TC NOTES

PRACTICAL **LEADERSHIP**
AND **GUIDANCE** FROM
TORONTO CENTRE

BLENDED FINANCE: IMPLICATIONS FOR SUPERVISORS

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BLENDED FINANCE: IMPLICATIONS FOR SUPERVISORS

Introduction[1]

Blended finance is the practice of using international development grant funding to encourage international and domestic private investment in projects to address the funding gap needed to achieve the United Nations Sustainable Development Goals[2] (SDGs) in emerging markets and developing countries (EMDCs). This funding gap was estimated in 2014 to be at least $2.5 trillion by 2030,[3] but has increased because of the COVID-19 pandemic.[4]

This Toronto Centre Note provides an overview of blended finance debates, considerations, and issues of interest for EMDC financial supervisors. It examines the constraints on the growth of blended finance in EMDCs including possible regulatory barriers, and it explores the role that supervisors can play in supporting the expansion of blended finance while maintaining the soundness of the financial sector.

This Note highlights the reasons why EMDC financial services supervisors should increase their understanding of blended finance transactions, including:

- the need for EMDC supervisors to raise their awareness of blended finance structures and risks, as their supervised firms may become increasingly involved in blended finance structures;
- EMDC supervisors with a developmental mandate, such as those in many emerging markets, have an even stronger reason to engage;
- the important role that supervisors can play in clarifying regulatory issues that affect the use of blended finance structures in their markets;
- the importance of international organizations aiming to develop blended finance working with national financial authorities on blended finance to maximize alignment;
- the need for practical capacity building to help EMDC supervisors engage with blended finance tools and balance their objectives of financial sector stability and achieving the SDGs; and
- the complementary role blended finance could play in the COVID-19 recovery efforts for EMDCs, for example in scaling up health security measures.[5]

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[1] This Toronto Centre Note was prepared by John Palmer and Lindsay Wallace with input from Clive Briault, William Coen, Jean Lorrain, Carl Hiralal, and Chris Clubb.

[2] The United Nations Sustainable Development Goals, also known as the Global Goals, were adopted by all United Nations Member States in 2015 as a universal call to action to end poverty, protect the planet, and ensure that all people enjoy peace and prosperity by 2030. The 17 interconnected global goals address issues that include poverty, education, gender equality, and climate change. More information can be found at www.un.org/sustainabledevelopment/

[3] United Nations Conference on Trade and Development (2014).

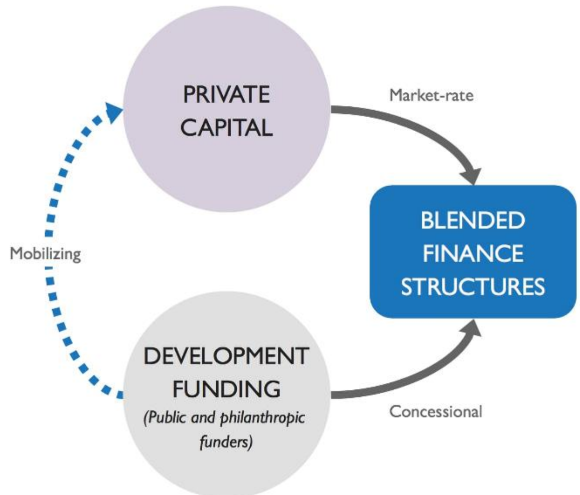
[4] According to the United Nations (2020), in March 2020 alone, investors moved over $90 billion from developing countries, the largest outflow ever recorded. Sumner et al. (2020) estimated that the impact of the COVID-19 pandemic could reverse global progress in addressing SDG 1 – to end poverty in all its forms everywhere – by at least a decade. The Bill and Melinda Gates Foundation (2020) estimated that 25 weeks of the pandemic pushed back progress in achieving the SDGs by 25 years.

[5] Convergence (2020).

This Note builds on previous Toronto Centre Notes that address such issues including those on sustainable finance and investing with impact,[6] climate change,[7] and the role of supervisors in achieving the SDGs.[8]

What is blended finance?

Blended finance is the use of catalytic public and philanthropic capital to mobilize additional private capital to projects that help achieve the SDGs and expect a positive financial return. Blended finance is an umbrella term that covers a wide variety of transaction types in different sectors and geographies. Convergence, a non-profit organization that acts as a global network of blended finance initiatives, holds a database of registered blended finance and is encouraging the growth of blended finance transactions. Further details on blended finance, including the types, trends, and key actors and sectors can be found in Annex 1.



While the term blended finance is new, the use of public funds to help reduce the risk for the private sector in financial transactions is not new, as public guarantees have been used as a tool for encouraging international and domestic lending for many decades. What is new is the increased urgency of using these tools in a more systematic and coordinated way to help achieve the SDGs. Given that the SDG achievement gap is greatest in emerging markets, much of the focus of blended finance is on cross-border transactions, where the development and private capital comes from one country for investment in another. However, domestic transactions, where both the private and development capital come from inside the same country or where there is a mixture of both domestic and international financial flows, are also possible. The challenges facing blended finance and the issues of concern to supervisors vary depending on whether the transaction crosses borders, and the level of engagement of domestic financial institutions.

The use of blended finance can be viewed as part of an overall trend of an increased emphasis by the financial and investment community on investments that advance improvements in the areas of environment, social impact, and improved governance (ESG). The International Finance Corporation (2019) estimates the market appetite for such types of investment at $32 trillion (and growing). Investments and transactions that use blended finance mechanisms are often seeking to address the same issues as sustainable and responsible investment including a slowdown in climate change, reduced poverty, or women's economic empowerment. The difference is the explicit inclusion of external philanthropic or donor resources to mitigate investor risk and encourage investments.

[6] Toronto Centre (2019a).
[7] Toronto Centre (2017, 2019c, and 2020).
[8] Toronto Centre (2019b).

Despite significant support from the international development community, cross-border blended finance has not yet transformed billions of international donor funds into trillions in investment. The global economic uncertainty arising from COVID-19 has made the need for blended finance and other innovations to address the SDG funding gap even greater. But the volume of private sector capital leveraged to date remains low, particularly for the least developed countries (LDCs).[9] OECD and Convergence estimate the total amount of annual investment flows created by blended finance at around $16-22 billion, with approximately $3-6 billion of development funding allocated on concessional terms. While the SDG funding gap is significant for most emerging markets, the LDCs have the greatest need for blended finance but have received only 6% of all blended finance flows.[10]

Constraints on the growth of blended finance

In its recent *Financing for Development Report*, the United Nations (2020) notes that while the amount of private equity and venture capital funds invested in emerging markets almost doubled between 2015 and 2018 to $70 billion, it represents only one-fifth of the private equity and venture capital investment made in the USA. It notes that Africa has significant challenges in attracting investment, with only $2.5 billion invested there annually over the past five years. A key rationale behind blended finance is that emerging markets are perceived by the global investment community as too risky and therefore international donors should be used to reduce that risk through blended finance structures to support SDG-aligned projects.[11]

Risks and investment mandates

There are several reasons why cross-border SDG-related investments to EMDCs have not increased at the rate needed to achieve the SDGs. Investment flows require a variety of conditions to be in place, including an enabling domestic environment and a pipeline of investable deals. The Blended Finance Task Force argues that developing countries with the right policy and institutional mechanisms should be able to attract investment and that those that prioritize sound policies, institutional capacity, and stable project pipelines will attract more capital.[12]

Investment mandates, low-risk ratings, and political/country, liquidity, and foreign exchange risks are all additional barriers to investment in EMDCs, including through blended finance transactions. Many investors do not have the mandate to invest in transactions that are below investment grade and are too risky. Many emerging markets are below investment grade and most of the LDCs are not rated. Convergence has cited these risks as the largest risks in blended finance transactions. Exit risk is a further risk for equity investments. They also note that risks are harder to measure and are more acute in developing countries.[13]

Another challenge is that many EMDC financial markets are too shallow to attract blended finance transactions. A recent study of the local dimensions of blended finance argued that

[9] LDCs are 47 countries identified by the UN that have the lowest level of socio-economic development.
[10] United Nations Capital Development Fund (2019).
[11] Organization for Economic Co-operation and Development (2018a).
[12] Business and Sustainable Development Commission (2018).
[13] Convergence and Business and Sustainable Development Commission (2018).

development finance institutions (DFIs)[14] face higher costs when using local partners and are disincentivized to use local financial institutions.[15] Engagement with local investors, investees, and local capital market participants can help with pricing and determining when viable financing cannot be obtained without the introduction of blended financial products.

Local currency risk is another significant barrier to cross-border investment, and part of the rationale behind the call for greater local engagement in blended finance transactions. One method of addressing these challenges is to use blended finance vehicles such as GuarantCo.[16] GuarantCo was established to mobilize local currency investment for infrastructure projects and to support the development of financial markets in lower-income countries through the use of guarantees. Projects may find it challenging to obtain debt finance in sufficient volume or tenor due to country- or project-specific risks or market constraints. This can often be overcome using an appropriately structured guarantee to enable direct lending from banks/financial institutions or capital market issuances.

LDCs face additional challenges in attracting blended finance and need a more holistic approach to addressing the barriers.[17] This is due to higher country risk, as reflected in below-investment-grade sovereign credit ratings, higher costs of project pipeline development, and higher levels of subsidies needed. Also, local capacity to engage in blended finance transactions is often lower than in other EMDCs. The UN has argued for a greater focus on technical assistance and market development in blended finance engagements in LDCs. The United Nations Capital Development Fund (2019) has called for those promoting blended finance transactions in LDCs to actively seek out domestic investors, to support local industry, and to ensure that local suppliers and value chains are effectively integrated into the transactions. LDC governments, concessional providers, and donors need to engage more to ensure complementarity between blended finance projects and other interventions that support private sector development and the promotion of a sound enabling environment.[18]

Perceived regulatory barriers to blended finance

Financial supervisors should be aware that there is a perception amongst blended finance advocates that global and national regulatory standards may be a factor in limiting cross-border blended finance transactions. Several organizations such as the Milken Institute and the OECD have argued that financial regulations are a barrier to increasing investment flows to EMDCs and have reduced investor risk appetite. They argue that those promoting blended finance transactions must be mindful of regulatory issues and that special regulatory treatment of blended finance tools may be necessary.[19]

Some commentators have argued that more stringent prudential standards under Basel III could limit the participation of developed country banks in guarantee structures, a common blended finance tool, particularly in emerging markets. Several organizations including the OECD and

[14] Development Finance Institutions (DFIs) are specialized development organizations that are usually majority owned by national governments. DFIs invest in private sector projects in low- and middle-income countries to promote job creation and sustainable economic growth. DFIs are a significant participant in blended finance transactions.
[15] San and Preston (2019).
[16] https://guarantco.com/
[17] United Nations Capital Development Fund (2019).
[18] Organization for Economic Co-operation and Development (2020).
[19] Milken Institute and OECD (2018).

Milken Institute[20] and the Centre for Global Development[21] have argued that, once implemented, Basel III may serve as a disincentive for developed country financial institutions to participate in guarantee structures, particularly in frontier and emerging markets. Basel III requires enhanced long-term funding, greater liquidity, and lower leverage, which could limit long-term investment by international commercial banks. Basel III's Net Stable Funding Ratio (NSFR) imposes a minimum requirement for stable sources of funding to match longer-term lending; the Liquidity Coverage Ratio (LCR) requires banks to hold sufficient high-quality liquid assets (HQLA) to withstand a 30-day stressed funding scenario; and the leverage ratio constrains the overall size of banks' balance sheets.

Most guarantees do not meet the criteria of HQLA as they are not payable on demand or traded on a secondary market. It is therefore difficult to see how they could be turned into cash at short notice in order to meet deposit withdrawals from a bank. However, many guarantees are provided by government development agencies such as the Swedish International Development Cooperation Agency (Sida), a government agency that provided approximately $800 million in guarantees for SDG-related projects in 2018. This funding mobilized an additional $2.1 billion in additional capital from the private sector for these projects. The Milken Institute argues that government donor agencies such as Sida or USAID should seek HQLA recognition for approved development-focused guarantees and to adjust certain structural features of guarantees to give financial supervisors and regulators comfort in granting such exemptions.[22]

Commentators also argue that new insurance regulations could limit blended finance engagements by insurance companies in infrastructure, but again further research is required. Milken Institute and OECD argue that Solvency II has reduced the interest in infrastructure investment by insurance companies. This is because it requires large capital buffers for longer-term and higher-risk assets. Solvency II may also limit insurance companies' ability to outsource investment decisions and portfolio management to entities that are not regulated, such as development finance institutions or multilateral development banks.

The impact of regulatory reforms including Basel III and Solvency II is regularly examined by the Financial Stability Board (FSB). One FSB (2018) study of the impact of the reforms on privately provided infrastructure finance found that the introduction of financial reforms in the G20 had only a second-order impact on the provision of infrastructure finance in both advanced and emerging markets. The study was based on in-depth analysis of financial transaction data, interviews, and surveys with market participants. Overall, the macro-financial environment, governmental policy, and institutional factors were found to be the main drivers of infrastructure finance. The research did not focus on blended finance transactions, but since they are likely to be less risky than other infrastructure finance, the results would probably be similar.

A similar FSB (2019) study of the impact of financial reforms on access to finance for small and medium-sized enterprises (SME) found no material or persistent negative effects. It did find some evidence that the stricter requirements tightened some conditions for lending and that the effects differed across the G20 jurisdictions. Similarly, the research found that factors such as public policies and macroeconomic conditions are a greater driver of SME financing levels than financial regulations.

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[20] Milken Institute and OECD (2018).
[21] Beck and Rojas-Suarez (2019).
[22] Milken Institute and OECD (2018).

Bankers and financial supervisors have different perceptions of the impact of financial reforms, and Basel III in particular, on cross-border transactions. A survey by the World Bank found that banks believe that more stringent regulatory requirements related to some activities and services will discourage their participation in such activities. On balance, supervisors and regulators believe that the long-term benefits outweigh the near-term costs. These benefits include greater financial and market stability; firms' increased resilience to stress; and better market discipline leading to greater investor and counterparty confidence.[23]

Research on the impact of new financial regulations on blended finance transactions should continue to determine whether regulatory changes are having a material impact on financial flows relative to other factors. In the meantime, the blended finance community should look to strengthen local financial markets and work to enhance financial stability and inclusiveness as a means of attracting external finance. Local supervisors and regulators have a key role to play in this regard.

Supervisory and regulatory engagement in blended finance

The risks inherent in blended finance transactions are not unique or unfamiliar to most financial supervisors. However, the use of blended finance structures introduces an element of complexity that requires extra attention on the part of financial supervisors. Blended finance rests on the use of financial enhancements to encourage private sector investors and lenders to participate in transactions that would normally exceed their risk appetites. Financial enhancements can include anything that would reduce the risk of an investment or loan, particularly full or partial guarantees as well as equity or subordinated debt participation.

EMDC supervisors need to understand the risks inherent in the projects to be financed and, second, how effectively these risks will be mitigated by the various enhancements provided by other parties such as international financial institutions, aid organizations, and NGOs. The functioning of the enhancements can be complex. For example, in the case of guarantees, there are conditions to be met before the guarantee becomes enforceable. If commitments to such projects on the part of regulated entities are, or are likely to become, material to the regulated entity, the supervisor needs to take the time to understand the risks and risk mitigation techniques and also to form a judgement on how effectively the regulated entity is able to manage these risks. For some regulated entities, participation in blended finance projects will be new, facing the entity with a steep learning curve and therefore higher risks and potentially weaker risk management while the learning is taking place.

The Convergence[24] database includes many examples of the use of financial enhancements in blended finance transactions. Box 1 outlines an example of a blended finance transaction designed to increase access to safe water. Issues of interest to supervisors are highlighted.

[23] Briault et al. (2018).
[24] Referred to in the proprietary database of Convergence, to which limited access was kindly provided to the Toronto Centre.

Box 1: Example of blended finance transaction

The Kenyan government set an ambitious goal of achieving universal and equitable access to safe and affordable drinking water for all by 2030. This included supporting and strengthening the participation of local communities in improving water and sanitation management. There were significant barriers to achieving these goals including:

- Most water service providers (WSPs) were county- or community-owned and operated small-piped water systems in rural and peri-urban areas.
- WSPs lacked familiarity with commercial bank lending practices.
- WSPs could not afford commercial interest rates.
- WSPs were not credit worthy; they could not provide sufficient collateral and lacked adequate self-financing.

Several international aid organizations and domestic bodies were prepared to help to achieve these important objectives, which were consistent with the SDGs, in particular Goal 6: *Ensure availability and sustainable management of water and sanitation for all*. These included the World Bank, the European Union, the Swedish International Development Cooperation Agency (Sida), the United States Agency for International Development (USAID), Kenya OBA (Output-based Aid) Fund, the Water Services Trust Fund of Kenya, and the KfW Aid on Delivery program. A local bank specializing in microfinance lending (the bank), was also interested in participating, but needed help to make the various water projects bankable.[25]

It was decided to create a program to incentivize rural and peri-urban communities to access loan financing to rehabilitate and expand small-piped water systems. To make this happen, the following financial enhancements were put in place:

- Communities contributed 20% of project costs in pre-financing (in effect equity to support the bank's loans to WSPs).
- The World Bank provided project grants and infrastructure subsidies to the bank to facilitate the bank's loan program.
- The Water Services Regulatory Board reviewed and issued credit ratings of water utilities.
- The bank provided eligible WSPs with a USD $9,000 project development grant to pay for consultancy services to develop a bankable project.
- The bank provided approved WSP projects with a USD $12,600 project implementation grant to pay for consultancy services to oversee project construction and set up post-implementation management systems.
- The bank purchased a partial credit guarantee from USAID Development Credit Authority covering 50% of the bank's exposure
- The bank financed 80% of project costs through a medium- to long-term loan.
- Once the project met targets, the World Bank Global Partnership on Output-based Aid provided an output-based grant to the community-owned WSP to help cover debt-service costs and make water rates affordable.

[25] Advani (2016).

There were several risks facing the bank:

- The principal risk facing the bank was credit risk. Without the various enhancements, the credit risk of lending to WSPs would have been unacceptably high. Credit risk was mitigated by the equity infusions from the communities owning the WSPs; the credit ratings assigned to WSPs, which assisted the bank in its credit decisions; the grants and subsidies to the bank; the partial credit guarantee purchased from USAID; and the conditional support provided by the World Bank to help WSPs service their bank loans. In addition, the loans to the WSPs were secured by a registered charge on the fixed assets of the project to be financed, an assignment of rights to assets, including receivables, developed with the proceeds of the loan, and a negative pledge on assets.

- Another risk was liquidity risk as the bank was providing five-year term financing to the WSPs, repayable in monthly instalments of principal and interest. Liquidity risk was partially mitigated by the USAID guarantee, but there could be conditionality and timing issues in enforcing the guarantee. Funding for the medium-term loans was likely short term, so the bank would require liquid assets to support the maturity mismatch.

- There was also currency risk as some of the financial enhancements were in U.S. dollars while the loans were in local currency.

- The complexity of the financing and related enhancements also introduced a level of operational risk.

- In other blended finance projects, such as those supporting the establishment of funds to invest in several projects, market risk can also be a factor.

EMDC supervisors will need to prepare themselves for the increasing engagement by their supervised institutions in blended finance. While the growth in the volume of blended finance transactions to date has been less than desired for the reasons outlined above, its growth is likely to continue. Supervisors will need to learn about blended finance and regulated institutions' role in supporting this important activity, as well as any implications the engagement of these firms in blended finance transactions may have in terms of risk levels. Supervisors that have a development mandate have an even stronger reason for engaging in blended finance as it can help to address some significant gaps in their economies.

EMDC supervisors will also want to examine their regulatory regimes and the tools available to help ensure that their financial environments are attractive to domestic and international investors. This includes:

- The role of credit lines and guarantees in stimulating investment and financing in emerging markets. Credit guarantee and other risk-sharing schemes are not new, with some of the oldest schemes dating back to the nineteenth century.[26] According to the UN, of the $20 billion of blended finance mobilized within country, externally supported credit lines contributed approximately $15 billion and guarantees contributed approximately $5 billion.[27] However, many development agencies and multilateral development banks with AAA-AA

[26] Abraham and Schmukler (2017).
[27] United Nations (2020).

ratings are reluctant to use simple credit guarantees, preferring to use risk-sharing agreements. EMDC supervisors should work with financial institutions and guarantee providers to explore opportunities for the application of credit relief for local banks in those agreements. There are several lessons to be learned from the application of these tools, including using a competitive framework for the guarantee and introducing incentives to reduce the level of guarantee.[28] Risks of moral hazard, over-financing of ultimately unviable projects, and over-indebtedness need to be managed.

- Local pension funds' engagement in blended finance transactions, particularly in the infrastructure sector, can signal the worthiness of projects and help to attract international investment. However, they may face regulatory barriers that need to be examined. The Blended Finance Task Force notes that pension funds in Africa are expected to grow significantly, but that they are highly conservative and allocate as little as 0.1% of their assets to infrastructure. Helping to crowd-in local investors is particularly critical as a way of helping to inspire confidence amongst international investors. Pension funds are often restricted by regulation from investing in infrastructure, and regulatory changes can support increased investment. One example cited by the Blended Finance Task Force is regulatory changes adopted by the Colombian government to allow pension funds to invest in infrastructure debt funds, which allowed them to invest in Fourth Generation (4G) road projects and increased the confidence of international investors in the project.[29]

Accelerating blended finance

Deepening local financial markets

EMDC supervisors should be aware that advancing blended finance requires greater attention to the development and deepening of local financial and capital markets and understanding why a blended approach is needed in the first place. This is increasingly being recognized by the donor community, which has set up a series of working groups to advance and coordinate efforts on a series of blended finance principles.[30] One working group focuses on using donor resources to help build inclusive financial and capital markets and argues that participation of local financial institutions in blended finance is limited by underdeveloped capital and financial markets.[31] The need to support the domestic financial sector in EMDCs has been made even more urgent because of the COVID-19 pandemic. EMDCs have less fiscal space to support domestic financial institutions. Convergence, CGAP, and others have argued for the blended finance donors to support financial intermediaries through wholesale local currency funding and risk sharing.

EMDC supervisors have a key role to play in clarifying with their supervised institutions the extent to which regulatory issues could be a factor in their markets and to advise on the extent to which those issues limit the use of blended finance vehicles. Local financial institutions should be encouraged and helped to incubate, anchor, and lead the arrangement of blended finance solutions, particularly those involving local currency finance. Engaging local financial institutions and investors in blended finance deals can help to develop capacity that can be used for future projects. The OECD has argued that including local financial institutions, such as

[28] Carnegie Consult (2016).
[29] Business and Sustainable Development Commission (2018).
[30] OECD (2018b)
[31] The Tri Hita Karana Roadmap for Blended Finance Transparency Working Group (2020).

local pension funds, is critical to providing local currency finance to blended finance projects and to reduce foreign exchange risk. Local firms are also better positioned to understand and price a variety of risks.[32]

Increasing knowledge of blended finance

There is significant scope to increase the knowledge of blended finance as a tool amongst EMDC supervisors as part of the growing interest in climate finance, financial inclusion, and responsible investment issues.[33] Specific guidance and training for EMDC supervisors is needed and supervisors should be part of the blended finance conversations in their jurisdictions. There are a few blended finance training programs, but they are focused on international donors and the private sector. A dedicated training program for supervisors on how best to assess the risks of and engage with blended finance transactions would help to increase awareness and understanding. Given the significant overlap between blended finance and other issues such as advancing financial inclusion and climate finance, such training programs could address these issues as well.

The most important role that supervisors can play is ensuring a well-supervised financial sector to make their economies more attractive to blended finance deals. Weak supervision and regulation contribute to financial crises and suboptimal economic growth both locally and internationally. Weak supervision and regulation usually occur because of issues related to ineffective legal frameworks, poor supervisory methodologies, and a lack of supervisory or regulatory expertise or resources.

Increasing transparency of blended finance flows

Greater transparency across blended finance stakeholders is critical to help the number of transactions grow and to support a research agenda. EMDC supervisors can ensure that financial reporting standards are in place and being followed to obtain a clearer picture of the volumes of blended finance deals entering their markets. Most of the organizations engaging with blended finance have called for greater transparency and reporting in terms of financial flows, deal details, level of subsidy, and importantly, the impact of blended finance on SDGs and on different groups such as women. Research by Convergence has found that only 25% of blended finance transactions had either a principal or partial focus on gender.[34] The OECD has set up a working group on blended finance transparency, which it defines as "the availability, accessibility, comprehensiveness, comparability, clarity, granularity, traceability, reliability, timeliness and relevance of both ex-ante and ex-post information regarding the use of public and private capital in blended finance transactions."[35]

Improved transparency could also potentially increase investment flows, but this remains a challenge due to the divergent perspectives of the different parties involved. Transparency at the project level, versus portfolio level, is constrained because of legal limitations. Increasing

[32] The Tri Hita Karana Roadmap for Blended Finance Building Inclusive Markets Working Group (2020).
[33] According to the United Nations Framework Convention on Climate Change, climate finance refers to local, national, or transnational financing – drawn from public, private, and alternative sources of financing – that seeks to support mitigation and adaptation actions that will address climate change. https://unfccc.int/topics/climate-finance/the-big-picture/introduction-to-climate-finance
[34] Convergence (2019).
[35] The Tri Hita Karana Roadmap for Blended Finance Transparency Working Group (2020).

certain disclosures could discourage future participation of private sector participants who want to guard their commercial privacy. The Blended Finance Task Force has argued for the development of a transaction data set to increase certainty by commercial capital providers, who prefer to invest in clear, comparable opportunities. Publishing transaction results in a standardized and accessible format, possibly managed by a third party, could help private capital to contextualize investment opportunities and lead to greater investment.[36]

Engaging global standard setting bodies in blended finance discussions

International organizations working to develop blended finance should work with associations of supervisors and individual supervisory bodies in EMDCs to engage them in the conversation and maximize alignment. One example is the discussion of blended finance tools during regular Financial Sector Assessment Programs conducted by the International Monetary Fund (IMF) and World Bank. Beyond the IMF and World Bank, much of the focus of blended finance policy coordination has been driven by donor agencies, international organizations,[37] and development finance institutions.[38] Financial supervision coordinating bodies have not been involved in the global blended finance discourse. In 2017, members of the Development Assistance Committee officially adopted the OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the SDGs. In the same year, the Blended Finance Task Force,[39] which included private sector organizations, added another voice to the global discourse on the use of these tools to fill the SDG funding gap. There are no supervisors or regulators on the task force. Continued research by bodies such as the FSB could shed more light on whether the perceived regulatory constraints are material to the limited flow of funds to blended finance.

Conclusions

This Note has highlighted the need for blended finance as well as some of the challenges and issues that are preventing blended finance from growing at the rate needed to address the SDG funding gap. These challenges include the need for EMDC supervisors to be aware of the structures and the risks as their financial institutions become more involved in blended finance transactions. It argues that EMDC supervisors should play a more active role in facilitating blended finance transactions and should be part of the blended finance conversation locally and globally. Supervisors can also be helpful in clarifying for financial institutions the extent to which regulatory impediments may be a factor in their markets. Finally, there is a need for specific training in blended finance for supervisors.

[36] Milken Institute and OECD (2018).
[37] https://www.oecd.org/dac/financing-sustainable-development/blended-finance-principles/
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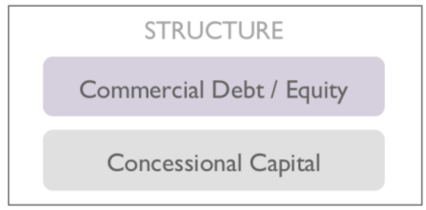
Annex 1: Blended finance overview

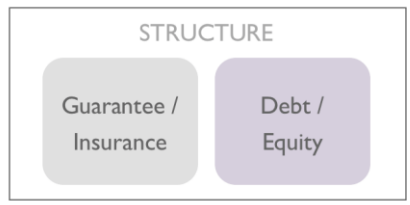
A: Types

From a supervisory perspective, it is helpful to examine different types of blended finance transactions. Convergence has identified four main archetypes of blended finance:

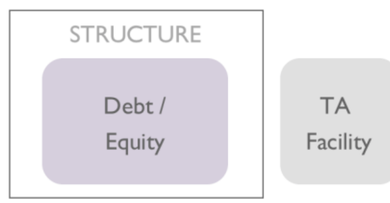
i. **Concessional capital** where public or philanthropic investors provide funds on below-market terms to lower the overall cost of capital or to provide an additional layer of protection to private investors. They comprise 44% of blended transactions in Convergence's database.



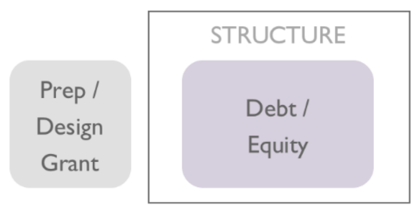
ii. **Guarantees/risk insurance** where public or philanthropic investors provide credit enhancement through guarantees or insurance preferred terms. They account for 21% of blended finance transactions.



iii. **Technical assistance funds** where a grant-funded technical assistance facility is established to help de-risk pre- or post- investment to improve the capacity of firms or financial intermediaries, thereby reducing risk and strengthening commercial viability. They account for 24% of blended finance transactions.



iv. **Design stage grants** that help to design the blended finance transactions. They constitute 9% of blended finance transactions in Convergence's data base.

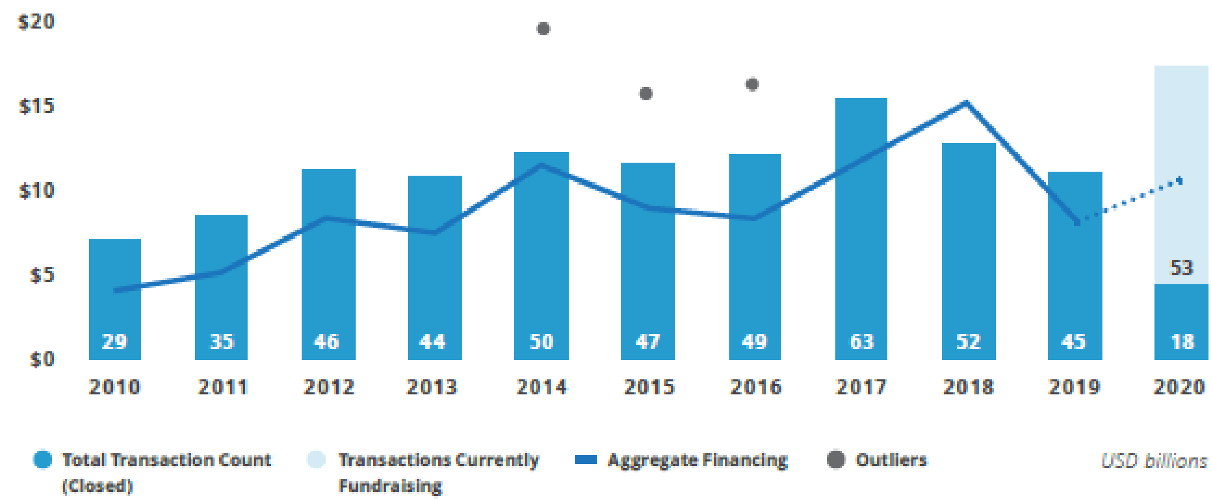


For the purposes of this Note, the main types of interest are concessional capital and guarantees/risk insurance as they are the types that have the greatest potential regulatory issues. Technical assistance funds and design stage grants can be seen to be generally risk reducing.

B: Trends

Volume: Blended finance has been growing in terms of the number of deals registered in the Convergence database (which is not comprehensive). However, the value of transactions has been fluctuating and has not yet consistently exceeded $20 billion a year.

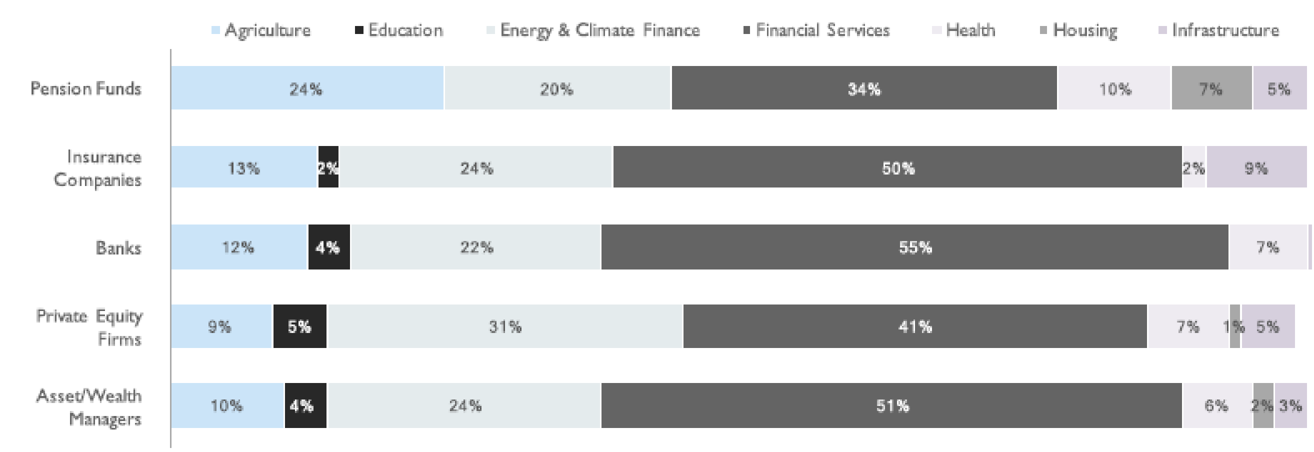
OVERALL BLENDED FINANCE MARKET (2010-2020)



C: Key actors and sectors

The breakdown below shows how the primary actors in the Convergence database allocates their resources by sector as a percentage. Financial services remain a significant sector of initial investment with these funds flowing to a variety of real sectors.

Institutional investor activity in blended finance in developing countries by sector based on Convergence deal database[34]



The table below from Convergence highlights the top institutional investors in blended finance deals in developing countries. Many of the private equity firms and asset/wealth managers are long-standing impact investors and the larger global asset managers have yet to participate in blended finance transactions.

Pension Funds	Insurance Companies	Sovereign Wealth Funds	Banks	Private Equity Firms	Asset/Wealth Managers
• ACV-CSC Metea • Christian Super • PensionDanmark • PKA • The Church Pension Fund	• Achmea • AXA • KLP • MetLife • Prudential Financial • Storebrand • Swiss Re	• State Oil Fund of the Republic of Azerbaijan	• BNP Paribas • Credit Suisse • Deutsche Bank • JP Morgan Chase & Co • Standard Chartered • Triodos Bank	• Abraaj • Gray Ghost Ventures • Leapfrog • LGT Impact Ventures • Persistent Energy Capital • Sarona Asset Management • Treehouse Investment	• Calvert Impact Capital • Incofin • Oikocredit • responsAbility • Sanlam