BY INVITATION ONLY
Roundtable discussion note

Bridging the Blended Finance Gap: What Role for Supervisors and Regulators?

IMF and World Bank Group Spring Meetings – Thursday April 18, 2024

While there are international experts on blended finance transactions, Toronto Centre (TC) is focused on the financial supervisory implications of blended finance.

Use of blended finance[1] transactions to attract private capital for investments in projects that hew to social development goals has grown over the past decade. But it has far from delivered on its early promise to bridge the widening gap between investments needed and investments made.

UNCTAD and the OECD estimate the annual capital investment needed to achieve the Sustainable Development Goals and Paris Agreement aims for the 142 low- and middle-income counties at $5 trillion. Actual investment is reaching about one-fifth of that, leaving a $4 trillion annual investment gap. Failure to narrow this gap will, among other harms, heighten financial sector risk – affecting markets, institutions, and entire financial systems.

Blended finance uses financial enhancements to reduce investment risk, encouraging private-sector investors and lenders to participate in transactions that would normally exceed their risk appetites. Those enhancements aim to transfer a portion of risk to other parties, such as governments, development institutions, or philanthropic organizations.

Obstacles to scaling blended finance have been researched and debated vigorously. A lack of sufficient de-risking is one reason potential investments have not attracted private capital in the hoped-for quantities, whether from local or foreign parties.

Reluctance on the part of private investors is driven by other factors as well, including underdeveloped financial markets and various policy and governance challenges and obstacles in individual countries.

According to recent research by Network for Greening the Financial System (NGFS), one other key factor, according to participants in blended finance, is regulatory and supervisory environments in both investor and investee jurisdictions. These have been described as failing to adjust rules and procedures proportionately to account fairly for blended finance transactions.

Can/should regulators and supervisors do more to mobilize private capital and help close the financing gap? How can blended finance approaches also strengthen Emerging Market and Developing Economies' (EMDE's) financial markets for more effective intermediation in the real economy? This discussion of the responsibilities of central banks, regulators, and financial supervisors explores three themes: the supervisory role, cases for simplification and consolidation, and questions around systemic capacity.

[1] For more information, please visit the website of the global NGO Convergence.

Issue 1: How to solve blended finance's complexity problem?

Studies of blended finance frequently highlight the issue of complexity. Transactions tend to be novel and complicated –particularly in comparison to their size, which, in lower-income countries, may be too small to attract institutional investors. Greater standardization and transparency might improve scalability – both within and across jurisdictions.

- What would help improve transparency and standardization for blended finance flows in your market? From a regulatory or supervisory point of view, would standard "templates" for such transactions be helpful?
- Viewing the issue from jurisdictions that are home to large capital pools, is it preferable for institutions to manage their own exposure to blended finance transactions, or to invest in specialized funds with asset managers who specialize in de-risking?
- How should global standard-setting bodies become engaged in blended finance discussions? How can they help improve standardization?

Issue 2: The supervisory role

Arguably, the most important role that supervisors can play is ensuring a well-supervised financial sector that makes their economies more attractive to blended finance deals. Advancing blended finance requires greater attention to the development and deepening of local financial and capital markets, domestic resources mobilization and understanding why a blended approach is needed in the first place. **Please review the implications of blended finance for supervisors in this** TC Note.

In surveys, institutional investors and banks have pointed to different types of regulatory and supervisory barriers to participation in blended finance transactions, citing treatment of risk capital, liquidity requirements, risk-retention rules, treatment of credit insurance and financial guarantees, and fiduciary rules.

- It has been suggested that a review be undertaken of whether aspects of regimes such as Basel III, Solvency II for insurers, or AML-CFT in general may have unintended consequences for the treatment of investments in EMDEs. In your opinion, would such a review be helpful?
- How might financial supervisors collaborate to accelerate the ability to do blended finance transactions to support domestic resource mobilization and economic growth?
- Are there actions supervisors can take to help attract more de-risking in their markets?
- What other actions would you suggest?

Issue 3: Capacity-building to scale up blended finance

Blended finance investments tend to bypass the regulated financial system - and public markets - through direct transactions, the use of microfinance vehicles, etc. Making them more standardized/less complicated could help them get onto listed markets. Still, central bankers and supervisors cannot afford to turn a blind eye to transactions outside of the established regulatory perimeters. Therefore, there is significant scope to increase the knowledge of blended finance as a tool amongst EMDE supervisors as part of the growing interest in climate finance, financial inclusion, and responsible investment issues. TC is exploring options to best serve supervisors' capacity needs.

- Do you think a dedicated training course is needed for supervisors on how best to assess the risks of, and engage with, blended finance transactions?
- If so, what should be the key thematic priority areas for such a course?
- How might supervisors help other stakeholders build capacity – and which types of capacity – to accelerate blended finance transactions?