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Sustainable Investing Research Initiative

Developing and Scaling up the Global Marketplace for Blended Finance:

Inaugural SIRI Decisionmakers Roundtable Discussion on Blended Finance

Columbia University
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SUMMARY OF KEY INSIGHTS OF THE ROUNDTABLE DISCUSSION

The mitigation of climate change, biodiversity loss, poverty, and other grand societal challenges has historically been primarily financed through public funding and private philanthropic giving. Yet, a large financing gap remains, especially in the Global South. The question is: how can we crowd in more private capital to finance innovative solutions in climate tech, renewable energy, nature-based solutions, social inclusion, and others, especially in the Global South?

To better understand the challenges and opportunities in mobilizing more private capital investments and the potential role of academia, the Sustainable Investing Research Initiative (SIRI) brought together a carefully curated set of key leaders in the public and private sectors, policymakers, and academia, including ministers of finance, corporate leaders, leading investment managers and asset owners, Development Finance Institutions, philanthropies, rating agencies, and others. The participants discussed the following key questions:

- Leadership experiences and key insights on next steps needed to scale up the global marketplace for blended finance with a greater focus on the Global South and SDGs?
- Key bottlenecks in incentivizing new private investors to engage in Blended Finance?
- Ecosystem building, role of academic institutions, and future plan?

The roundtable discussion was under Chatham House rules. We have prepared a high-level summary of key insights of this roundtable discussion. Our hope is that these insights are helpful in informing future plans and actions of each participating organization and hereby help scale up the global marketplace for blended finance and catalytic capital. Similarly, they inform SIRI's research activities and educational programming.

Reforming Macroprudential Policies, Climate and Development Policies, and the World Bank

1) The current global prudential and regulatory framework for the global financial system was established after the 2008 global financial crisis. This includes the Basel Committee, the Financial Stability Board, Basel 3, Solvency 2 and all the financial and providential regulatory framework. Importantly, the global financial regulation was established before the Paris Agreement and has not been revised with the 2015 Paris agreement. That is, we wrote in the Paris Agreement that we need to align all financial flows with the global climate objectives. Yet, we have not revised the global financial regulations and ensured they were consistent with our new global climate objectives. As a result, a number of requirements that are meant to safeguard financial stability in the short run are now potentially preventing our ability to address climate change, to invest enough, and to invest where we need investments the most (namely, in economically developing and emerging countries where domestic flows are not enough to reach the nationally determined contributions (NDC's) and national targets). For example, regulations in Europe require much higher capital reserves for investments in emerging markets infrastructure compared to investments in European markets. This makes European investors, and developed market investors overall, more interested in investing domestically due to lower capital requirements. In sum, global financial regulations need to be assessed against our climate objectives and potentially be revised in order to align the financial system with the climate goals.

2) While blended finance is considered to be key to rapidly mobilize and scale the necessary volumes of investments, it does not exist in the current financial and prudential framework. Blended finance is not recognized as a distinct category under the Basel 3 and Solvency 2 framework which also means financial institutions using it get unnecessarily panelized when they include this investment on their balance sheet. That is, given the absence of a distinct category, supervisory entities and regulators view blended finance as similar to securitization, which requires high liquidity and considerable capital to protect balance sheets against the potential risks. Since risk-mitigation mechanisms (e.g., guarantees from multilateral development banks and others) used in blended finance are not properly recognized, financial institutions using blended finance are unnecessarily penalized. This makes such investments less attractive for private sector investors.

3) More coordinated action and capital mobilization across the climate and development spheres are needed. So far, international discussions and frameworks around climate and development are mostly separated. To make progress, it is important to integrate and

blend discussions of climate and development financing going forward, rather than treating them as distinct silos. Breaking down these barriers between the development and climate agendas could help drive more coordinated action and capital mobilization across the climate and development spheres.

4) Reforms are needed at multilateral development banks (MDBs) such as the World Bank in terms of their guarantee business (including expanded access to guarantees, improved guarantee structure, etc.) to mitigate risk and catalyze private finance.

5) An important potential game-changer for incentivizing low-carbon investments are global carbon pricing mechanisms. Investors show growing interest in low-carbon projects that are commercially viable in markets where a carbon price or similar mechanisms (e.g., ETS markets that incentivize low-carbon investments in Europe) exists. Such a mechanisms allow investors to factor in the cost of carbon into their decisions and provide a powerful incentive to invest in low-carbon options. Establishing a global carbon pricing mechanism would be a major "game changer" in helping address many of the challenges discussed around scaling blended finance. The EU's Carbon Border Adjustment Mechanism (CBAM) could help foster dialogue on carbon pricing in other regions/countries over time.

Risk Perception of Credit Ratings

Blended finance is highly dependent on credit ratings (and hence the credit rating agencies). Yet, credit rating agencies are not used to this form of funding, and it remains a challenge for rating agencies to fully integrate blended finance schemes, protections, and risk mitigation mechanisms into their rating methodologies. Credit rating agencies often do not differentiate project risks from country risks. There is a need to engage with credit rating agencies to update their methodologies in order to better assess risk in blended finance. Their methodologies need to change to better recognize risk-mitigation mechanisms (e.g., when technical assistance, guarantees, first-loss guarantees, or other insurance-schemes are provided by MIGA and others) in order not to overestimate the risk of these projects. Addressing obstacles preventing credit rating agencies from properly assessing and incorporating risk-mitigation features of blended finance funds merits further exploration.

Below are more details about the key issues faced by investment managers w.r.t. credit ratings in blended finance:

1) When assessed by credit rating agencies, the score is usually either a composite of the underlying assets or based on the sovereign risk rating.

- Rating agencies usually don't have in-depth knowledge or databases on the specific underlying assets/projects at a micro level, making it difficult to accurately gauge credit risk. Given the lack of access to statistical data to assess the credit risk rating of the portfolio of investments (be it in renewable projects, sustainable agriculture, microfinance, etc., in emerging markets), they tend to conservatively rate the credit risk of such portfolios.

- They also tend to cap the rating of the underlying investees to the level of the country rating (rather than that of the blended structure protection). Country risk ratings tend to be fairly low for those investing in less developed countries. Having better data on actual default rates of past blended finance projects could help credit rating agencies assess the true risk more accurately. The newly launched GEMs (Global Emerging Markets) Risk Database may help assess project risks: https://www.gemsriskdatabase.org/

2) Credit rating agencies do not take into account the structure of the blended finance vehicle (e.g., junior or mezzanine, first and second loss tranches, etc.), that is, they do not offer a rating of such vehicles. Instead, they rate the full fund, which is not helpful as only the rating of the senior tranche—which is the one dedicated to private investors—is needed. If the rating agencies could rate the assets based on their actual risk, taking into account the cushion provided by the junior and mezzanine tranches, the senior tranches might warrant an investment grade rating.

- Several participants pointed out that, to their knowledge, there has never been a single instance of a default event on the senior tranche of a blended finance vehicle. But yet, the senior, protected tranches are almost always assigned an equivalent rating as their underlying assets, essentially ignoring the fact that it has a cushion which grows as a percentage over time as the underlying assets amortize.

- Rating agencies do not integrate adequately and in full the protection offered by blended finance mechanisms:
    - For guarantees, that are usually partial (40/50/60% of guarantee coverage) several rating agencies integrate those guarantees only if the guarantee is at 100%.

    - The mezzanine tranche, particularly if in form of subordinated notes, is often not recognized as a protection to senior investors and only the first lost/catalysts shares will be integrated.

- Rating agencies apply some liquidity notch down as the senior notes/senior equity tranches in blended finance are supposed to be held up to maturity, and while technically they could be considered tradeable securities, there is no organized market on which one could sell them. At the same time, the investors that invest in the senior tranche are usually long-term institutional investors, who are not looking for short-term liquidity, and as such the notch down does not seem to be justified.

According to the participating experts, resolving the above issues would tremendously help in making blended finance funds more attractive for institutional investors and hereby help scale up the global marketplace for blended finance.

In sum, there is a need to actively engage in discussions with credit rating agencies to improve their understanding and methodologies for assessing blended finance. There is also a need to ensure that proposed blended finance schemes are properly evaluated by credit rating agencies, so that private investors have clarity on how such investments would be treated from a risk perspective. This outreach to credit rating agencies could help address the issue of them potentially overestimating blended finance risks.

Risk Perception of Private Investors and Costs for Asset Managers

1) <u>Attracting private investors remains difficult due to high-risk perceptions of blended finance deals in emerging markets</u>. Partly, this is due to the rating agencies not fully accounting for blended finance protections in their assessments and, as a result, overestimating blended finance risks. In addition, compliance concerns (e.g., due to corruption, governance risks) in emerging markets present a key obstacle to attract private investors to emerging markets, even if those risks may not be directly related to the specific investment opportunity.

2) <u>Blended finance deals tend to be more costly for an asset management company compared to traditional investments</u>. Blended finance is very human resource-intensive due to the extensive reporting requirements demanded by DFI investors in their funds. It also takes considerable time to structure and implement blended finance transactions. For

these reasons, blended finance is less attractive from a pure cost standpoint for an asset manager.

Need for Project Preparation and First-Loss Capital to Mobilize more Private Capital

Blended finance needs to ultimately attract traditional sources of capital, not just relying on up-front public funding. This includes capital from developed markets as well as capital from emerging markets and developing countries. Hence, the aim is to build local capacity, lower risks, and to create investable opportunities that mobilize traditional capital flows into these markets.

1) For blended finance projects to be successful, they need to have a technology that is both technically and commercially viable. Project preparation and the development of pilot projects are crucial as the lack of tangible projects may hinder investment. More dedicated funds are needed for project preparation work. Once preparation is complete using public money, projects can progress to financing from MDBs, DFIs, and private investors. By having governments directly pay those costs, this model aims to overcome underfunding of upfront preparation work. It helps get projects investment-ready so that downstream private capital is willing to participate in later investment stages once opportunities are de-risked. To foster smooth and successful project implementation, it is important to build and strengthen project implementation capacity within governments. This involves working directly with governments to strengthen their internal capabilities and resources for successfully carrying out infrastructure and development projects from start to finish. In this regard, the work with local banks is crucial.

2) Blended finance structures can help de-risk investments and mobilize a multifold of the amount of capital invested. Blended finance funds have the highest impact ratios for CO2 emission reductions, biodiversity preservation, etc., compared to other investment strategies. Yet, scaling up has been challenging. It is difficult to find first-loss takers to launch new blended finance funds. The lack of catalytic capital/first loss capital is a major issue that is being discussed and emphasized to governing bodies such as the G7, G20, OECD, and country treasuries/ministries.

3) DFIs (including IFC) tend to invest at the mezzanine or senior levels with less risk (acting similarly to private investors). While DFIs are playing a key role in blended finance, they typically are not willing to serve as first-loss takers. Instead, DFIs often only invest in blended finance funds if someone else (e.g., a foundation) offers a first-loss mechanism. DFIs then invest at the mezzanine or senior levels with less risk. Relatedly, DFIs are quite

involved, but more could be done to communicate whether and to what extent their investments are catalytic, and how they are mobilizing private capital through their investments. In the past they have not communicated much about attracting private capital.

4) At this moment, foundations play an important role in serving as first-loss takers and catalysts through their grant funding, program-related investments (PRIs), and mission-related investments (MRIs). Yet, much more first-loss capital is needed. Such junior-level investing could potentially come from, e.g., DFIs and governments. Also, it is important to note that the foundations' strategic priorities may shift over time (as issues like clean energy rise or fall on their agendas), introducing uncertainty for funds reliant on specific foundation partners. To reduce such uncertainty, it would be helpful if foundations were to pursue longer term strategic priorities, and if funds were able to diversify their pool of first-loss takers.

5) First loss capital programs from governments and foundations need to provide more long-term objectives to allow investors to better anticipate potential fundings when launching a new fund or project as this asset class requires more time to mature from idea generation to investment compared to more traditional asset classes.

Data, Impact Measurement, and Communication

Understanding how to measure and communicate impact is critical. Fund managers need to understand how to meaningfully measure their impact as well as how to effectively present themselves and their impact credentials to asset owners who are seeking impact investment opportunities. Asset owners (e.g., young, wealthy individuals and foundations) increasingly demand to see the impact of their investments. In recent years, their focus has shifted more towards climate change and more capital has flowed towards larger planetary-impact investments that can drive systemic changes to decarbonize sectors, compared to people-focused community investments.

1) Measuring impact is a critical issue that requires quality data. Impact measurement should be tied directly to clear environmental/social goals (e.g., forests as a system, income inequality as a system). For investors, this includes two key questions: How can an investor most usefully define a system (e.g., "forests")? How can an investor most usefully set goals for that system? Goals should include both specific targets/metrics as well as broader directionality (e.g., increase carbon sequestration, enhance biodiversity, support Indigenous peoples). Moreover, investors should consider country-specific SDG needs and priorities when setting their goals for blended financing and making their investment decisions.

2) In addition to impact data, investors need to better understand the financial risks and returns of their blended finance investments.

3) Environmental/social impact data (along with financial performance data on financial risks and returns) need to be effectively communicated to investors. This involves connecting fund managers to asset owners/investors in a meaningful way. Clients are open to different approaches for measuring impact, as long as it can be clearly demonstrated and articulated to the client.

4) Measuring and communicating environmental/social performance data to investors is a key aspect that takes significant capacity building, standardization work, and staff resources to address properly. Smaller asset managers might have research/reporting teams, but reporting remains staff-intensive compared to larger asset managers, driving up their costs. Technical assistance is also often needed through dedicated "facilities teams" to support local partners in emerging markets with reporting, to fulfill various EU and investor requirements such as EU Taxonomy alignment. Meeting all of the assessment, measurement and disclosure needs takes considerable time and human capital that is not always available or affordable for (smaller) fund managers.

5) Data are key. Investors can only be educated about blended finance if relevant (financial and impact) data are available. Establishing a platform that provides granular data on impact and financial performance would be helpful.

Research

Academic research on blended finance is in its infancy. Much more research is needed to better understand the current practices in blended finance and how to scale up the global marketplace for blended finance. <u>The need and urgency for rigorous academic research is vast</u>: this includes understanding the challenges and opportunities that arise to identify and scale up investable projects; the preferences, constraints, and language of each investor type; the characteristics of effective private-public partnerships; the balancing and allocation of risks across investors; how to improve financing structures; whether and how blended finance vehicles are correlated with traditional asset classes; how to attract more first-loss capital to catalyze more investments; how to implement and leverage carbon pricing mechanisms to incentivize more investments; how to speed up the scaling up of the blended finance market; among others. In sum, robust data and rigorous academic research of blended finance initiatives could better equip practitioners to engage in meaningful conversations with the investment community, including foundations, public and private investors, rating agencies, Chief Investment and Risk Officers (CIOs and CROs), and other relevant constituencies and hereby help drive forward progress.

Education and Communication

The lack of investors' understanding of blended finance cannot be overemphasized. This is partly due to the higher complexity of blended finance deals involving several capital providers (with different restrictions, preferences, and language/terminology), and partly due to investors' unfamiliarity with climate and nature-related investments, their unfamiliarity and increased risk perceptions of investments in low-income countries, the relative shortage of relevant data, their educational background in traditional finance and lack of training in blended finance, the lack of used cases and blueprints, etc. Expertise in impact investing and blended finance is currently limited within the broader investment world. There is generally less understanding and expertise of impact investing and blended finance among those managing large pools of capital. The larger the pool of capital, the smaller the staff tending to it. Education is needed because of this. In short, developing curriculum and training around blended finance and fostering effective communication would substantially help advance practice. This can take several forms:

1) <u>Need to foster cross-sector communication</u>. Blended finance involves several types of capital providers and requires effective cross-sector communication. As such, it is important to enhance our understanding of each type of investors' unique goals, constraints, preferences, incentives, and specific terminology and language. To be effective, communication needs to be adjusted to the language and perspectives used by the specific investor (insurance, pension, sovereign fund, foundation, etc.). Appropriate training can be provided to blended finance practitioners in the field.

2) <u>Need to foster the development of innovative solutions by aligning people working at the project level with those at the investment level</u>. Bridging the two could help inform each other and frame the propositions and discussion. This would help foster the development of practical solutions at the project level and, at the same time, provide fund managers with the relevant technical information to effectively present the projects (and their expected impact) to their investors.

3) <u>Need to enhance impact reporting</u>. This requires capacity building, standardization, and staff resources. A technical assistance facility can help do the reporting according to EU standards as well as various other reporting requirements.

4) Need to enhance the effective communication of impact and financial performance data to asset owners. Asset managers need to understand how to align their investments with the asset owners' purpose and interests. The focus of asset owners (e.g., younger wealthy people) has shifted more towards climate change and planetary-impact investments that can drive systemic changes. Asset managers need to better understand how to organize and channel their investments towards achieving Net Zero (and other planetary goals). Plus, they need to understand how to effectively communicate their impact and financial performance to the asset owners.

5) Need for curriculum development. To educate the next generation of blended finance experts, relevant graduate courses can be developed and offered to graduate students. This includes courses in blended finance, impact measurement and management, impact investing, project finance and other courses such as biodiversity finance, environmental economics, renewable energy, social entrepreneurship, etc.

6) Need for executive training in blended finance for Chief Investment Officers (CIOs), Chief Risk Officers (CROs), DFIs, family offices, foundations, and others. Education is key to overcome bottlenecks in impact investing and blended finance. Providing such training to professionals would allow them to stay current on innovative blended finance and impact investment models.

   As a case in point, foundations can distribute their funds through grants as well as investments (e.g., program-related investments (PRIs) and mission-related investments (MRIs)) to support social enterprises and get them "investment ready" and able to attract market-rate capital. While more complex legally compared to regular grants, such investments can help promote and facilitate impact investing. Currently, only a small fraction of foundations have a dedicated investment team. Most of them only have a grants team and their funds are distributed mainly through grants rather than investments.

   To address the need to train various capital providers, executive trainings could be offered as customized programs targeted towards specific investors (e.g., targeted towards DFIs, foundations, or CIOs/CROs) or as open-enrollment programs that are open to different capital providers and enhance cross-sector learning, communication, and understanding.

7) Need for case studies to serve as blueprints. Case studies can serve as a powerful tool to raise awareness of cutting-edge models and for investors (including foundations, family offices, asset managers, pension funds, DFIs, and others) to use as blueprint. Developing

such case studies would help decrease the cost and time needed to structure and implement such deals and hence accelerate the scaling up of blended finance. Moreover, such case studies could serve as a helpful illustration explaining the underlying mechanisms and hence as a valuable communication and training tool. Such tool could be used to inform investors, educate graduate students, train blended finance experts (ranging from CIOs, CROs, DFIs, to family offices, foundations, and others), and inform policymakers. To help educate investors of innovative finance models and investment opportunities, a comprehensive playbook (pitch book) -- which includes both blended finance and impact investment deals and structures -- could be developed and compiled into a single resource for others to learn from. To be effective, case studies should be presented in a way that is oriented towards various types of investors, using their lens of financial and impact metrics, their specific terminology, and perspective.

NEXT STEPS

We hope the above summary helps inform each participating organization about the critical bottlenecks and opportunities in blended finance, and inform the organization's future actions. At SIRI, we have already undertaken steps to address some of the identified needs. In particular, we have formed a small sub-expert group of roundtable participants to engage with a rating agency to help them better assess the risks of blended finance deals and update their methodologies. (Thank you everyone!) Also, SIRI will launch a series of educational programming and research activities.

If your organization is also interested to explore potential avenues of collaboration with SIRI, please reach out to SIRI Director and SIPA Vice Dean Professor Caroline Flammer (caroline.flammer@columbia.edu).

Following the success of the first roundtable discussion, we will hold future roundtable discussions and a conference on blended finance in the near future. These future roundtable discussions will be focused on specific countries. We will invite this core group of participants along with key leaders from the given country. In particular, the second roundtable discussion will focus on India (on Sept 24, 2024), followed by the annual conference on blended finance (on Sept 25, 2024), and the third roundtable discussion will focus on Brazil (date tbd). Future roundtables will focus on other countries.

Please save the dates – Future Roundtable Discussions and Annual Conference (Sept 24-25, 2024)!

THANK YOUS

A big thank you to everyone for joining the inaugural SIRI Decisionmakers Roundtable Discussion on Blended Finance. Your insights were invaluable to the conversation (and to this summary report) and to making progress in developing and scaling up the global marketplace for blended finance!

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