Blended Finance: combining public and private funding to meet sustainable financing needs

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Although blended finance is not a new concept, it is enjoying a revival as a way to mobilise scaled private capital flows for purposes of achieving sustainable development goals. In this article we look at what blended finance is and how it combines public and private capital for climate, nature and sustainable development purposes.

Blended Finance entails the strategic use of public capital to incentivise investment from the private sector to plug the funding gap for climate, nature and sustainable development more broadly. This is not a new concept, but historically blended finance has been more orientated towards impact finance and development finance purposes. In recent times, market participants have been exploring the potential for blended finance in respect of climate mitigation, adaptation and resilience projects, as well as for nature purposes and mixed projects, which seek to achieve combined environmental and sustainable development goals.

Blended finance applies public sector and other concessional capital (including philanthropic finance) to catalyse private sector investment, using structuring techniques to reduce the risks associated with the private sector investment (which may be geographical, financial or derive from other factors) and, in some cases, to enhance financial returns for private sector investors so that they can meet relevant investment criteria.

The goal is to use the minimum amount of concessional capital to open the door to private sector investment which may not have otherwise invested.

Blended finance not only opens up new opportunities for private sector investment but has been revolutionising public sector investment: instead of giving grants and writing-off financial assistance, the structures also provide potential for public funding returns, so that profit can be made and subsequently reinvested.

So what is blended finance?

Convergence defines blended finance as using "*catalytic capital from public or philanthropic sources to **increase private sector investment** in developing countries to realize the Sustainable Development Goals (SDGs) and climate goals. Blended finance allows organizations with **different objectives** to*

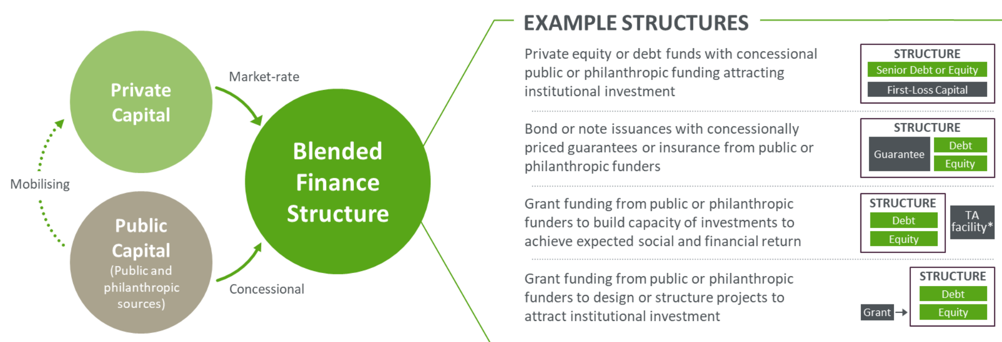
***invest alongside each other** while achieving their own objectives (whether financial return, social/environmental impact, or a blend of both)".*

We note that the use of the term "blended finance" varies. Some require application in developing countries, others not. Some require a combination of climate and social goals to qualify, others not. And blended financing may be proposed to be implemented under multiple different potential structures (more on that below). So it is important to pin down the intended meaning when engaging in discussions on the subject, noting that in all cases the idea is to combine private and public or other concessional capital in a funding structure that addresses barriers that private capital funders might otherwise face when investing for relevant purpose-driven outcomes – including high perceived and/or real risk (eg due to geographical risks and/or credit/financial challenges and/or technological risks) and otherwise uncompetitive or insufficient financial returns.

Convergence's "archetypes" – typical blended finance structures

As mentioned above, blended finance structures are not "one-size-fits-all" but there are multiple potential arrangements under this umbrella. Convergence has identified four key structural archetypes, as follows:

Figure 1: Typical blended finance structures



*Technical assistance facility
Source: Convergence ©, adapted from Convergence Blended Finance (2024). The State of Blended Finance 2024. Convergence Report.

Taking each of these in turn, we will now turn to look at how these models work in practice (also noting that structural features can be, and often are, combined to calibrate the desired risk profile and financial returns for capital enablement):

Concessional or equity/first loss capital

- **Public* capital** is invested as concessional subordinated (could be junior and/or or mezzanine) debt or equity. Junior investments are inherently more risky, as being subordinated means that in the event of losses being incurred in an investment structure, the junior investors would experience that loss first. In the typical commercial finance world, junior and mezzanine investments are often associated with higher returns (i.e. to compensate for the relevant risk profile) but in blended finance, this capital is typically structured with a low (or potentially zero profit) financial return profile. This can make the overall investment package much more attractive from a senior private capital investment perspective.
- **Private capital investment** is structured as "senior" (i.e. with priority in respect of returns, and so as to suffer losses only after the junior investments have been fully depleted) to match the risk and return profile required by private investors. The structuring is being implemented to provide a public capital buffer so that the investment risk is quantifiably decreased. Potential

	financial returns may also be enhanced as a result of the role of concessionary capital in the overall arrangements. This is the most frequently used type of blended finance. *including development finance institutions and philanthropic funding
Credit enhancement	Guarantees (up to 100%), insurance, contingent loans, off-take agreements or other risk-sharing mechanisms issued by, or paid for by, the public sector can be used as effective credit enhancement for projects (including to support underlying loans being made to them for financing purposes). For example, a private credit provider might be willing to lend monies to a relevant purpose-orientated project at a rate of interest that is viable for that project, if losses in respect of that loan are guaranteed up to a particular amount. The guarantee, which is from a third party generally well-known creditworthy public body, is effective credit enhancement as it provides the lender with an alternative source of repayment in the event of underlying project default. Providing credit enhancement in this way means that these arrangements can decrease the cost of capital for relevant projects in order to bring funding down to project appropriate, affordable rates, without requiring any actual up-front funding by the relevant public body. As a result they are often also referred to as "unfunded" arrangements and many public and philanthropic bodies have "guarantee facilities" which provide for this type of support on a repeat, standard terms, basis.
Technical assistance funding (TA Facility)	Alongside the capital (whether funded or unfunded) structure, monies are also frequently made available to provide expertise to the project to build pre- or post-investment capacity. The key here is building 'invest-ability' as that also lowers credit risk of a project and so works to help attract private capital at relevant, appropriate rates. According to Convergence in September 2023, 26% of transactions had a TA component.[1]
Grants	Grants may also be made, being the provision of funding into structures where there is no intention for return of the relevant amount – this may be appropriate to fund transaction design and/or pilots for example, to attract future investment from other sources.

To enhance understanding, it is helpful to consider a case study and we have set out some detail regarding **Africa Agriculture and Trade Investment Fund (AATIF)** below:

AATIF is a blended finance vehicle which invests in businesses along the agricultural supply chain. The fund's aim is to "increase food security, strengthen income among people employed in the agricultural sector, and strengthen the competitiveness of local agriculture businesses". DWS manages the fund and provides direct finance to commercial farms, processing companies and cooperatives, and invests in financial institutions and large agricultural intermediaries on-lending to small and medium companies.[2]

Fund characteristics:

- Financing: debt, mezzanine or equity
- $6 million TA Facility: supporting beneficiaries, including for due diligence impact assessment and accounting
- First loss guarantee from Federal Ministry of Economic Cooperation and Development (Germany)
- Investment from KfW and Deutsche Bank at mezzanine level; DWS equity investment and European Commission invests in junior equity tranche.

See here for more detail about the AATIF.

Barriers to private investment for climate, sustainable development and nature

Although blended finance is not a new product, it is not mainstream. Transactions remain complex and bespoke, often with many negotiating parties who have conflicting expectations and documentary requirements. Consequently, transactions can take a long time to arrange which can increase cost and reduce usability – a lack of commonly accepted terms and documentation makes it more difficult to scale blended finance to achieve the volumes needed.

Recommendations to increase volume:

- Standardising transaction structures: in line with the Convergence archetypes, structures 1a/b, 2a/b etc could be mainstreamed in the market alongside key understanding of "ways of working together" amongst the main participants – this is a design point, to assist mobilisation of funding quickly, reducing legal and other costs.
- Understanding the needs of key private capital investment allocators: by gaining deep understanding of the red lines around investment opportunities for institutions, insurers, pension funds etc. and then shaping more "off the shelf" blended finance investment products around these, capital volume and speed to execution could be improved. Participants should look to harness private sector expertise in structured finance to solve the many difficulties in creating a repeatable, investible product which is attractive to multiple different private capital allocators.
- Evolving the reputation: blended finance needs to evolve from being understood as primarily a smaller scale "impact" product into large scale climate, sustainability and nature financing vehicle, which is designed for significantly sized, risk adjusted and efficient capital allocation and speedy deployment.

Blended finance structures also suffer regulatory and other challenges

In addition to the market challenges for blended finance discussed above, there are also regulatory challenges in this space. Parties have to navigate an increasingly complex regulatory perimeter affecting blended finance. Regulations such as the EU Alternative Investment Fund Management Directive and the EU Securitisation Regulation pose compliance issues for some arrangements. Many investors have policies which prohibit investment in securitisations for example, or are subject to risk capital and liquidity rules that make blended finance investments unattractive, despite the obvious sustainability benefits and practical risk adjustment features being offered. In addition, the tax system in many jurisdictions is designed for entities which are *either* not for profit or for profit – whilst blended finance structures often fall between the two. Even when regulatory and tax issues for a transaction are resolved for one set of investors, the addition of new groups of investors may entail structural acrobatics with multiple vehicles (potentially across a number of jurisdictions) and further differentiated terms, in order to bring everyone into the same deal. In this context, common pathways to "getting the deal done" including agreed arrangements on documenting level of impact/outcomes, financial reporting and compliance features, straightforward accommodation of multiple bespoke "investment policies and exclusions", governing law and jurisdiction, acceptable credit ratings and due diligence processes, would be of significant value to sponsors and structurers (and as a result, ultimately to project beneficiaries, who will be able to access larger amounts of less conditioned capital at appropriate prices).

Next steps

The market for blended finance in the climate and nature context remains nascent. Therefore we can expect teething issues whilst participants focus on scaling a few structures which will become standard when the private and public sector participants find more common ground on terms and practices which are suitable for them all.

Blended finance is one of a number of available financing and investment tools for channelling capital into climate and nature, with some particular features that make it appropriate for leveraging “mixed purpose” outcomes (which combine environmental and social or community features, for example) and also developing country applications, which might not otherwise be commercially investible at appropriate pricing. It is set to become an increasingly important way to mobilise private sector funds to mitigate and adapt to climate change and finance conservation and restoration of nature.

Our Sustainable Finance & Investment team creates thought leadership to ensure that you can navigate your sustainable business future. Please contact us to discuss blended finance further, including how to use blended finance to implement your climate and nature investment strategy.

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References

1 Convergence Technical Assistance Blended Finance - Convergence Resources | Convergence