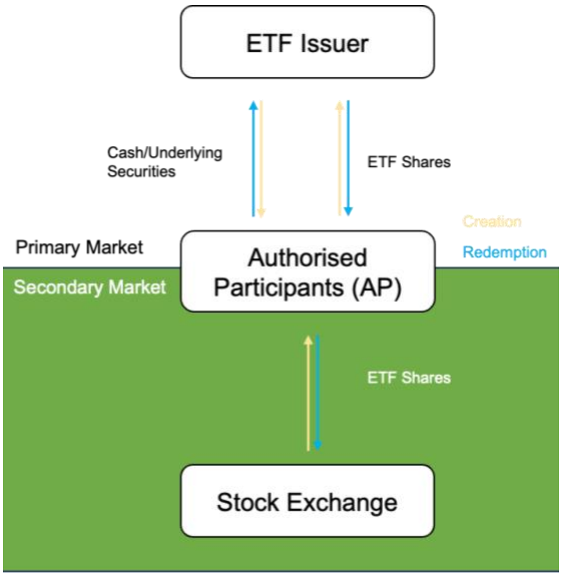
Why this matters?
The shift to passive investing isn't a temporary trend – it is a fundamental change of how capital flows. Development finance should monitor this trend and position itself to capture the capital flows it sets in motion, helping countries that need it most to also benefit. This is about meeting capital where it is decisively heading at scale.

3.2. Creation and Redemption Process

In addition to on-exchange trading, ETF liquidity is enhanced by an efficient creation and redemption process, which allows professional investors to trade directly with the fund in the primary market through a network of market actors referred to as 'Authorised Participants' (APs). This network of investors contributes to the liquidity of an ETF and to the trading conditions of the asset class.

The creation/redemption process takes place in the primary market between the ETF manager and APs, who regulate the supply and demand of ETF shares in the secondary market. APs can first create ETF shares in large increments known as 'creation units' by assembling the index basket of bonds or stocks tracked by the ETF, in their corresponding weightings, to reach creation unit size.

The AP then delivers the basket of securities to the ETF sponsor. In return, the ETF sponsor bundles the securities into ETF shares, and delivers them to the AP. The majority of ETF trading involving actual investors occurs in the secondary market, where they buy and sell newly issued or existing shares of ETFs either on-exchange or over the counter (OTC).

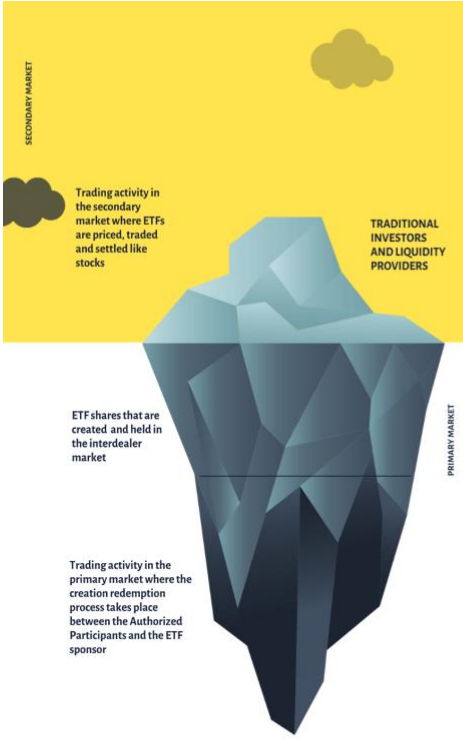


Once ETF shares are created, they flow into the secondary market where, as is the case with all publicly traded stocks, their price is determined in real time by the market, based on supply and demand.

[3] BCG

[4] EY, European ETF market forecast to grow 15% annually over next five years reaching $4.5 trillion by 2030

When the demand for ETF shares outweighs the supply in the secondary market, APs are likely to create shares by interacting with the ETF issuer. As supply outweighs demand in the secondary market, APs will likely use the reverse mechanism and redeem ETF shares with the ETF issuer. As long as APs can effectively and efficiently trade the underlying basket of securities to create and redeem shares, this mechanism will serve to adjust the supply and demand imbalance.



3.3. Liquidity & Structural Advantages

ETFs offer an attractive alternative to mutual funds and holding individual bonds or stocks, largely due to their unique structure.

In the case of fixed income for instance, when an investor redeems shares from a mutual fund, the fund typically needs to sell specific bonds in the market to raise the necessary cash. In contrast, ETFs benefit from additional layers of liquidity. When an investor sells ETF shares to a market maker, the shares can often be resold to another investor without triggering any securities sales in the primary market. Alternatively, the market maker may hold the shares in his inventory while managing risk.

Unlike individual securities, ETFs can also benefit from the breadth of interest in an entire asset class, which can contribute to tighter bid-offer spreads than the underlying instruments.

The underlying securities of ETFs with exposure to underdeveloped capital markets or niche themes can however be fairly illiquid underlying assets. Underlying instruments may in such circumstances exhibit higher spreads or lack quotation altogether.

In times of market turmoil, this can lead to price dislocation between the ETF and illiquid

The Financial Times did in April 2025 observe that collateralised loan obligation (CLO) ETFs, which had surged to $30 billion in assets over the previous two years by offering attractive yields, were now facing their first major stress test.

Following record outflows of $1.8 billion in one week amid broader credit market selloffs, these funds began trading at unusual discounts to their net asset value, raising questions about how well ETFs can handle market volatility when their underlying assets are essentially private credit instruments that don't trade as actively as typical ETF holdings[5].

There is however also evidence of market participants turning to the ETF market, which has proven to play a critical role for price discovery. The same article suggests that ‘ETFs give real-time price transparency’ when liquidity in the underlying instruments had all but disappeared.

[5] https://www.ft.com/content/42a7bacb-05f3-4c04-80eb-c29b9f720d8d

The liquidity of an ETF's underlying securities underpins the liquidity of the ETF itself. There should therefore be no suggestion that they are possessed of magical capabilities. Their accretive potential, linked to the addition of market liquidity for their shares to that of the underlying securities should however not be underestimated.

Why this matters?
In stark contrast to complex structures requiring years to implement, ETFs can be launched in months and tap into $15 trillion in existing assets. They solve three critical problems simultaneously: investor familiarity, enhanced liquidity, and broader asset exposure. This isn't just another financial instrument, it is a mechanism to systematically redirect mainstream capital flows.

4. Sustainable Development Indices: the missing link

ETFs track indices which measure the performance of a basket of securities such as equities, bonds or commodities and are intended to replicate a certain segment of the market using a rules-based and standardised methodology.

In the fixed income space J.P. Morgan or Bloomberg Emerging Markets bond indices are for example widely utilised by fixed income fund managers, institutional investors, and other market stakeholders as portfolio performance benchmarks while indices managed by MSCI, S&P or FTSE play a similar role in the equity space.

Benchmarks are rules-based and as such can mechanically allow eligible issuers to tap into mainstream capital markets through the abundant passive or benchmarked active pools they are comprised of.

When a bond or equity issuer meets an index' criteria, passive funds designed around such index must, in accordance with their rules, buy the eligible securities of that issuer which will consequently automatically benefit from private capital flows.

In recent years, major index providers have added sustainability-focused indices to their offering, a trend that boosted both the number of ETF products in the market and the assets they attract. Morningstar suggest there exist 7428 sustainable funds with Europe accounting for 74% of the total. This trend is encouraging and could help bridge the sustainable development goals funding gap.

When it comes to EMDEs, more needs to be done as indices and ETFs remain underutilised, with the capital flowing to these regions remaining highly concentrated on the most developed countries.

4.1. Addressing Index Representation Challenges

The challenge of limited EMDE representation in sustainable indices demands urgent attention, as current benchmarks systematically underweight those developing countries most in need of sustainable development investment.

To truly harness the potential of passive strategies for sustainable development financing, two tracks should be employed:

- development stakeholders should engage with index providers to encourage a gradual shift towards a higher degree of inclusion for ODA-eligible countries in existing indices
- a new suite of indices specifically targeting ODA-eligible developing countries should be developed, employing both top-down country selection based on development needs and bottom-up securities selection criteria that require minimum revenue generation in developing countries, adequate ESG compliance, and demonstrated ability to contribute to SDG achievement.

Such indices could serve as the foundation for new ETF products that channel the growing passive investment flows toward sustainable development in emerging markets, potentially transforming how the global ETF market engages with those countries requiring patient capital to finance their sustainable development.

Why this matters?
This is the leverage point PCM has been missing. Instead of persuading investors one by one to consider development themes, index inclusion makes the decision automatic. When an eligible security enters a major index, passive funds should buy it regardless of portfolio managers' subjective views on emerging markets or sustainable development.
It is mobilisation without persuasion.

4.2. Index Inclusion: a mechanical path to private capital mobilisation

When securities achieve inclusion in major indices, they unlock access to vast pools of passive investment capital. Unlike active funds that select individual securities, passive and index-tracking funds must systematically purchase any security included in their benchmark. This powerful mechanism operates across different levels of the market. Individual companies meeting index criteria attract direct passive fund purchases of their corporate bonds or equity, while sovereign bonds gain access to benchmark-driven flows that typically contribute to lower government borrowing costs.

When entire markets achieve index inclusion, the transformation can be significant, attracting both passive flows and renewed interest from active managers seeking to capitalise on improved liquidity and accessibility.

These index-driven flows tend to be remarkably stable, remaining invested for as long as the security retains its index status. This provides a more reliable capital base than discretionary investment decisions that can shift with market sentiment. The effect is often amplified by opportunistic investors, drawing in additional capital on the basis of a variety of investment rationales.The Indian Precedent
India's recent experience with bond market index inclusion powerfully illustrates these dynamics. After beginning economic liberalisation in 1991, India deliberately chose to conduct all government borrowing in local currency bonds to avoid the dollar dependency that contributed to the 1997 Asian financial crisis. This defensive strategy worked well for domestic stability but limited international investor access.

Recognising its potential benefits, Indian policymakers began actively pursuing international bond index inclusion in 2019, focusing particularly on JP Morgan's influential indices. The breakthrough came in June 2024 when JP Morgan added Indian government bonds to its flagship Emerging Market Global Bond Index (GBI-EM), including 23 Indian Government Bonds with a combined value of $330 billion.

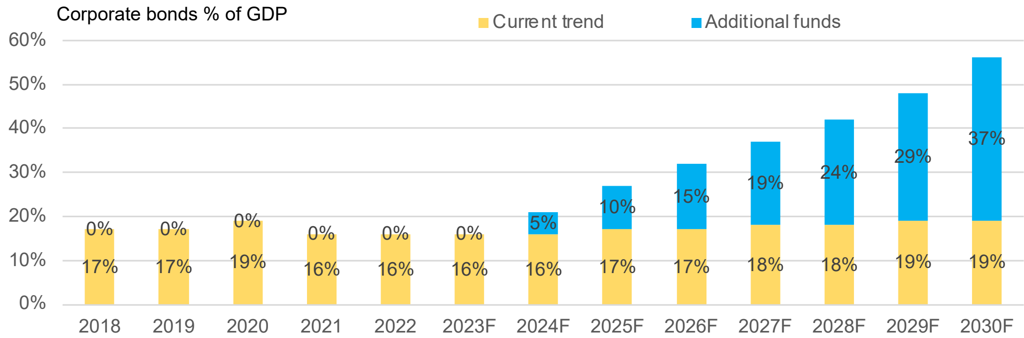
The market response exceeded expectations. Foreign investors poured over $10 billion into Indian government bonds following the inclusion announcement, pushing foreign ownership to an all-time high of 4.45%[6]. S&P Global projects that this inclusion could initially attract $20-40 billion in inflows, potentially growing to $180 billion over the next decade. Beyond government bonds, the spillover effects are expected to transform India's corporate debt markets, with available funding potentially tripling relative to GDP by 2030[7].

This remarkable transformation demonstrates how strategic index inclusion can fundamentally reshape market access for EMDEs. By meeting the technical requirements for index membership, countries can tap into the massive flows of passive capital that would otherwise remain inaccessible, creating the sustained funding streams essential for achieving sustainable development goals.

It also illustrates how ETFs are interlinked with the underling primary markets they track and what effects their flows could have in stimulating capital market activity.

Index Inclusion To Unleash More Funds for India's Corporates

Available funds for corporates could almost triple by 2030 if foreign ownership of Indian governement bonds rises to 10 %



Date complied June 9, 2023
F=Forecast
Source: Securities and Exchange Board of India; The Institute of International Finance

[6] https://www.reuters.com/world/india/what-indias-inclusion-jpmorgans-bond-index-means-its-markets-2023-09-22/

[7] S&P https://www.spglobal.com/en/research-insights/special-reports/look-forward/unlocking-india-s-capital-markets-potential

4.3. Understanding the rules

Index providers classify countries as frontier, emerging, or developed based on specific criteria, including market size, liquidity levels, and accessibility for investors.

These classifications reflect economic maturity and financial market development, helping investors gauge risks and opportunities in different regions. By analysing these factors, index providers seek to ensure that each country is placed appropriately within global investment frameworks.

A country graduating from Frontier Market to Emerging Market status signals to investors that it has made substantial strides in enhancing capital market accessibility, strengthening corporate governance, and improving transparency.

This upgrade reflects growing investor confidence, as it indicates a more developed financial system and regulatory environment, potentially attracting greater foreign investment and fostering economic expansion. Indices evolve alongside companies and markets, reflecting shifts in the financial landscape. Businesses may cease operations, merge, or debut on stock exchanges, while fixed-income securities undergo maturation and new issuances.

To maintain accuracy, index providers conduct systematic reviewing and rebalancing, striking a balance between keeping data relevant and avoiding excessive portfolio turnover. Equity indices, given their relatively stable composition, are typically adjusted two to four times a year, whereas bond indices require more frequent revisions given the dynamic nature of fixed-income markets.

Development finance actors should broaden their mandates accordingly. Deploying targeted technical assistance to stimulate local market development and to help local companies qualify for inclusion in indices should be one of the key steps they need to consider.

Developing local capital markets and aligning standards with international capital markets can only be beneficial to EMDEs, helping attract additional international capital and drawing a clear public markets path to growth and expansion for local companies.

Why this matters?
Index criteria aren't arbitrary - they're the gatekeepers to massive capital flows. Understanding and working within these rules is far more scalable than creating parallel financing systems. When a country graduates from frontier to emerging market status, it automatically accesses larger, more liquid investor pools. Development finance should prioritise helping countries and companies meet these criteria.

5. Perfection is not of this world, ours is to strive towards it

ETFs provide investors with diversified market, sector, or country exposure at relatively low cost. However, this broad-based approach has inherent trade-offs that may not align with all investment or development objectives.

The passive nature of most ETFs means they mirror index compositions rather than actively selecting securities, limiting investors' control over specific risk exposures. This can result in unintended concentrations, particularly problematic during period of market stress when correlations increase, and certain sectors dominate index weights.

Moreover, passive strategies are inherently reactive rather than anticipatory. They cannot actively adjust to shifting economic conditions or capitalise on market inefficiencies that skilled active managers might exploit. While this reactive approach ensures broad market participation, it lacks the nuanced risk management and opportunistic positioning that active strategies can provide.

These limitations underscore why sound index construction is critical, including appropriate diversification rules, optimal rebalancing frequencies, and clear methodologies for treating underperforming securities. Such considerations become especially important when using ETFs as tools for development finance, where the stakes of portfolio construction extend beyond financial returns to broader economic and social outcomes.

The main challenge to the effective adoption of ETFs and passive strategies is the necessary growth of the universe of eligible instruments across developing economies introduced in Chapter 1 of this Short Read.

What to do?

Perhaps most importantly, for ETFs and passive investment strategies to become a potent addition to the development finance PCM conversation, coordinated efforts are needed to continuously widen the universe of securities that satisfy to index criteria.

Whilst the deployment of technical assistance may be appropriate to help securities issuers meet many of these, liquidity criteria, even acknowledging they tend to be relaxed for frontier market indices, are a significant challenge.

The stimulation of market liquidity continues to be a significant gap in the development finance toolbox. Whether it be through the provision of market making capital to investment banks or through direct market participation, the mobilisation potential of enhancing liquidity on local capital markets can no longer be ignored.

Why this matters?
ETFs aren't a silver bullet - they require liquid underlying markets. But perfect shouldn't be the enemy of good. The current approach to PCM has left us with a $5 trillion annual funding gap whilst $15 trillion flows through standardised instruments are largely ignored. Strategic market-making support and technical assistance to expand the investable universe could unlock exponentially more capital than traditional approaches.

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For more information:
Please contact the CDFS at info@thecdfs.org with any comments or questions about this Short Read.