Blended Finance: Unlocking Commercial Finance for Sustainable Development

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The transition to a green economy will requires massive funding. It is estimated that the investment needs of emerging markets and developing economies could reach $1 trillion a year by 2030 (International Monetary Fund, 2022). Much of this should have come from the governments and international agencies like CDC Group or International Finance Corporation (IFC). Unfortunately, most economies around the world are running large deficits. On the other hand, the development institutions have a wide array of financing requests. While institutional investors have been involved in green finance, they have typically focused on low-risk bankable projects. To achieve Sustainable Development Goals (SDGs) and meet the needs of climate finance there is a need to bring together public and private sources of financing. One approach to solving this problem is blended finance.

In fact, in the FY22 budget the Indian government announced the use of blended finance approach for the sunrise sector. The sunrise sector includes healthcare, livelihoods, education, climate action, deep tech, digital economy, pharma and agritech. Thus, the potential for blended finance in India is large.

So, what is blended finance?

There is no single definition of blended finance. Different funders adopt different definition.

The World Economic Forum and OECD define Blended Finance as "…the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets." (OECD & World Economic Forum, 2015)

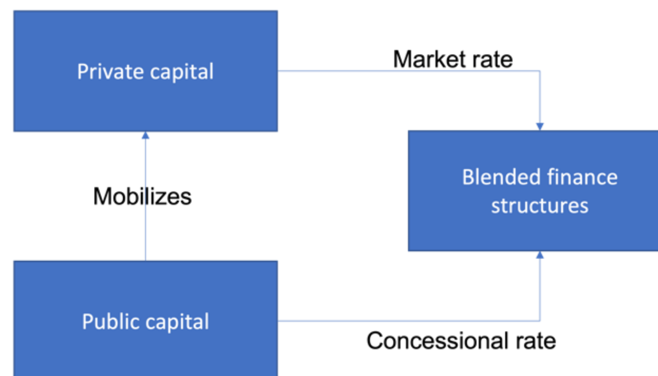
According to International Development Finance Club, "…blended finance aims at enhancing the quality of partnership between the public and private sector by maximizing synergies while setting clear impact targets towards sustainable development." (International Development Finance Club, 2019)

Development Initiatives defines blended finance as, "…blended finance refers to a combination of resources, either from official public sources (governments and/or DFIs) or philanthropic actors with capital from other sources (either official public or private actors)." (Development Initiatives, 2016)

If one were to observe carefully from the definitions listed above, a key feature of blended finance are:

1. Additionality: Some of the financial requirements have to be met from private sources.
2. Positive development impact: The blending of finance will result in social, economic or environmental benefit.

Figure 1: Blended finance



Source: author

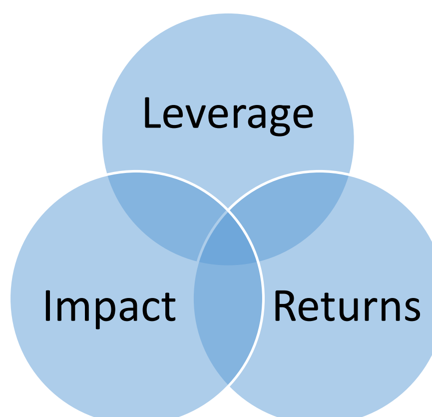
While private sources are more easily understood, the public funding needs a little explanation. Public sources include government agencies and development financial institutions (DFIs). These DFIs may be bilateral (single country) or multilateral (multiple countries).

The Three Pillars of blended finance

Blended finance has three key characteristics:

1. **Leverage**: Public and development finance acts as a lever to attract private finance.
2. **Impact**: Provides economic, environmental, and social progress through investments.
3. **Returns**: It allows private investors to earn returns commensurate with market expectations.

Figure 2: The Three Pillars of Blended Finance



Source: OECD and World Economic Forum. 2015. 'Blended Finance Vol. 1: A Primer for Development Finance and Philanthropic Funders'. World Economic Forum.

Blended finance can work across many geographies, an array of financial instruments and a wide variety of structures. It brings together many types of stakeholders that partner in a fund transaction. It brings together a unique mix of private and public capital.

How does blended finance work

Money is raised from investors – private (institutional investors) and public (concessionary investors by the intermediaries (development banks, foundations and NGOs) who invest in climate, social and development projects (*What Is Blended Finance, and Why It Matters*)

Investors

- There are two types of investors that provide long-term, large scale capital that is necessary to fund critical development needs:
    - **Institutional investors** are banks, insurers, and asset managers among others who invest a significant component of the required capital. They usually invest for profitable risk-adjusted returns.
    - **Concessionary investors** consist of public development assistance and foundations. They invest a lesser portion of the capital and are willing to accept a higher risk of loss. They invest in below-market rates of return.

Intermediaries

- These consist of teams of subject matter experts (SMEs). These SMEs are often sponsored by development banks, private institutions and NGOs. Intermediaries bring investors with financial resources and investment projects together.

Projects

- These projects include clean water access, medical facilities and sustainable development programs. They receive finance and put the money to use to meet specified criteria.

Then there is the issue of what financial instruments are used in blended finance.

a. **Equity**: Ownership in the project/company.
b. **Debt**: money lent to be repaid later along with interest. There are two types of debt instruments—market rate debt and concessional debt.
c. **Guarantees**: They protect the investors from the risk of capital losses.
d. **Grants**: Here a financial commitment or investment is made without any expectation of repayment or compensation over a fixed period of time.

OECD Principles

The OECD has set out the following principles for a common framework for blended finance (*Blended Finances Principles - OECD*).

Principle 1: Anchor Blended Finance use to a Development Rationale

Principle 2: Design Blended Finance to Increase the Mobilisation of Commercial Finance

Principle 3: Tailor Blended Finance to Local Context

Principle 4: Focus On Effective Partnering for Blended Finance

Principle 5: Monitor Blended Finance for Transparency and Results

These principles are aimed at helping increase the adoption of blended finance. They also act as guide maps for blended finance professionals.

Growth of blended finance

Blended finance has grown rapidly both in the number of deals and the total capital committed. It is estimated that roughly USD 180bn worth capital has been raised through blended finance to date. This money to be used for sustainable development in developing countries.

Figure 3: Growth of Blended Finance

Year	Number of Transactions Closed	Total Capital Committed (USD bn)
2011	181	41
2012	225	51
2013	270	59
2014	323	80

2015	378	99
2016	432	115
2017	498	128
2018	558	144
2019	612	155
2020	677	161
2021	739	168
2022	759	170

Source: Blended Finance, https://www.convergence.finance/blended-finance

Three questions

Before going for blended finance, one needs to ask three questions:

1. Development rationale: Will the project create a developmental impact?
2. Additionality rationale: Does the financial institution providing public finance add value beyond what the market offers?
3. Concessional rationale: Do residual participation or behavioural constraints exist?

Blended finance succeeds only when all three rationale (development, additionality and concessional) hold simultaneously. A positive development impact is necessary but not sufficient to justify the use of blended finance. Even without subsidies, social welfare can be increased by providing goods and services that generate large positive externalities.

Similarly, the use of additionality is necessary but not sufficient. The question to ask is: Can the market finance the project without the use of public resources?

By looking at each rationale separately, it is possible to identify the benefits (or distortions) to society that justifies the use of concessional finance at appropriate levels.

Approaches to Blended finance

There are three main approaches to blended finance: technical assistance, risk underwriting and market incentives (OECD & World Economic Forum, 2015, International Development Finance Club, 2019).

Technical assistance: Technical assistance is a key tool that address the knowledge gaps and allows the project to be developed. Here the development funds can be used to provide many things. These include

- Advisory and consulting services for project preparation. These are particularly critical in the early stages of the project, for instance, exploration services.
- Operational assistance in form of management and marketing,
- Product development,
- Training to improve skills,
- Knowledge transfer and other professional services,

To improve the viability of the investee's project and in turn improve investment performance. This greatly improves the ability of the project to attract private capital by reducing the costs and risks associated with new markets or technical uncertainty. It also reduces transaction costs and reduces operational risk.

Risk underwriting:

Risk underwriting instruments can benefit in either of the two ways. They can improve the credit rating or profile of the project or the company. Alternatively, they can provide comfort to investors that they will be able to recover their investments or absorb losses. This mechanism provides a shield against losses from negative events or provides direct compensation or assumes losses. Insurance policies and guarantees are two most common risk underwriting tools.

Insurance policies: In these contracts when an adverse event occurs a third party will make the specified payment.

Guarantees: Guarantees are a promise that in the event an undesirable event occurs, the guarantor will assume responsibility and take action on behalf of the guaranteed party.

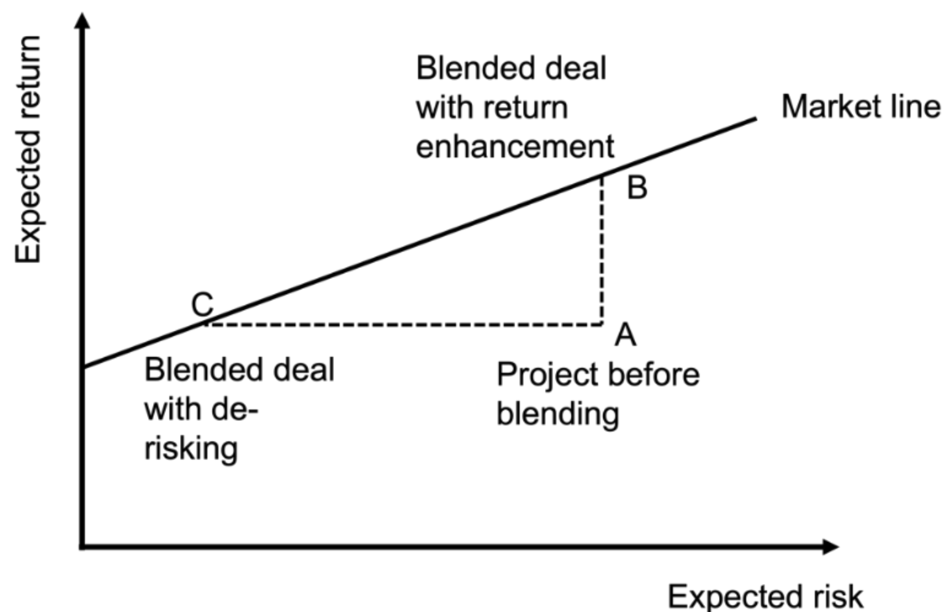
Market incentives: There are several sectors where high impact projects can be undertaken. However, they often lack normal market fundamentals. Here market incentives are required. Market incentives become important in markets that require innovation. Without incentives the potential for these markets cannot be realised. Market incentives can take several forms. These include advance market commitments, awards, prizes, challenge funds, matching funds, and development impact bonds, among others.

Blended finance and cost of capital

Blended finance is used as a means of creating acceptable risk-return profiles for institutional investors so that they can allocate capital to these projects. This is achieved through de-risking the project or through return enhancement, or a combination of both. Typical de-risking instruments may include (partial) risk guarantees, first-loss positions, grants, technical assistance, subordinated debt or junior equity. These are

often used in areas where capital is not flowing at scale or unlocking new sources of capital. Return enhancement can be created by giving investors priority rights to cash flows generated.

Figure 3: Blended Finance: The Risk-Return Tradeoff



Source: authors

As can be seen in figure 3, the use of blended finance can either raise the return profile of the project (from A to B) by using revenue enhancement mechanisms or reduce the risk of the project (A to C) by using de-risking strategies. A combination of revenue enhancement and de-risking would lead to a point on the market line between B and C.

The future of blended finance

Given the constraints of high debts and constrained finances because of the pandemic and rising interest rates it is increasingly becoming difficult for public finance to meet pressing social and climate financing needs. Financial markets alone cannot do the job. However, public and private finance together can do the job. Let us look at the scale of the problem. It is estimates that to achieve net zero greenhouse gas emissions by 2050 would require $275 trillion in physical assets (Financing the Net-Zero Transition: From Planning to Practice, McKinsey, n.d.). Given the scale of investments, it is impossible for either the private or the public sector to fund them. The investors will need a mix of public and private funds to meet the global challenges. New instruments, financing structures and risk mitigation tools will have to be designed to meet the funding gap. Strong and appropriate governance structures can help minimize several risks and reduce moral hazards

associated with these projects, especially where insurance and guarantees are in place. In developing and less-developed economies and development banks will need to play a key role and take the help of private sector to meet the large financing needs.

YES BANK uses blended finance to help the agariyas to address the manifold challenges. The bank blends its financial innovation with socio-environmental sustainability, together with a local co-operative bank. It also takes the support of an NGO as a local implementing agency on the ground.

Features of the blended finance facility

- YES BANK provides grants towards credit enhancement and credit affordability. Credit enhancement ifs offered by means of a first loss default guarantee to the cooperative bank. Credit affordability is improved through interest subvention.
- The twin benefits of credit enhancement and credit affordability enables the cooperative bank to offer an affordable 5-year tenor loans to farmers who use the money to purchase solar pumps.
- To enable repayment, the repayment is scheduled only during the earning season.
- YES BANK also helps the local NGOs by providing implementation support.

Key attributes of the facility

- YES BANK helps align the interest of all the stakeholders in the value chain. These stakeholders include the rural cooperative bank, woman salt farmers, NGOs and donor bank (the private bank).
- It helps distribute the risk among stakeholders and thus reduce the risk for the primary lender.
- By reducing risk YES BANK enables the delivery of energy inclusion products and services to the women at the bottom of the pyramid.
- It creates a positive impact in the form livelihood improvements, woman empowerment, energy inclusion and financial inclusion.

The performance of YES BANK acts as a guide for social transformation through blended finance for development banks, multilateral organizations and donor/philanthropists

Source: (Yes Bank, n.d.)

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