A BLENDED FINANCE TOOLKIT FOR FINANCIAL SUPERVISORS

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TORONTO CENTRE
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1. INTRODUCTION [1]

Financing international development, including the Sustainable Development Goals (SDGs), requires significant amounts of capital for emerging market countries and industrialized countries.[2] However, the public sector cannot provide it all, nor can Development Finance Institutions (DFIs) or Multilateral Development Banks (MDBs).

About $4-5 trillion annually is required to cover the financing gaps. At least half that amount is estimated to be needed from private sector sources, an unprecedented contribution to emerging markets and developing economies (EMDEs). Domestic resources are growing in EMDEs, but most will need considerable foreign investment to meet their targets.

Investor concerns about real and perceived financial risks are a major challenge in financing sustainability projects. The investments needed are mainly in EMDEs. They often involve a broad spectrum of financing basic economic activities, such as agriculture and trade, but also investing in new technologies, new geographies, and new currencies for foreign investors. The financial risks of these projects are complex and often prevent private investors from being involved.

Blended finance can help spur private investment by mitigating investment risks and stabilizing risk-adjusted returns for private investors. It can help increase financing for sustainable development and reduce risks that unsustainable development can create for investors, consumers, financial intermediaries, and financial stability.

Yet, from a financial supervisor's perspective, blended finance can raise potential risks. These relate to the nature of the projects being financed, the reliability of the de-risking entity, and the complexity of many structures. Thus, financial supervisors might help increase the ability to do blended finance transactions in their markets to increase sustainable finance and a less risky future. However, they should also make sure that those they supervise have the ability to manage the risks that may arise from participating in these transactions.

To date, blended finance is well below targets.[3] There are many reasons for that, and efforts are underway to identify and address them, but the gap suggests that the obstacles have been challenging to address. Most obstacles fall under areas that are not the responsibility of EMDE

1. This Toronto Centre Toolkit was prepared by Alison Harwood and Olaf Weber.

2. See Weber, O. (2019). Sustainable Finance and the SDGs: The Role of the Banking Sector. In S. Dalby, S. Horton, R. Mahon, & D. Thomaz (Eds.), Achieving the Sustainable Development Goals (pp. 226-239). Routledge.

3. As of the end of 2023, $213 billion was mobilized through blended finance transactions. The median average financing total was $15 billion per year over the last decade. See Convergence (2024).

financial supervisors. Some are regulatory constraints imposed on foreign financial institutions and investors in EMDEs by foreign governments. Others are real sector policies that affect project pipelines and the undeveloped nature of sustainability agendas, such as taxonomies and impact data.

Nevertheless, there are actions that EMDE financial supervisors can take to facilitate blended finance, and actions to help those they supervise manage any related risks.

Today, foreign financial entities from developed markets are more involved in blended finance transactions in emerging and developing countries than local financial institutions. Thus, concerns about participation risks are primarily an issue for developed market financial supervisors. However, financial entities from EMDEs are increasingly looking to support sustainable development in their countries, so concerns about risks can also arise for them.

It should also be noted that not every transaction is suitable for blended finance. It is most appropriate for projects that generate revenues and where the risks and returns are not so high and/or uncertain that de-risking them would make the transaction uneconomical or unappealing to a de-risking entity like a DFI or an MDB.

This Toronto Centre Toolkit provides financial supervisors with:

- An understanding of blended finance and its benefits and challenges.
- An understanding of the potential financial risks related to blended finance.
- Possible activities for financial supervisors to reduce the financial risks associated with blended finance.
- Examples of transactions that illustrate successful and less successful blended finance.

Efforts to develop blended finance will be affected by the broader context: the strength of the country's sustainability components (the framework, data, and disclosure) and the attractiveness of the investment climate. This Toolkit focuses on issues specific to blended finance and references how the broader context affects it.

2. THE IMPORTANCE OF BLENDED FINANCE FOR SUSTAINABLE DEVELOPMENT

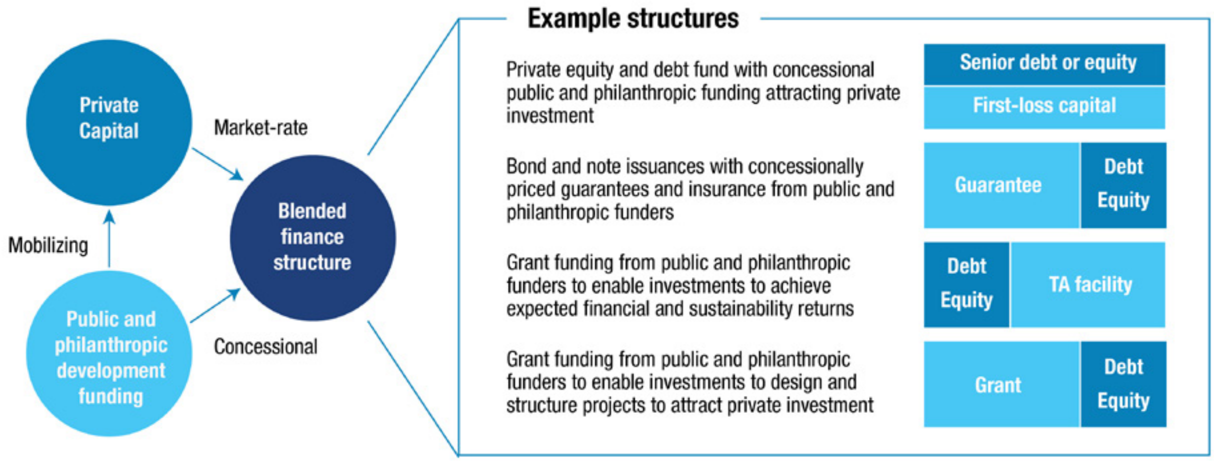
2.1. WHAT IS BLENDED FINANCE?

The OECD Development Assistance Committee (DAC) defines blended finance as the strategic use of development finance to mobilize additional finance towards sustainable development in developing countries (OECD DAC, 2017). As shown in Figure 1, blended finance uses public and philanthropic funding to encourage private capital.[4] It provides higher concessions for projects with a higher sustainability impact.

Development institutions and public and philanthropic entities can help reduce investment risk and increase returns to private investors in three ways (see Figure 1):

- Provide guarantees or take first loss or equity positions to reduce risk (see Box 1).
- Offer concessionary capital and financing at lower rates, leaving higher risk-adjusted returns to private investors in the project. Lowering the risks is often more important than raising the return.
- Provide technical assistance to strengthen potential investees so they can better manage their business, which can also reduce risk and increase returns. This assistance can also improve policies, regulations, government capacity, and other actions that help create beneficial financial sector and business environments.

Figure 1: Blended finance



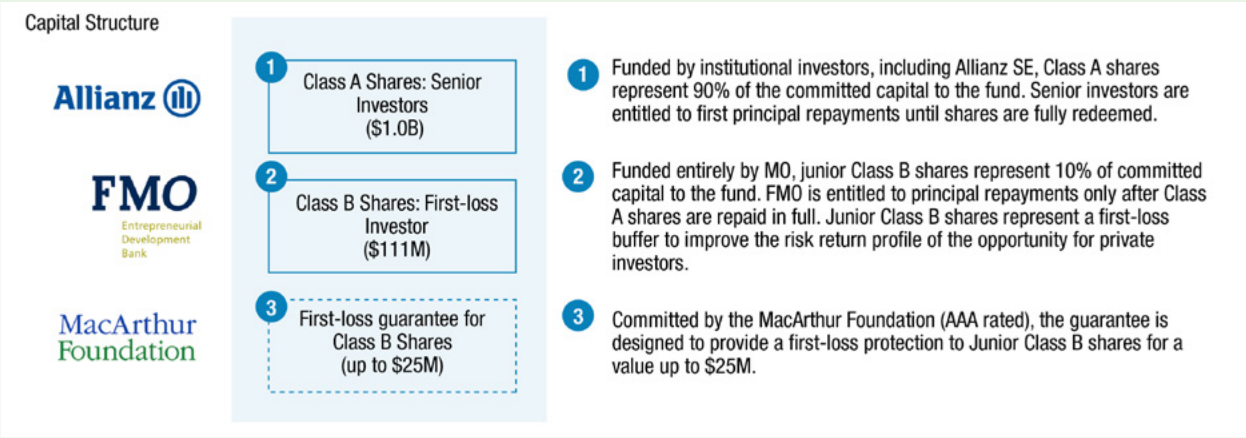
Source: https://www.convergence.finance/blended-finance, edited by the authors.

4. Flammer, C., Giroux, T., & Heal, G. (2024). Blended Finance

BOX 1

Example of de-risking through guarantees and first-loss positions

The SDG Loan Fund stacked a $25 million guarantee from the MacArthur Foundation and a first-loss reserve of $111 million from the Dutch Development Bank FMO[5] (together with the Class B Shares) to raise $1 billion from the German insurance giant Allianz and Swedish bank Skandia (Class A Shares). The funds will expand financing for small and growing businesses, resilient agriculture, and climate solutions. This will result in up to 120 loans for agribusiness –including agro-processing, trading and production; financial institutions, including microfinance; and renewable energy, including solar, wind and small-scale hydroelectric power – across more than 80 EMDEs in Africa, Asia, Eastern Europe, and Latin America.



Source: *The SDG Loan Fund: Convergence Review* and *Blended Finance Best Practices and Case Studies.*

2.2. BLENDED FINANCE: SUITABILITY AND PARTICIPANTS

While blended finance applies to all countries, sectors, and project sizes, it has been most used in projects addressing poverty reduction, decent work, economic growth, climate action, and gender equality.[6] It is used primarily in an EMDE market context. However, its application for financing climate transition and energy projects in industrialized countries has recently been discussed.[7]

Blended finance is particularly suitable for projects that address social, environmental, and economic challenges and have revenue streams, but struggle to attract sufficient private investment due to perceived risks or low initial returns. These include:

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5. FMO represents Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.

6. Basile, I., & Dutra, J. (2019). Blended finance funds and facilities: 2018 survey results.

7. Popovic, T., Lygnerud, K., Denk, I., Fransson, N., & Unluturk, B. (2024). Blended finance as a catalyst for accelerating the European heat transition? Smart Energy, 14, 100136. doi: https://doi.org/10.1016/j.segy.2024.100136

- Sustainable infrastructure projects: Blended finance can benefit projects like renewable energy (solar, wind, hydropower), waste management, clean transportation, and water and sanitation infrastructure. These projects typically have high upfront costs and long payback periods.
- Climate resilience and adaptation: Projects focused on adapting to climate change – such as flood defences, resilient agriculture, and infrastructure designed to withstand extreme weather – are vital. Many have limited revenue streams and are less appropriate for private capital, but a growing number of activities build resilience and do have revenue streams.
- Agricultural and food security: Sustainable agriculture, smallholder farming, and food security projects in developing regions often face financial barriers due to unpredictable returns and risks from climate variability.
- Health and education projects: Blended finance can improve public health (for example, the production of vaccines and other medicines) and education (such as digital learning in low-income regions or educational facilities).
- Affordable housing and urban development: Affordable housing projects often struggle with commercial viability due to high development costs and limited returns.
- SME development and financial inclusion: Due to perceived risks and limited collateral, SMEs and microfinance initiatives face funding challenges.
- Digital and infrastructure projects: Digital connectivity, telecommunications, and technology infrastructure projects in developing markets are critical for economic growth but often struggle with funding due to market uncertainty.

In terms of participants, blended finance projects typically involve a range of entities:

- Public and philanthropic investors, including multilateral development banks, development financing institutions, governments, and private investors, are at the core of financing the transaction.
- Project developers, technical experts/consultants, and impact measurement and evaluation organizations are key to developing the transaction.
- The public sector/government, NGOs, and civil society are key stakeholders and beneficiaries.

2.3. IMPORTANCE OF BLENDED FINANCE FOR SUSTAINABLE DEVELOPMENT

Trillions of dollars in private capital are needed to help finance a sustainable future that increases job security and access to housing, food, and education. Failure to finance a sustainable future can increase poverty and inequality and set development targets back generations. Blended finance can help mobilize the private capital needed to reduce these threats.

In the climate area, for example, the inability to create a more sustainable future can lead to increased frequency and intensity of destructive events like floods and wildfires. These harm business operations, employment, and investment values, create loan defaults, and reduce collateral values. These challenges raise concerns about investor protection, the safety and soundness of financial institutions (FIs), and financial sector stability.

Many EMDEs are suffering from climate challenges caused by the actions of the developed world; their own emissions are minimal. Financing adaptation is critical for building their resilience. But so too are financing activities that reduce their future emissions. Many EMDEs (for example, in Africa) have young and rapidly increasing populations. Building sustainable climate practices is vital for their future.

Sustainable finance is also critical for financing medicine, access to affordable healthcare and housing, healthy food, and more productive agriculture for greater food security. All of these are important for social and economic stability and sustainable development.

Integrating private sector investments into projects addressing sustainable development is needed to achieve sustainable development goals. A lack of blended finance can reduce the ability to mobilize private investment to finance necessary environmental and social projects and to mitigate or adapt to climate and other destructive events. This leads to decelerating economic development and increased poverty. Without blended finance, the scale of climate-related healthcare, education, and affordable housing investments might be reduced. This would have a negative impact on the economy, financial stability, social sustainability, and life improvements.

2.4. CRITICAL CHALLENGES TO DEVELOPING BLENDED FINANCE

There are many challenges for blended finance, such as:

- Lack of enabling financial sector environments;
- Lack of project pipelines;
- Lack of entities to de-risk transactions;
- Insufficient data, transparency/disclosure, and impact frameworks;

- Complex transaction structures;
- Uncertainties about the financial risks and returns;
- Lack of expertise in blended finance; and
- Lack of supervisory instruments and tools addressing blended finance.

EMDE financial supervisors do not have the power to address all of these issues. Some of these challenges are not specific to blended finance. Some affect all sustainability-related finance; for example, the lack of sustainability frameworks, taxonomies, data, and disclosure. In addition, as discussed below, several regulatory barriers are imposed by foreign financial supervisors that might impair the ability of foreign FIs to participate in blended finance transactions in EMDEs, such as Basel III.

As a result, other domestic authorities and foreign supervisors will need to take the lead in addressing many of these challenges. Financial supervisors in EMDEs should recognize and focus on areas under their jurisdiction and consider appropriate steps for their local markets.

BOX 2-A

Blended Finance Resources

Convergence is the global network for blended finance. It publishes trends and statistics on market size, use of blended finance (by region and sectors), transaction examples and participants, and specialized reports on evolving areas. For example:

- *Blended Finance 101*
- *The Role of Technical Assistance in Blended Finance Transactions*
- *State of Blended Finance 2024*, with a section on the regulatory context and key regulations affecting blended finance transactions
- *State of Blended Finance 2024: Climate Edition*, which discusses the use of blended finance for climate-related transactions, including trends, themes, deals, and investors
- *Webinars on Blended Finance Deals, Updates, Educational Resources*.

Blended Finance Best Practice: Case Studies and Lessons Learned provides examples of different types of blended finance transactions. It was prepared by the Sustainable Markets Initiative and Investor Leadership Network, supported by Global Investors for Sustainable Development, UN PRI, and Glasgow Financial Alliance for Net Zero.

Appendix 1 in this document describes a few basic blended finance structures.

BOX 2-B

The Global Financing Facility for Maternal and Child Health

The Global Financing Facility (GFF) was established to improve health outcomes for women, children, and adolescents in low- and middle-income countries. Through a blended finance approach, the GFF combines concessional finance, grants, and private-sector investment to address health gaps that require substantial funding and sustained commitment. This model attracts private capital by using concessional loans and grants from donor governments and philanthropic organizations to mitigate financial risk, making it more appealing to private investors. The GFF's financing is often layered, with public and philanthropic funds assuming initial losses to create a buffer, thus lowering investment risk for private sector players. This structure allows for investment in critical health infrastructure, such as maternal care facilities and child vaccination programs, in countries with limited resources. Additionally, through partnerships with governments and local organizations, the GFF ensures that projects align with national health priorities and deliver measurable impact. https://www.globalfinancingfacility.org

3. POTENTIAL RISKS FROM PARTICIPATING IN BLENDED FINANCE TRANSACTIONS

Blended finance can help mobilize sustainable finance and reduce risks related to unsustainable development. However, from a financial supervisor's point of view, engaging in blended finance transactions can also expose EMDE financial institutions, investors, and consumers to potentially serious risks. These risks can arise from three aspects:

1. **The nature of blended finance involves projects with potentially high risks, low returns, and highly illiquid loans and investments.**
2. **The de-risking elements may affect the ability of the de-risking entity to meet its obligations.**
3. **The complexity of the transactions can complicate all parties' ability to fully understand their potential risks, obligations, and other key elements affecting them.**

These issues primarily concern FIs, investors, and supervisors from developed markets, as they are the most active participants in blended finance transactions. However, financial entities from EMDE markets are increasingly looking to contribute to financing sustainable development in their countries, and blended finance can help them do that. EMDE financial supervisors should be aware of these potential risks to evaluate the ability of those they supervise to manage the risks effectively.

3.1. GENERAL ASPECTS OF BLENDED FINANCE TRANSACTIONS IN EMDES

The following list presents a selection of blended finance risks that are discussed in detail below:

- Blended finance often aims to attract private investors to projects with lower or uncertain returns. Public or philanthropic capital provides a safety net, but private investors may still face lower and more volatile returns than purely commercial investments. This might create a risk of limited returns.
- Similarly, blended finance is often used for projects that lack the creditworthiness and investment risk that lenders and investors prefer, resulting in higher default risks and financing gaps.
- The providers of concessional capital might prefer impact over financial returns, which might lead to higher financial risks.
- Blended finance often occurs in EMDEs where regulatory environments are less stable, possibly leading to policy shifts or regulatory changes and causing political and regulatory risks.

3.2. POTENTIAL DEFAULT BY THE DE-RISKING ENTITY

Defaults by the de-risking entity can cause unintended financial exposures, threatening the commercial and prudential standing of all investors and FIs participating in the transaction, including those in EMDEs.

De-risking provided by experienced, well-capitalized entities like international or regional DFIs and MDBs is unlikely to create challenges. These entities are unlikely to default on their guarantees or concessionary finance due to financial weakness or a lack of understanding of their roles and obligations. However, they may withdraw from a project for other reasons, such as determining that the project is not developing as expected, which could expose EMDE investors and FIs to the project's potential risks and uncertain returns.

These concerns can be heightened when de-risking is provided by entities that may be less capable of fulfilling their obligations for financial, operational, or other reasons. EMDE governments and DFIs, such as development banks and guarantee agencies, are increasingly stepping into de-risking for local transactions. That can be a positive step and help mobilize more private capital for domestic development. However, it can create serious risks if EMDE governments and institutions over-extend their de-risking to encourage private investment, take on more contingent liabilities than they can manage due to fiscal pressures or broader development financing needs, and default on their obligations.

Defaults might also occur because of other contextual developments, such as:

- Political and economic instability: EMDEs often face political upheaval and macroeconomic pressures such as inflation and currency devaluation.
- Weak local government institutions: Regulatory changes, corruption, or inefficient local governance might increase financial risks.
- Changes in governments (see the example in Box 2).

In addition, defaults might occur due to project-related elements; for example:

- Misjudging transaction risks: Complex structures and contracts or uncontrollable external factors can create unexpected stress that cannot be mitigated.
- Project performance: Projects might underperform in terms of cash flow and financial return generation.

These concerns are exacerbated in the least developed countries where financing is most needed. These countries require more de-risking, concessionary capital, and technical assistance to create investment opportunities that attract private capital. Still, their governments are least able to take on extensive contingent liabilities, given their fiscal and other pressures and less sophisticated markets.

Whatever the reason, a default will have serious consequences, exposing FIs and investors to potentially high risks and low returns. In addition, a failed guarantee can reduce confidence in participating in blended finance transactions. These points highlight the need to engage with strong, dependable, de-risking entities.

BOX 3-A

South Africa's Renewable Energy Independent Power Producer Procurement Program

South Africa's Renewable Energy Independent Power Producer Procurement Program (REIPPPP) uses blended finance in the renewable energy sector. Combining development finance, government support, and private capital has attracted significant private investment in renewable energy. However, because of a change in political leadership, the government stopped signing new renewable power purchase agreements and prioritized energy from coal and nuclear power. This caused additional uncertainty and risks for investors.[8]

[8] Relancio, J., Cuellar, A., Walker, G., & Ettmayr, C. (2016). South African CSP projects under the REIPPP programme- Requirements, Challenges and Opportunities. Solarpaces 2015: International Conference on Concentrating Solar Power and Chemical Energy Systems.

3.3. THE COMPLEXITY OF BLENDED FINANCE TRANSACTIONS

Blended finance transactions can be complex in terms of their structures, parties involved, governance, and contracts. This complexity creates challenges worldwide, especially for less developed markets with less sophisticated investors, financial institutions, and other domestic entities that may be involved in the transaction. The main complexities are:

- Complex structures: Blended finance structures can involve various financing elements, such as capital stacks, with varying risks and returns to different investors and pools of assets with complex ways of assessing and managing their risks.
- Complex parties and governance: They can also involve various parties, such as DFIs, guarantee organizations, private investors, and companies/borrowers. These entities may have different goals and interests, complicating their interactions and governance. They may have different tolerances for and abilities to manage risk.
- Complex contracts: Because there are multiple parties, there will be multiple contracts and multiple authorities. These complex contracts can make understanding each participant's contractual obligations, contributions, and returns difficult and complicate the ability to renegotiate a transaction if there is a problem. In addition, local FIs and investors, particularly from less developed markets, might have difficulty securing their rights when participating in a transaction with global FIs and investors who are more sophisticated and likely financially stronger.

These complexities can have numerous implications:

- **Impair the ability to evaluate and manage risk:** Complex structures combined with a possible lack of expertise can: (1) cause investors, financial intermediaries, asset managers, and those borrowing the funds to misunderstand their transaction commitments and exposures, misjudge risks, and fail to protect against those risks adequately; (2) create instability for themselves and transaction partners if they need to withdraw because they cannot manage the exposure; (3) lead to reputation and legal risks as others in the transaction challenge the FIs for their failure to stand by their contractual obligations; and (4) enable and hide corruption among partners.
- Make it difficult for investors from less developed markets to sufficiently protect their rights in the face of more sophisticated, often foreign transaction partners.

- **Create illiquid investments:** Complex structures can make it difficult for FIs to exit their positions, diminishing their ability to meet emerging needs and raise new funds, improve their capital adequacy, meet liquidity requirements, and manage other prudential concerns.
- **Reduce the ability to achieve results:** Achieving results in complex financing partnerships can be difficult due to challenges such as differing objectives between public and private actors, a lack of shared terminology, and limited opportunities for dialogue between governments and those involved in blended finance.
- **Create long gestation periods:** Extended periods can create additional risk. Examples include increased time to reap returns; the need to renegotiate contracts under new circumstances that complex structures and contracts can complicate; and changes in government that can affect policies, risk mitigation, and other outcomes that can impair current investors and deter new ones.

3.4. RISKS FROM LACK OF DATA AND DISCLOSURE

The lack of data and disclosure on sustainability impacts and sustainability-related risks is not specific to blended finance transactions; it affects all impact-focused activities. But it is a critical challenge for them.

The lack of data to substantiate the impact of development impairs the ability to determine if a blended finance transaction has the intended positive impacts. Achieving impact is why many investors invest in these transactions and why DFIs and others de-risk them. In addition, impact assessments that neglect the needs of communities located at the financed projects might lead to delays because of lawsuits or blockades in later project stages.

Disclosure regarding sustainability-related risks needs to be strengthened in many jurisdictions. That will improve the ability of investors to make informed investment decisions, FIs and supervisors to identify and manage related risks and impacts, and countries to assess how effectively their sustainability targets are being financed and what risks might result when they are not.

Overall, the lack of sufficient data and sustainability-related disclosure impairs the ability of individual FIs and their supervisors to conduct scenario analyses and stress tests to determine any vulnerabilities at the institutional and systemic levels. This disclosure has been voluntary and unregulated, resulting in often incompatible and inconsistent definitions of what constitutes a sustainable or green investment and the scope of reporting.

Finally, de-risking resources are scarce. Improved data and disclosure help ensure those resources are used for transactions with strong sustainability and that require de-risking to attract private finance. Making these determinations is not the responsibility of financial supervisors. Other parts of the government are involved with the country's Nationally Determined Contributions, and entities like Ministries of Finance, central banks, and real sector policymakers share them. However, financial supervisors can contribute to these discussions.

BOX 3-B

Selected Challenges to Developing Blended Finance

Apampa's blog addresses how *Regulatory Roadblocks are Holding Blended Finance Back*. November 17, 2024.

See *Evaluating the Impact of Blended Finance Transactions -- Case Studies* by Convergence, which discusses how they evaluated the impact of several transactions. May 16, 2023.

Scaling Up Blended Finance for Climate Mitigation and Adaptation in EMDEs, Network for Greening the Financial System, provides a list of challenges to developing blended finance. December 2023.

Dirk Zetzsche and Pedro Vilanculo's paper on *Blended Finance*, March 22, 2024, and the June 2024 Oxford Business Law Blog *Blended Finance* reviews some of the legal and related issues.

4. ACTIONS TO ACHIEVE SUPERVISORY OBJECTIVES

As noted, many obstacles to blended finance transactions are not within the jurisdiction of EMDE financial supervisors. However, there are actions these financial supervisors can take to help increase blended finance transactions in their countries and to do them prudently. As the Toronto Centre Note on Blended Finance (2021) and other documents state, countries with the right policy, regulatory, and institutional capabilities, as well as project pipelines, should be able to attract private capital to support sustainable growth.

Two key steps that financial supervisors can consider:

1. **Remove unnecessary obstacles to doing blended finance transactions that fall under their jurisdiction.**
2. **Assess whether entities they supervise have the ability to manage the potential risks of participating in blended finance transactions and respond if needed.**

In addition, supervisors can encourage the use of simple, standardized transaction structures, greater disclosure, capacity-building, and effective collaboration.

4.1. CREATING AN ENABLING POLICY AND REGULATORY FRAMEWORK

Financial supervisors can take steps to help reduce unnecessary obstacles to doing blended finance transactions in the markets that fall under their jurisdiction. These include ones that might constrain foreign investors, MDBs, DFIs, and the use of needed instruments. Elements that financial supervisors can work on in this regard are:

- **Create or encourage the creation of standards and definitions** for blended finance to provide clarity about how blended finance is defined and what actions are allowed.
- Identify and address regulatory and other related policies that unnecessarily obstruct the use of blended finance.

Today, most regulatory challenges affect the ability of foreign investors and FIs to provide financing for EMDEs and fall under the scope of the foreign institution's regulator. However, EMDE supervisors need to understand these elements to (1) recognize where outside obstacles might impede steps to encourage blended finance and (2) gain insights into the obstacles that might create constraints to FIs and markets they supervise. In addressing any of these areas, EMDE supervisors will want to apply approaches appropriate for their country's level of development.

A recent review[9] highlighted financial sector regulations and policies that can hinder blended finance. Private FIs and investors face several regulatory challenges when investing in EMDEs. Mandates that limit investments in low-rated, sub-investment-grade economies restrict many investors. In addition, highly regulated institutions like banks and insurance companies must hold more capital for riskier assets, which limits their capacity to invest in these regions. Basel III reforms have also standardized some risk-weighting metrics, limiting banks' ability to independently rate senior tranches of blended finance vehicles as lower risk, making them less attractive for investment. Moreover, international standard setters lack sufficient data on default and recovery rates in EMDEs, leading to risk ratings that may not accurately reflect actual investment risks.[10]

As supervisors think through actions regarding **prudential regulation**, a policy question to consider is the appropriate capital regime for different financial institutions, and whether capital requirements for blended finance transactions should be reduced since the transactions are intended to reduce risk. Given the de-risking involved, there is discussion among financial supervisors about whether to lower risk weights for blended finance transactions. This is not a straightforward consideration, given

9. Apampa, A. (2024, November 17). Regulatory Roadblocks are Holding Blended Finance Back. https://www.convergence.finance/news/7ov5wl8KTfhyzwCl4lu9y3/view

10. For more information, see *Blended Finance Best Practice: Case Studies and Lessons Learned*, Sustainable Markets Initiative and Investor Leadership Network, October 2024. Supported by Global Investors for Sustainable Development, UN PRI, and Glasgow Financial Alliance for Net Zero and *Evaluating the Impact of Blended Finance Transactions -- Case Studies*, Convergence, May 16, 2023

the potential risks in these transactions. Financial supervisors must determine whether and, if so, how much reducing risk weights is warranted. Any discussion about changing risk weights requires understanding the de-risking entity's risk profile and other transaction risks. Moreover, no one approach will work for all transactions, given how complex and varied they will be.

- **Enable financial instruments** that are most useful for blended finance transactions, as appropriate for the local market.

Supervisors should review and, where applicable, remove obstacles, such as the ability to aggregate small investments into larger pools through funds. They should also use securitization to take advantage of its pooling and blended finance properties, do tranching, provide guarantees, and hold first-loss positions. Supervisors should also check that different types of risk-sharing and blended-finance mechanisms are not unnecessarily restrained. These structures are most needed for blended finance transactions. At the same time, it will be important for supervisors to consider whether enabling any of these activities introduces other risks to the market and determine whether enabling them is appropriate.

- **Streamline any unnecessary regulatory and bureaucratic processes** related to blended finance transactions, including reducing red tape and offering transparent processes for related approval, licensing, and regulatory compliance

4.2. RISK MANAGEMENT BY FINANCIAL INSTITUTIONS

Given the potential risks from blended finance transactions, supervisors should ensure that the FIs they oversee have appropriate mechanisms to identify, evaluate, and manage them. As part of their general assessments, supervisors should pay particular attention to how an FI that provides blended finance identifies, evaluates, and responds to the three core elements of a blended finance transaction that can give rise to risks:

1. **The transaction structure and the obligations it creates for the FI.**
2. **The strength of the de-risking entity.**
3. **The roles and obligations of partners and their ability to meet them.**

Supervisory oversight can include assessing whether the FI uses credible scenario analyses and stress testing that will enable the FI to determine whether it needs to strengthen its prudential standing. Again, the lack of data and disclosure can impede an FI's ability to do quality, informative vulnerability analyses and set and monitor targets.

In addition, supervisors need to ensure that FIs have adequate financial resources to support the risks and strong governance regarding blended finance, including:

- **Internal controls and procedures** that flag when blended finance transactions are experiencing problems or not meeting metrics and targets and suggest how to address these problems.
- **Policies to ensure that management and staff have the skills and competencies** to understand the risks and use transaction structures and partners suitable for their skills and competencies. An example might be working with simpler structures and strong partners to reduce their risks.

Given this information, supervisors can determine whether to require FIs to strengthen their ability to mitigate risks through higher capital, liquidity, solvency requirements, or changing counterparty limits. To help reduce an FI's risk, the supervisor can encourage the FI to:

- Build its capacity.
- Partner with well-established, well-capitalized, and knowledgeable de-risking entities and other partners to reduce the risk of defaults.
- Use simpler, standardized structures that fit its capabilities.

4.3. ENCOURAGING STANDARDIZATION OF TRANSACTION STRUCTURES AND PROCESSES

While some blended finance transactions will require complex constructions, many will not. Blended finance transactions can draw on many well-known financial structures, such as standard loans, funds, and straightforward asset-backed and securitization structures. Innovation in blended finance can be achieved by applying known approaches to new and different financing situations.

Supervisors need to be attuned to whether using more standardized approaches and templates creates additional risk for FIs; for example, by masking or downplaying complicated relationships or exposures. Supervisors should consider:

- **Encouraging the adoption of simple, well-known, and more standardized structures** to decrease risks associated with transaction complexity and long gestation times. A two-tranche structure, including a first-loss and senior tranche, can be used for clarity.[11] Standardization can also increase liquidity, secondary markets, and possibly indices, which may attract more significant investment flows.
- **Encouraging private investors, financial institutions, rating agencies, and de-risking entities (DFIs, foundations, etc.) to use and create templates** for standard financing structures.
- **Considering whether preferential reporting or regulatory treatment might be provided to encourage using standardized, more straightforward structures**. For example, the European Union adopted regulations for simple, transparent, and standardized (STS) securitizations. The EU also provided preferential prudential regulatory treatment to encourage STS securitization, given its benefits for SDG financing.

4.4. IMPROVING DATA AND DISCLOSURE

Improving sustainability-related data and disclosure is key for blended finance transactions to scale sustainable finance and to assess and manage risks. Supervisors can take steps to help improve data and transparency to strengthen the sustainability agenda by contributing to efforts that:

- **Improve sustainability frameworks by developing definitions, taxonomies, and principles** to help investors and others understand what types of investments contribute to sustainability goals, and how.
- **Improve sustainability disclosure** by developing, adopting, and enforcing standardized reporting frameworks for blended finance. These help private investors and public stakeholders evaluate the performance of projects and assess risks more effectively. Using standardized approaches creates comparable disclosure that can reduce green- and impact-washing, provide investors with better information, reduce risks, and help steer investments to projects with higher sustainability impacts. Supervisors should look to implement the new ISSB standards[12] to provide a global baseline of comparable, consistent, and reliable sustainability reporting. That also can help attract foreign investors.

11. See, for example, page 35 of *Blended Finance Best Practices and Case Studies*, which discusses why and how a simple structure was used.

12. IFRS. (2023). General Requirements for Disclosure of Sustainability-related Financial Information. In: IFRS.

4.5. BUILDING CAPACITY

Given the critical need for credible, knowledgeable partners in a blended finance transaction, building the capacity of EMDE supervisors and FIs is especially important – to understand, use, and effectively manage blended finance's benefits and potential risks. Increased capacity can be achieved by:

- **Training supervisors:** Supervisors should learn about blended finance transactions to understand the potential risks they may pose for those they oversee and the financial system more broadly. Training will help them determine whether to take measures to maintain prudential standing and financial stability.
- **Encouraging those they supervise to develop their capacity.**
- **Sharing information on transactions:** Sharing information on transaction experience can help educate people about the value of blended finance transactions and what worked and did not work. Supervisors can share any information they can make public on data and lessons learned, and encourage others to do so.

4.6. COLLABORATING AT HOME AND ABROAD

Blended finance transactions engage various domestic financial markets and institutions – banks, asset managers, insurance firms, pension funds, securities firms, and numerous real sector parties. Financial supervisors can collaborate on several levels to help move the agenda forward.

At home, financial supervisors can collaborate with:

- **Other domestic financial supervisors** to identify and address common risks and obstacles and, where appropriate, agree on standards and definitions.
- **Other domestic financial market stakeholders**, including private financial institutions, companies, investors, MDBs/DFIs, and rating agencies, to gain insights into necessary actions to create an enabling and prudent environment. Combining perspectives and knowledge through ongoing dialogue can accelerate market development.
- **Other parts of the government** to encourage them to take actions that will further the use of blended finance to help achieve the broader sustainability agenda. Countries may have a sustainability committee that facilitates this type of cross-cutting information sharing to achieve a country's common goal.

On the international front, countries and financial supervisors worldwide are looking at ways to increase the use of blended finance transactions. Blended finance is evolving, and new approaches and tools are being discussed and formulated. Supervisors can benefit considerably from participating in and following developments of global initiatives, and strongly encouraging those they supervise to do so. Engaging with global standard-setting bodies – like IOSCO and IAIS, industry associations like the IIF, and global networks like Convergence – provides opportunities to exchange knowledge (see Box 2). Peers and countries in similar situations and those a few steps ahead can share knowledge about lessons learned, successful structures, and valuable resources.

BOX 4-A

Selected Resources on Regulatory Matters

- *B20 Finance & Infrastructure Policy Paper*, done under the auspices of Brazil as head of the G20, September 13, 2024. It discusses regulatory and other issues to enhance the use of blended finance.
- Convergence *State of Blended Finance 2024* with a section on regulatory challenges for blended finance.
- *The Role of Insurers in Derisking and Scaling Blended Finance* is from a roundtable in Asia on October 11, 2023 organized by the Global Asia Insurance Partnership and Monetary Authority of Singapore to discuss these issues.
- The Network for Greening the Financial System's *Scaling Up Blended Finance for Climate Mitigation and Adaptation in EMDEs*, NGFS, December 2023, discusses the importance of blended finance, key barriers to its growth, and supervisory and other actions to enable its use.
- *Blended Finance: Implications for Financial Supervisors*, Toronto Centre, January 2021.

BOX 4-B

Selected Actions for Promoting Blended Finance

- *G20 Principles for Blended Finance* are four principles to help scale blended finance in emerging market countries. The principles are non-binding and encourage governments to target blended finance to local contexts, build local capital markets, and work together with private actors to move the agenda forward while advancing local sustainable development priorities.
- *G20 Bali Global Blended Finance Alliance* is intended to scale and replicate blended finance instruments for developing countries by accelerating investments and modernizing the development finance system. It will do so by reducing transaction costs, unlocking opportunities for transition finance, providing capacity building and strengthening the network across relevant actors. It will work on the premise of the G20 Blended Finance Principles.
- *The NGFS's Scaling Up Blended Finance for Climate Mitigation and Adaptation in EMDEs* provides recommendations for addressing development challenges.
- *The OECD DAC Blended Finance Guidance* provides direction for how to implement the G20 principles. Guidance on Principle 3 is most directly relevant for financial supervisors. Most of the additional recommendations concern actions to be done by others, but the information is helpful for financial supervisors to know.
- Toronto Centre. *Blended Finance: Implications for Supervisors*, February 8, 2021.
- See two World Bank Group Blogs, one noting the importance of technical assistance and the other the importance of governance for success: *What Is Blended Finance And How Can It Help Deliver Successful High Impact High Risk Projects*, January 2020, and *Blended Concessional Finance: Governance Matters for Impact.* March 2019, with links to related papers.
- See *Blended Finance Best Practice: Case Studies and Lessons Learned*, by the Sustainable Markets Initiative and Investor Leadership Network and supported by Global Investors for Sustainable Development, UN PRI, and Glasgow Financial Alliance for Net Zero.

5. CONCLUSION

Blended finance can help accelerate financing for sustainable development. That is a much-needed and positive step. However, blended finance also has some inherent elements that can create risks for those participating in the transactions. This Toolkit has explored ways financial supervisors might improve the ability to do blended finance transactions while also seeking to ensure those they supervise can manage the potential risks.

The number of blended finance transactions has fallen far below anticipated amounts. As noted, most reasons for that are obstacles outside financial supervisors' responsibilities. However, EMDE financial supervisors still have a role to play in helping move blended finance forward, not least because more financial institutions and investors from their markets are likely to play a more significant role in these transactions.

Financial supervisors can:

- Recognize the value of blended finance and remove unnecessary obstacles to its development that fall under their jurisdiction.
- Supervise to ensure that FIs under their jurisdiction have the capacity to identify, evaluate, and manage the risks inherent in blended finance transactions.
- Build their supervisory capacity regarding blended finance transactions and encourage those they supervise to build their knowledge and risk-management capacity.
- Contribute to efforts to improve data and disclosure, and share, where appropriate, information on lessons learned; and encourage those they supervise and other key financial market participants, such as rating agencies, to do so as well.
- Collaborate at home and abroad to learn from and share experiences with others. This includes following global initiatives that are working to enhance the use of blended finance in effective and prudent ways.

In conclusion, financial supervisors can play a role in shaping a blended finance ecosystem that balances innovation with prudence. Supervisors can spur private investment in sustainable development by fostering an enabling environment, ensuring robust risk management, and promoting transparency and collaboration.

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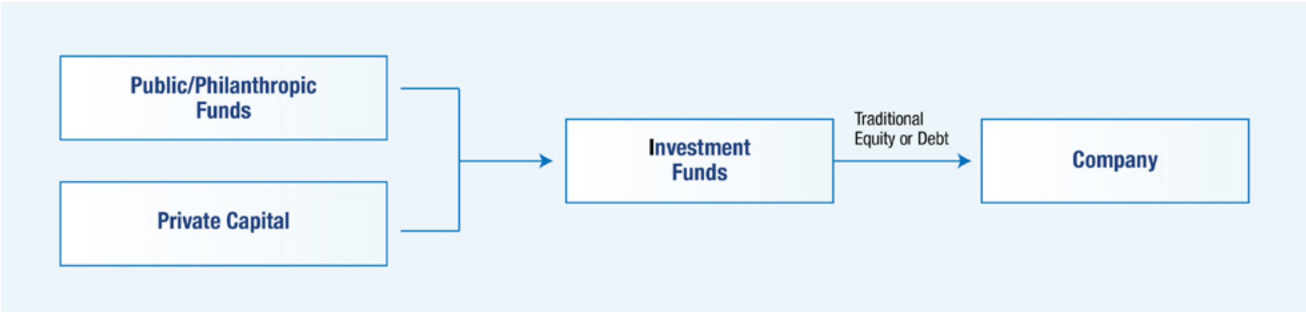
APPENDIX 1: TRANSACTION STRUCTURES AND EXAMPLES

BLENDED FINANCE: TRANSACTION STRUCTURES AND EXAMPLES [13]

Blended Finance Through a Fund

Concessional funding from a public/philanthropic entity that helps attract full-return private capital – provided through a fund to a company.



Blended Finance Through Mixed Investments in One Company's Capital Structure

Sistema bio, Mexico Sistema.bio is a Mexican company that develops biodigesters, which turn animal waste into biogas, a clean and renewable energy, as well as biofertilizer. Since its founding in 2010, the company has maintained a blended capital structure, attracting grants, concessional debt and equity, and private investments to achieve international scale, including completing a bridge financing round in 2020.

13. See: *Mapping Examples of Corporate Blended Finance*, CFO Coalition for the SDGs

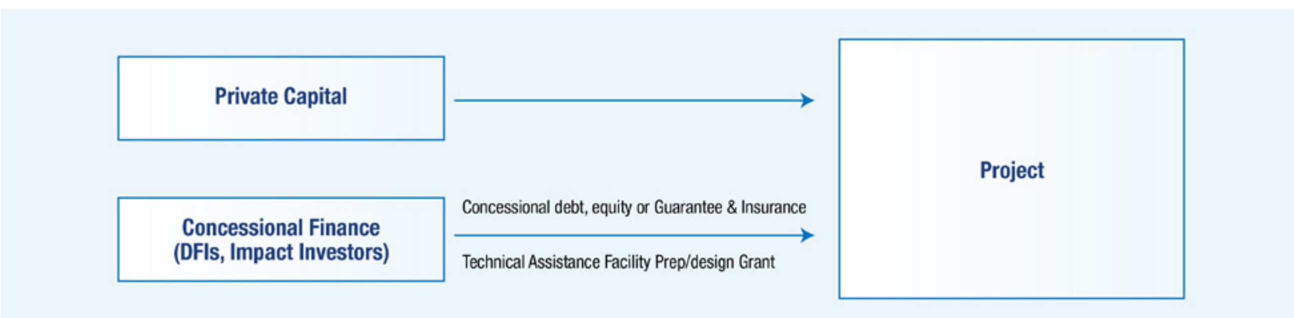
Sistema.bio, Colombia: Capital Structure

- Grant: $3 million*
- Equity: $12 million
- Seed: $0.5 million
- Series A: $7 million
- Bridge: $4.5 million (convertible)
- Series B: $10+ million (target)
- Debt: $5.5 million

* Shell Foundation, both repayable and nonrepayable

Blended Finance by Providing a Guarantee or Insurance to a Project or Firm

This is the most common structure:



Rwandan Development Bank Using WB Concessional Funding to Catalyze Private Capital. [Impact alpha 2024] Rwandan Development Bank - BF

This is a simple structure where the Development Bank of Rwanda used $10 million of concessional World Bank/IDA funds as collateral for a $24.8 million seven-year local currency bond issuance, effectively reducing the risk for investors and the cost of borrowing for the bank. In the event of a default, investors have the recourse to take ownership of the collateral.