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ROUNDTABLE DISCUSSION PROCEEDINGS

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

Toronto Centre hosted a roundtable discussion about blended finance on April 18, 2024, during the IMF/World Bank Group Spring Meetings. Participants included central bank governors and heads of supervisory authorities, many of them from Africa, along with other supervisors and regulators from developing and developed countries, and representatives of development finance organizations and financial institutions.

The purpose was to discuss how their organizations have responded to the emergence of blended finance as a tool to increase investments that support sustainable development goals (SDGs).

For more on the key issues and context, read the discussion note that was reviewed by the participants in advance.

Babak Abbaszadeh, CEO of Toronto Centre, welcomed the participants. He noted that, while blended finance is seen as important for achieving SDGs, some stakeholders have suggested that financial regulatory standards are blocking its potential.

Supervisors[1] have not been invited to join global conversations about blended finance, yet their work is critical to ensuring safe and sound financial systems – which in turn are crucial pre-requisites for economic growth and mobilizing domestic resources. Are supervisors part of the problem with blended finance, or the solution?

The discussion was moderated by **Jean Pesme**, Global Director of Finance in the Finance, Competitiveness & Innovation practice at the World Bank and board member, Toronto Centre. The opening speakers were Governor **John Rwangombwa** of the National Bank of Rwanda and Governor **Erik Thedéen** of the Sveriges Riksbank and board member, Toronto Centre.

The blended finance context: 'Underwhelming'

Blended finance is the use of public and philanthropic capital to create structured transactions that distribute risk and return – "derisking" – to attract additional private capital.[2] While the term blended finance is relatively new, the use of public guarantees to encourage private investment is not. But there is a heightened sense of urgency to use these tools because meeting the bare requirements of SDGs will require investments of a trillion dollars.

Participants noted that governments at all levels of development are hard-pressed to fill that gap amid soaring debt, sticky inflation and high interest rates. Investment flows into many low- and middle-income countries have failed to recover from the pandemic, and in some cases have declined even further.

Meanwhile, the performance of blended finance in attracting private capital has been, as one participant put it (to general agreement), "underwhelming."[3]

Participants shared direct experience with recent, successful transactions. The discussion moved on to common themes and conclusions.

Consensus emerged on the following four themes.

1. Leverage success

Successful examples of blended finance transactions came from different countries, but yielded similar lessons. Participants discussed the hallmarks of a successful blended finance vehicle:

a) Supervisors from Emerging Markets and Developing Economies (EMDEs) firmly supported transactions that involve the domestic government and financial system. Most blended finance transactions, however, tend to invest in projects directly, bypassing the local financial system. This one-on-one approach deprives

[1] For the purposes of this discussion, the terms 'supervisors' and 'regulators' are used interchangeably.

[2] Definition drawn from the Toronto Centre TC Note Blended Finance: Implications for Supervisors (2021)

[3] The discussion was conducted under the Chatham House rule, therefore no contributions are attributed to individuals.

local institutions and agencies of the opportunity to build experience and capacity. Similarly, blended finance ventures rarely invest in sovereign debt, but it was argued that doing so would help shore up governance and institutional resilience, ultimately supporting efforts to improve investment quality.

b) There was consensus that blended finance would gain from portfolio-based approaches. Funds and multi-deal offerings that diversify risk are more appealing to institutional investors than a $10-million deal whose potential return is not worth the cost of the due diligence time. This is already a visible trend for financing projects in middle-income countries, as well as green bond funds offered to institutional investors. Coalitions that include development finance agencies and multilateral development banks are working to build pipelines of suitable deals that could be financed collectively.

c) Successful deals tended to have rigorous requirements for (and supervision of) two aspects. First, do they meet the development goals defined in the deal? And second, what is the exit plan. A missing or vague exit plan is a red flag.

d) Transactions should not distort the market, which means any assessment should assess whether a deal will attract investors who otherwise would never consider it. Successful deals attract private capital to new types of investment and bring returns that encourage re-investment. Monitoring market distortions or other unexpected negative outcomes should be constant and active.

Supervisors and, particularly, regulators wish to be given enough information about the details of the deal to build their knowledge about the elements of successful transactions.

2. Pursue standardization

Standardized transactions would likely increase the volume of blended finance deals and would make them easier to supervise, participants agreed.

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. They also tend to be opaque; greater transparency of detail and outcomes would support developing standard models of transactions that distribute risk, returns, and exit plans in similar ways.

Transparency and reporting were seen as essential to building standards for blended finance transactions. Developing standards would promote duplication of successful investments and ultimately scale up blended finance structures, reducing transaction costs. However, the more customized, complex, and opaque the deal, the higher the costs. Bankers who create blended finance vehicles have a financial disincentive to reduce complexity because standardized deals would likely earn lower fees.

Supervisors expressed keen interest in the development of definitions, taxonomies, and standards by which blended finance transactions may be assessed.

Economies with stable financial systems are more likely to attract investment of any kind, blended or not. A growing financial sector is of little value if it is not stable.

The discussion also posed a question: If a blended finance transaction makes guarantees about risk to investors, does it also make guarantees about alignment with SDGs? And if so, who evaluates the quality of that alignment and the outcome, and against what standard?

3. Prioritize financial stability

Many regulatory and supervisory agencies in developing nations operate with a dual mandate of financial stability and development. There was some discussion of this balance in the context of conversations in the blended finance space about a need to loosen risk rules and liquidity requirements related to guarantees and concessional arrangements.

Participants shared a firm view that financial stability is an absolute mandate. Economies with stable financial systems are more likely to attract investment of any kind, blended or not. A growing financial sector is of little value if it is not stable.

This is supported in the review by the Network for Greening the Financial System (NGFS) of barriers to growth in blended finance, which points to weaknesses in legal, institutional, and governance frameworks in developing economies as significant hurdles.

Supervisors favour working with banks and capital market participants to help develop their knowledge and capacity. However, they do not believe in easing

a regulation or a requirement to favour a green bond over a brown bond – all that counts is the risk. Still, the door is not closed to examining and discussing risk assessments of blended finance transactions.

In surveys, institutional investors and bankers have cited the treatment of risk capital, liquidity requirements, risk-retention rules, credit insurance and financial guarantees, and fiduciary rules as barriers to blended finance. 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.[4]

Parallels were noted with the advent of FinTechs, whose operations and risk profiles did not fit regulations and procedures built for traditional financial institutions. Eventually, many jurisdictions came to use regulatory "sandboxes" to test and learn what adjustments or additions were needed to effectively regulate and supervise FinTechs.

The participants discussed the sandbox approach to developing appropriate oversight methods and guardrails for blended finance. They agreed that much of the value would stem from sharing experiences and outcomes with peers in other countries.

4. Engage

Blended finance is seen as full of promise; supervisors believe they have useful roles to play in scaling up this form of investment to advance market development. There was consensus on the following actions:

a) Learn more about the blended finance universe. Share those learnings and experiences to build knowledge and develop models of successful transaction structures.
b) Encourage an active process that identifies structures or instruments that work in multiple jurisdictions, then approach blended finance actors such as multilateral development banks with those findings.
c) Build this approach from the ground up, using locally tested knowledge and experience. Regulatory sandboxes would be one means to test and learn, and then share those learnings.
d) Examine whether regulators and supervisors have the means to build incentives for blended finance, without compromising financial stability.
e) Engage with money managers to understand their view of risk ratings, as many institutional investors appear to shun developing economies while investing in high-yield bonds with similar ratings.
f) Participate actively in global conversations about blended finance standards, as well as emerging taxonomies and performance indicators for climate change-related investments.

In closing, Babak Abbaszadeh indicated that Toronto Centre will host more discussions and develop capacity-building workshops for supervisors (in collaboration with partners such as Convergence and the NGFS) to enhance financial authorities' understanding of blended finance.

To learn more, see the TC Note Blended Finance: Implications for Supervisors.

[4] See for example State of Blended Finance 2024 by Convergence.