BETTER FINANCE BETTER WORLD

THE BLENDED FINANCE TASKFORCE

In partnership with the Business & Sustainable Development Commission and SYSTEMIQ

Key takeaways from the Blended Finance Taskforce

Momentum is building in the $50+ billion blended finance market. The market could double in the next few years as investors look to take advantage of risk mitigation tools and more development capital is made available for blending. To achieve this growth, we need to mainstream blended finance with more multi-billion dollar vehicles.

As institutional investors chase returns in a low-interest rate environment, they have a window of opportunity to use blended finance to de-risk investment in emerging markets infrastructure, where infra equity has performed well relative to other asset classes and infra debt has seen historically low default rates.

MDBs/DFIs play a central role in scaling up the blended finance market. They need to increase mobilisation ratios significantly: for every dollar, they mobilise less than $1 of private capital; DFIs are only marginally better. MDBs also need to increase their share of private sector activities. Setting ambitious targets will improve how the development banks do business.

Strong pipelines can be developed and private investment will flow if developing countries get policy and institutional mechanisms right. Developing countries should develop blended finance institutions which can link policies to sectoral strategies, investment plans and sustainability standards.

Scaling up the blended finance market can increase the global rate of growth, deliver the Sustainable Development Goals (including on climate) and strengthen long-term returns for savers. For this to happen, leaders across the whole investment system will need to take collective action.

The infrastructure imperative

2017 saw improved growth across most of the world economy; earnings expectations in emerging markets almost doubled; and interest rates remained at near-historic lows. This was also the year of “sustainable finance” – where discussions about how to make our financial sector “greener”, more sustainable and more responsible grew exponentially – as a matter of good conscience, but also of good business. As low interest rates persist, investors are increasingly looking at alternative asset classes – including infrastructure and emerging markets – to meet return requirements and diversify portfolios. Compared to other asset classes, infrastructure equity and debt funds have provided strong long-term returns globally. 70% of institutional investors report historical performance on their overall asset allocation to infrastructure (both funds and direct equity investment) between 12% and 17%. In developing countries, the evidence is less comprehensive. However, returns appear on average to be 200-600 basis points above those in developed markets (albeit with higher variation in outcomes). Historical default rates also show lower credit losses than comparable corporate issuers.

Notwithstanding its track-record, most institutional investors (who are typically looking for long-term, liquid, investment-grade assets with large ticket sizes), find infrastructure – especially in developing countries – a difficult asset class. It is illiquid. Regulatory frameworks limit the potential for institutional investors to play. The business models often involve substantial counterpart risk. FX hedges are expensive and typically only available over a relatively short time-frame. Infrastructure remains a sector which is prone to corruption. Institutional weaknesses and missing markets

act as barriers to matching large-scale capital with sustainable investment opportunities. And international private capital will only participate at scale if complemented by sizeable amounts of domestic private capital. All this compounds to limit capital flows, especially cross-border into emerging markets and mean that, overall, institutional investors allocate only 1% of their portfolios to infrastructure. This is even lower in emerging markets.

Of course, even if the aggregate performance related to infrastructure investing is reasonable, the devil is in the detail and investors, without deep experience in the asset class, are understandably cautious. But with momentum building around "blended finance" – which sees governments increasingly willing to provide a significant risk cushion for development-related investments – there is an opportunity for a much wider set of investors to start participating in traditionally more challenging asset classes like emerging markets infrastructure.

What is blended finance?

"Blended finance" has become something of a buzz word in recent years. We define it as follows:

> *"Blended finance is the strategic use of public or philanthropic **development capital** for the mobilisation of additional external private **commercial finance** for SDG-related investments."*

Blended finance is seen as one of the best ways to attract the $6 trillion a year needed to narrow the infrastructure funding gap (a trillion of which is estimated to come from the private sector) and achieve the UN Sustainable Development Goals (SDGs) because it allows commercial investors to invest in places and projects where they otherwise could not.

Blended finance examples

There are already many good examples of blended finance structures, and momentum in the market is growing.

EXHIBIT | Blended finance examples

FOOD AND AGRICULTURE	CITIES	ENERGY AND MATERIALS	HEALTH AND WELL-BEING
&Green Fund: concessional funds from Norway to support sustainable intensification of agricultural production and business models that reduce deforestation in tropical areas	**Affordable housing** and mortgages in Honduras using OPIC loans for low income families to overcome lack of safe housing and limited financing for local development	**Climate Investor One:** technical assistance, first loss capital, subordinate equity and guarantees in a multi-stage renewable energy fund	**Global Health Investment Fund:** first-loss guarantee from Gates Foundation and SIDA for a low-income country fund that seeks to eradicate preventable diseases
Terra Bella Fund: USAID technical assistance and first-loss provisions for sustainable land use projects	**Housing microfinance** funds with concessional long-term loans to local financial institutions e.g. by the World Bank	**Laos hydro project:** MIGA political risk insurance for development, construction, and operation of a trans-basin power plant	**Elazig Greenfield Hospital Bond:** MIGA political risk insurance coupled with EBRD liquidity facility enabled credit rating of bond issuance above Turkey's sovereign ceiling

By using development capital in more catalytic instruments like guarantees, insurance, currency hedging, grants (especially for technical assistance) and first loss capital, blended finance can mitigate a range of different barriers to investment (both real and perceived). Barriers to investing in SDG-related sectors like sustainable infrastructure, particularly in emerging markets, can include political risk, currency volatility, lack of liquidity, weak local financial markets, and challenging investment climates, including poor regulatory and legal frameworks. However, with a raft of instruments available to address specific barriers to investment, blending offers the private sector an unprecedented opportunity to participate in new markets and asset classes with a risk cushion.

EXHIBIT | Blended finance instruments and risks

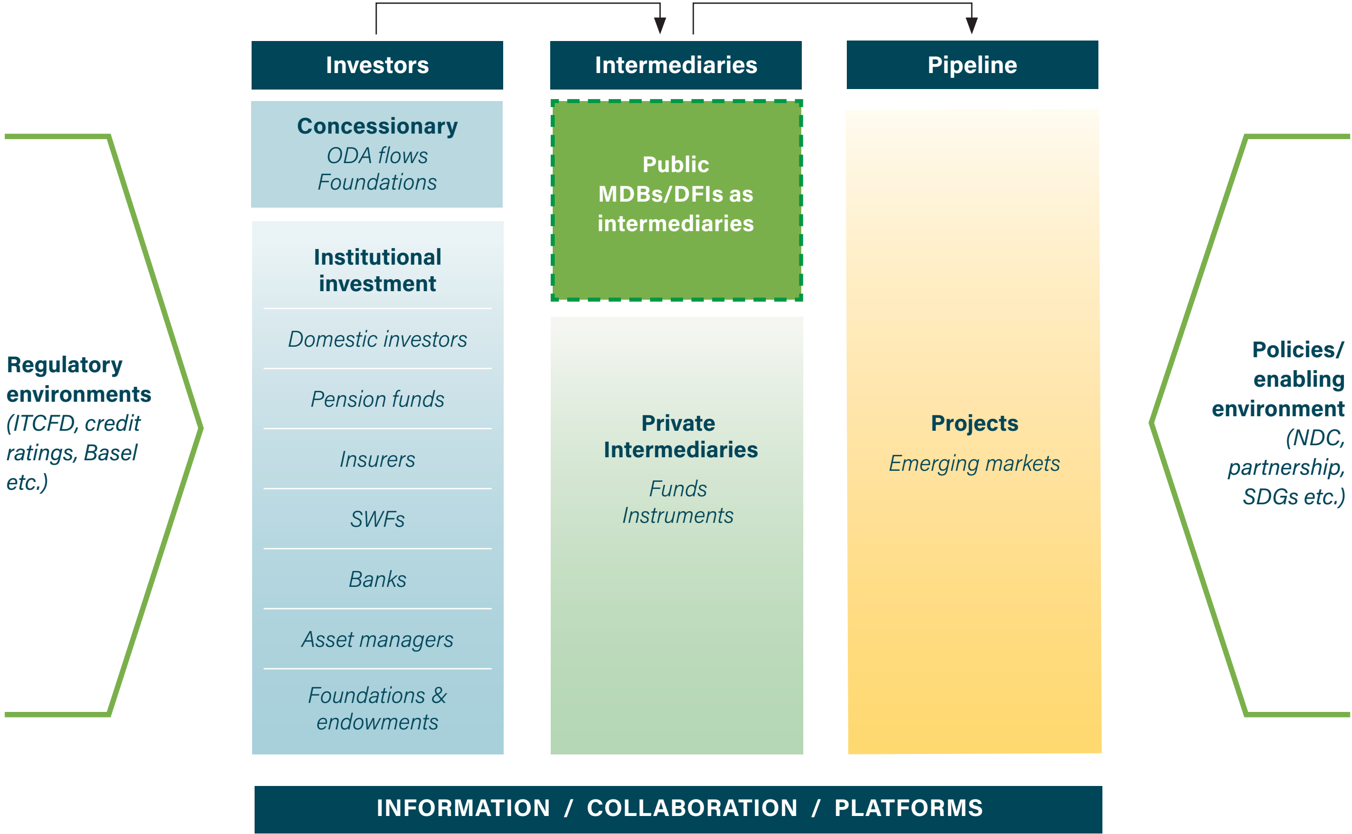
RISKS

INSTRUMENTS	MACRO		CREDIT / COMMERCIAL			TECHNICAL		FINANCE	INFRA SPECIFIC	
	Political/ country risk	Currency risk	Credit risk	Liquidity risk	Demand risk	Construction risk	Operation risk	Access to capital	Lack of pipeline	Off-take risk
1. Guarantees										
2. Insurance										
3. Hedging										
4. Junior/ subordinated cap										
5. Securitisation										
6. Contractual mechanisms										
7. Results-based incentives										
4. Grants										

Blended finance system change

Despite all the momentum, there are barriers within the financial system which stop blended finance from being deployed effectively, and prevent the market from scaling. Investors perceive infrastructure and other SDG-related assets as too difficult. The development banks, as the main blenders of capital, are not achieving high enough mobilisation ratios, meaning they don't crowd in as much private capital as they should for every development dollar. There is also a lack of quality infrastructure assets in the pipeline; this is driven by a lack of the right policy and institutional mechanisms in developing countries to attract long-term capital. In other words, against what is an improving macroeconomic context, the financial system is still not set up to meet the scale of the infrastructure opportunity and the development challenge.

EXHIBIT | Blended finance ecosystem



Blended Finance Taskforce

Tackling just one part of the system will not do the job. It will not turn the billions of development capital into trillions of commercial investment flows. What we need is a comprehensive, coordinated plan of attack. The Blended Finance Taskforce was launched by the Business and Sustainable Development Commission in 2017 to do just that. The Taskforce brings together leaders from finance, business, development and policy. Its aims are twofold: (1) to lay out the economic opportunity inherent in the use of blended finance, particularly for sustainable infrastructure in emerging markets; and (2) develop an action plan to drive the system-change required to rapidly scale the blended finance market, in order to deliver this opportunity. In doing so, the Taskforce intentionally applies a "private sector" lens to identify how blended finance can make the SDGs more "investable" for commercial players.

Key insights about the Blended Finance Taskforce

1. **Momentum is building around the $50+ billion blended finance market.** The last 5 years has seen the blended finance market double in size, driven largely by investment in clean energy. The market could double again in the next 3-4 years as providers of concessional and other forms of development capital earmark more money to be used for blending, and as private investors look

to take advantage of this risk cushion. To make this happen, we need to see a dramatic scale-up in the size of blended finance vehicles, moving from many fragmented $100 million funds, to a growing number of vehicles, each with $1-10 billion of capital. In parallel, the market will still require innovative, more bespoke funds to ensure small-scale and higher-risk, frontier projects are served.

2. **There is a window of opportunity for private institutional investors.** Compared to other asset classes, infrastructure equity and debt funds have delivered strong long-term returns globally. In general, infrastructure tends to provide portfolio diversification benefits, and historical default rates show lower credit losses than comparable corporate issuers. Investors have an unprecedented opportunity to increase their portfolio exposure to this asset class while benefiting from significant downside protection provided through blended finance.

3. **The MDBs and DFIs will be critical to scaling the blended finance market and can do so by setting ambitious targets to mobilise external private finance.** The MDBs currently have private capital mobilisation ratios of less than 1:1 – meaning for every dollar of development capital, they mobilise less than $1 of private investment across their portfolios. This ratio needs to increase significantly, and would need to more than double over the next decade to get anywhere close to the trillion dollar financing target. Achieving higher ratios will require the MDBs to sharply increase their share of private sector activities which currently accounts for only around 30% of MDB activities. They also need to ramp up the mobilisation ratios of the private sector arms from less than 2:1 to closer to 4:1 (or more). The bilateral DFIs also need to commit to higher mobilisation ratios. Increasing these targets will likely shift portfolios more toward infrastructure investment and toward more stable middle-income countries. But it could also free up additional development capital for frontier, low-income countries and high additionality projects. Setting targets should also change how the development banks do business and engage with the private sector, leading to product standardisation and asset pooling across the MDBs/DFIs.

4. **Developing countries which generate high quality infrastructure assets will not be short of financing.** Many middle-income countries are already tapping into international capital markets at historically low rates. As blended finance models begin to scale alongside other mechanisms such as green bonds and One Belt, One Road (OBOR) funds, capital will not be the constraint. Instead, performance differentiation over the next decade is more likely between those developing countries that get policy and institutional mechanisms right, versus those that are slower to adapt. Developing countries that prioritise sound policies and institutional capacity can build stable project pipelines, particularly using blended finance institutions which can link these policies to sectoral strategies, investment plans and sustainability standards.

5. **There is a major opportunity for the world to increase its underlying rate of growth, deliver the Sustainable Development Goals (including climate) and strengthen long-term returns for savers.** Scaling up blended finance could be the game-changer which makes it possible to capture this prize. The Taskforce calls for leadership across the entire investment system in order to make this happen including: (i) the providers of capital (including institutional investors, foundations and developed countries), (ii) intermediaries who blend capital (both public and private); and (iii) developing countries.

The action plan to scale blended finance

The business case for scaling up the blended finance market is clear: blended finance offers a window of opportunity for private investors looking to increase their exposure to sustainable infrastructure in emerging markets. It has the power to drive up long-term returns for savers; it is one of the critical pathways to delivering the SDGs; and it can contribute to the creation of high-quality assets. In doing so, blended finance can become a key driver of global growth. But the blended finance market needs to scale dramatically if it is going to have this kind of impact.

This will require decisive leadership from a diverse set of actors. The Taskforce has released its flagship report, “Better Finance, Better World”, as a consultation paper to develop a clear action plan for this agenda. This will involve working closely with key institutional investors, a number of the leading foundations that have already committed to taking strong action around blended finance, the progressive coalition of SWFs that is emerging after the One Planet Summit, the MDBs and DFIs, the OECD and a number of developing countries that are committed to this agenda.

The Taskforce would welcome your input on developing the action plan and will be accepting comments until 16 March 2018. You can find the consultation paper “Better Finance, Better World” here: http://businesscommission.org/our-work/blended-finance-taskforce-for-the-global-goals.

EXHIBIT | Leadership agenda and call to action

LONG-TERM CAPITAL

1. **Institutional investors** should mandate asset managers to invest in emerging markets sustainable infra; embrace TCFD; and use blended finance to support SDG-investments in line with their fiduciary duty.
2. **Foundations** should coordinate their endowment, programme-related and grant-making strategies in support of blending.
3. **Developed countries** should set mobilisation targets for ODA and do the same for their MDBs and DFIs.

INTERMEDIATION

4. **MDBs and DFIs** should target higher private capital mobilisation. This will drive changes to incentive structures, product standardisation, asset pooling, private sector skill building etc. **MDBs** need to increase the relative share of their private sector activities. **MDBs and DFIs** should share information on historical performance of blended finance vehicles.
5. **Private asset managers / project developers** to accelerate entry into the market.

PROJECT PIPELINE

6. **Developing countries** should prioritise strong enabling environments with good policies, supportive regulatory regimes and government capacity for infrastructure investment especially for domestic institutional investors.

   Developing countries could create blended finance vehicles with the capacity to develop high quality assets for investment.

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The Blended Finance Taskforce is co-chaired by Lord Mark Malloch-Brown and Jeremy Oppenheim, with the generous input of its Steering Committee. Members of the Blended Finance Taskforce act in their personal capacity and support the general thrust of the arguments, findings and recommendations made in the materials of the Blended Finance Taskforce (but should not be taken to agree with every word or number). The institutions with which they are affiliated have not been asked to formally endorse the report. Special thanks also goes to Senior Advisor, John E. Morton, to SYSTEMIQ for Secretariat support and to numerous organisations for their input including CPI, KOIS Invest, Convergence and Tideline. The Taskforce also appreciates the coordination and thought leadership from a number of blended finance initiatives including those of the leading MDBs and DFIs, the OECD, the WEF, SDIP and the NCE.

If you would like to know more about the Taskforce, or are interested in becoming a member of the Steering Committee, then please email katherine.stodulka@systemiq.earth and catharina.dyvik@systemiq.earth.