

WHO IS THE PRIVATE SECTOR?

KEY CONSIDERATIONS FOR MOBILIZING INSTITUTIONAL CAPITAL THROUGH BLENDED FINANCE

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WORKING PAPER



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EXECUTIVE SUMMARY

The Blended Finance Taskforce (Taskforce) was launched in 2017 as an initiative of the Business & Sustainable Development Commission (BSDC). Bringing together leaders from finance, business, development, and policy, the Taskforce's aims are twofold: i) to lay out the economic opportunity inherent in the use of blended finance; and ii) develop an action plan to drive the system-change required to rapidly scale the blended finance market. The Taskforce's recommendations will initially be presented as a consultation paper at the World Economic Forum in Davos in January 2018, to engage further with external stakeholders before finalizing the concrete action plan. The final version of the Taskforce report (*Better Finance, Better World*) will be published at the World Bank / IMF Spring Meetings in late April 2018.

Institutional investors make up a diverse group, each operating with different mandates, constraints, and risk-adjusted return preferences. However, they are often mistakenly treated as a homogenous group of investors, while there is value in better understanding the unique investment preferences and regulatory conditions of different segments. Therefore, the Taskforce commissioned Convergence to support in segmenting the private sector ecosystem to better understand how to drive more institutional investment towards the Global Goals in developing countries. Tideline contributed in an advisory role. This resulting report provides an analysis of the investment motivations, requirements, and constraints of six segments of institutional investors: i) pension funds, ii) insurance companies, iii) sovereign wealth funds, iv) commercial banks and investment banks, v) private equity firms, and vi) asset/wealth managers.

OPPORTUNITY OF THE GLOBAL GOALS AND POTENTIAL OF BLENDED FINANCE

There is a significant market opportunity presented by sectors underpinning the Global Goals. According to analysis conducted by the BSDC in *Better Business, Better World*, the Global Goals have the potential to create at least \$12 trillion in opportunities for businesses in four economic systems: i) food and agriculture, ii) cities, iii) energy and materials, and iv) health and well-being. However, the realization of these opportunities will require significant investment. Blended finance is increasingly recognized as an important structuring approach to mobilize new sources of capital towards the Global Goals.

Blended finance most commonly refers to the use of concessional development capital from public and philanthropic sources to create more attractive investment opportunities for the private sector to contribute to the Global Goals. According to Convergence's database of over 200 historical blended finance transactions, blended finance mobilized over \$50 billion in total capital towards the Global Goals in developing countries between 2005 and 2016. The leverage—or amount of commercial capital catalyzed by each dollar of concessional capital—achieved by each blended finance transaction varies greatly across structure types and sizes, focus sectors, and target countries. Initial analysis of 56 blended finance structures with concessional debt/equity catalyzing commercial investment found a median leverage ratio of 2.6, where leverage is calculated as commercial capital divided by concessional capital.

While blended finance has mobilized a significant amount of capital, it still only represents a small percentage of the total financing needed for the Global Goals. The Taskforce will seek to identify the approaches and structures through which private capital – particularly from institutional investors – can be attracted, fully realizing the potential of blended finance. While blended finance is simply a structuring approach, underlying transactions are familiar to institutional investors. Blended finance transactions today are aligned to many alternative asset classes, such as private equity, infrastructure, and illiquid credit.

INSTITUTIONAL INVESTMENT TRENDS

Current institutional investment in blended finance transactions is limited. Many institutional investors have invested in one or two transactions, but few have participated regularly in blended finance transactions. Institutional investment in blended finance is generally diversified across sectors, with financial services and energy & climate finance being the main sectors of focus for blended finance transactions.

If the right structures and incentives are put in place to direct institutional investment to blended finance structures, this investment could potentially meet the annual funding needs for investment-appropriate Global Goals in developing countries. The institutional investors analyzed in this report represent over \$200 trillion in assets under management (AUM). AUM in alternative asset classes most relevant to blended finance globally amount to around \$6 trillion. Based on our analysis, developing countries comprise around 30% of alternative investment portfolios: institutional investors currently allocate a little over \$2 trillion – just over 1% of

their total assets – to alternative asset classes in developing countries relevant to blended finance. Moreover, allocations to alternative assets and developing countries are expected to grow – a trend that offers opportunity to influence capital flows through blended finance.

KEY CONSIDERATIONS AND OPPORTUNITIES FOR SCALING INSTITUTIONAL INVESTMENT IN BLENDED FINANCE

Blended finance structures must create assets that fit within the mandates, constraints, and risk-adjusted return preferences of each institutional investor segment. Based on our research, there are five key considerations that will determine whether and to what extent an institutional investor participates in blended finance: i) communication and messaging, ii) policy and regulation, iii) mandate, iv) allocation and capacity, and v) transactional factors.

For blended finance to attract institutional investment at scale, investments should be communicated in a way that is consistent with asset classes that are familiar to and understood by institutional investors, to appropriately describe the investment opportunities available in developing countries that would also drive progress towards the Global Goals.

A plethora of global and national policies and regulations affect institutional investors, several of which present constraints and disincentives limiting investor appetite for assets created by blended finance transactions. Key policy and regulatory considerations for each segment are as follows:

- Pension funds: Ability to sell illiquid assets; restrictions in some asset classes and geographies.
- Insurance companies: Risk-based capital requirements that impose high capital charges for investments with high levels of risk (e.g., equity and non-investment grade debt).
- Commercial banks: Most constrained relatively; required to allocate high levels of capital when lending to high risk borrowers over medium-term tenors and to incur loss in initial year due to creating reserve in alignment with International Financial Reporting Standard (IFRS) 9.
- Investment banks: Capital charges create restrictions for investing on balance sheet, while underwriting activities are impacted by US regulator's acknowledgment of credit enhancement products provided by public funders.
- Asset/wealth managers: Regulations applied to their clients (e.g., pension funds and insurance companies).
- Private equity firms and sovereign wealth funds: Typically have the least regulatory restrictions relative to other institutional investor segments.

An investment mandate to support the Global Goals is generally driven by leadership and/or stakeholders at individual institutions as opposed to forces affecting broad segments. There are several examples of pension funds, insurance companies, banks, private equity firms, and asset/wealth managers with strong investment mandates to support the Global Goals. In most cases, this mandate has been directed by senior leadership (e.g., CEO) and/or other stakeholders (e.g., shareholders, client). A strong leadership- or stakeholder-driven mandate enables organization-wide implementation and success.

There is significant variation between segments and within segments regarding allocations to alternative asset classes in developing countries as well as the expertise to analyze and manage alternative assets:

- Pension funds are likely to have an allocation to participate in asset classes in developing countries relevant to blended finance though often have limited capacity and expertise.
- Insurance companies are likely to have an allocation to participate in asset classes in developing countries relevant to blended finance, and tend to have a more developed capacity to invest in these markets driven by large investment teams and expertise in developing country investment.
- Sovereign wealth funds have the most varied allocation and capacity to participate in asset classes in developing countries relevant to blended finance, while allocations and capacity vary greatly from fund to fund.
- Commercial banks and investment banks often have the strongest capacity to participate in asset classes in developing countries relevant to blended finance; banks typically don't have allocations – rather, they advise their clients on their allocations.
- Asset / wealth managers' allocations are driven by their clients' interests and are facing increasing pressure to build out capacity to offer alternative product offerings.
- Private equity firms typically have well-aligned allocations and capacity.

There are several transactional factors that impact attractiveness of blended finance opportunities for institutional investors. Commonly cited developing country risks (e.g., political/country, liquidity, and FX risks) are generally seen as the largest risks to blended finance transactions in developing countries. Many solutions to address these risks, some of them within the definition of blended finance, already exist and should be refined and/or scaled up. There is also a set of additional infrastructure-specific risks, such as sourcing investable infrastructure projects and off-take risks (e.g., ability to secure buyer for power produced by asset). While risk-adjusted return expectations vary by asset class, institutional investors generally expect a premium for alternative asset classes in developing countries. As expected and well documented, institutional investors require large deal sizes. Tenor / investment horizon preferences depend on underlying asset class, with some trends across segments for debt-related investments. Nearly all institutional investors that have participated in blended finance transaction comment on the need for improved coordination among co-investors, in particular with development finance institutions (DFIs). Blended finance structures are often complex, and the unique nature of each transaction is also a challenge for institutional investors. Institutional investors often prefer to partner with institutions to originate, arrange, and manage investments in developing countries. DFIs are well positioned to play this role, but are not sufficiently incentivized to do so.

RECOMMENDATIONS FOR SCALING INSTITUTIONAL INVESTMENT IN BLENDED FINANCE

Based on our analysis, there are several actions that can be taken to mobilize institutional capital at scale for the Global Goals through blended finance. These actions fit into four broad categories:

- **Engaging with institutional investors:** Institutional investors are bound by obligations to their stakeholders to fulfill their investment mandates, including meeting certain financial return thresholds. Absent from most of these mandates today is any explicit focus on the Global Goals or other development objectives. Even where a social, environmental, or impact mandate may be of interest, there is a lack of willingness to sacrifice financial returns in favor of those impacts. Public and philanthropic funders must acknowledge this context and craft appropriate engagement strategies. To this end, public and philanthropic funders should communicate in the language of institutional investors and focus on the credible, commercial investment opportunities that are presented by the Global Goals. Blended finance solutions should focus on producing assets that are familiar to institutional investors and to which they already have allocations. Framing blended finance as a structuring approach within recognized and well-understood asset classes is key to scale.
- **Designing appropriate products and scaling successful solutions:** Public and philanthropic funders should collaborate on a strategic number of well-proven blended finance solutions, while also promoting standardization and reducing complexity. It is critical that this work is undertaken in close consultation with private sector investors to ensure resulting transactions are aligned to institutional investor interests. In addition, more mainstream assets (e.g., investment grade listed bonds and notes) should be created, with the objective of shifting away from stand-alone transactions towards portfolio solutions.
- **Building off DFI capabilities and experience:** DFIs have a comparative advantage in developing country investments and are often trusted by institutional investors. DFIs should increase the number and volume of transactions they arrange with the express purpose of transferring participation in aggregated portfolios of those assets through syndication, or other means, to institutional investors. In addition, DFIs should disseminate and communicate the historical return metrics of their portfolios to overcome varying risk perceptions held by institutional investors.
- **Disseminating return and impact data:** One of the main factors influencing the decision-making of institutional investors is past performance. There is currently a paucity of return data on blended finance transactions, in particular return data for the commercial layers of capital in blended finance transactions, which can be a hindrance for attracting new investors into the field. Further, there is a need for greater transparency in the blended finance market to build the evidence base for institutional investors to justify participation. Institutional investors have no standard frameworks to compare an investment opportunity's impact on the Global Goals. A trusted industry intermediary could play an important role in collecting return data and impact metrics and reporting trends and benchmarks out to the market.

INTRODUCTION

The Blended Finance Taskforce (Taskforce) was launched in 2017 as an initiative of the Business & Sustainable Development Commission (BSDC) to deliver a set of recommendations to tackle the systemic barriers to mobilizing private capital at scale for the Sustainable Development Goals (SDGs; also referred to as the Global Goals) through blended finance. BSDC was launched at the World Economic Forum in Davos in January 2016. It brings together leaders from business, finance, civil society, labor, and international organizations, with the twin aims of mapping to the robust economic opportunity that could be available to business if the Global Goals are achieved and describing the appropriate role business can play in delivering these goals. In the BSDC’s landmark report *Better Business, Better World*¹, blended finance was identified as a key mechanism to unlock large-scale financial flows for development, especially into sustainable infrastructure. The Taskforce’s aims are twofold: i) to lay out the economic opportunity inherent in the use of blended finance; and ii) develop an action plan to drive the system-change required to rapidly scale the blended finance market. The Taskforce’s recommendations will initially be presented as a consultation paper at the World Economic Forum in Davos in January 2018, in order to engage further with external stakeholders before finalizing the concrete action plan. The final version of the Taskforce report (*Better Finance, Better World*) will be published at the World Bank / IMF Spring Meetings in late April 2018.

The Taskforce commissioned Convergence, with Tideline serving as an expert advisor, to segment the private sector ecosystem. This work builds off initial landscaping work commissioned by the Taskforce, which was published as *The State of Blended Finance* report². Convergence is dedicated to building the case for blended finance and engaging its global members to create and invest in blended transactions. Convergence offers its members a curated, online platform for members to connect with each other on live blended finance transactions, as well as original knowledge products such as case studies, data on deals, reports, training, and webinars. Convergence also selectively offers grant funding for the design of new vehicles that could attract private capital to global development at scale. Tideline is a consulting firm that provides tailored advice to clients developing impact investment strategies, products, and solutions. Tideline’s services include strategy development, investment and market analysis, customized research, and investment product development and its clients include large institutional foundations, asset and wealth management firms, financial institutions, family offices, and development finance institutions (DFIs).

This report summarizes findings from the Taskforce’s private sector ecosystem workstream as a means to understanding how to drive more institutional investment towards the Global Goals. Institutional investors make up a diverse group, each operating with different mandates, constraints, and risk-adjusted return preferences. However, they are often mistakenly treated as a homogenous group of investors, while there is value in better understanding the unique investment preferences and regulatory conditions of different segments.

This report looks at six institutional investor segments: i) pension funds, ii) insurance companies, iii) sovereign wealth funds, iv) commercial banks and investment banks, v) private equity firms, and vi) asset/wealth managers. The table below describes each institutional investor segment. This report focuses primarily on institutional investors in developed countries, given the amount of capital they have under management to deploy. Out of scope for this report are companies in developed countries willing to make foreign direct investments in developing countries, as well as investors / companies in developing countries; however, both these investor segments are also very important contributors to the Global Goals³.

Figure 1: Institutional investor segments analyzed⁴

| | Segment | Summary | Detailed Description |
|--------------|---------------------|---|---|
| Asset Owners | Pension Funds | Invest pension payments from policy holders to pay future retirement benefits | Pension funds source capital from the pooled contributions of employers, unions, or other organizations. The pool of funds is invested on the contributors’ behalf, and the earnings on the investments generate income to the contributor upon retirement. Pension funds often represent the largest institutional investors in many nations, and as a result, their investment activities often dominate the stock markets in which they are invested. Pension funds are often able to allocate a small portion of their portfolios to alternative asset classes, though face significant risk and liquidity constraints. |
| | Insurance Companies | Invest premium payments from policy holders to | Insurance companies collect premiums to protect policy holders from various types of risk. Premiums are invested to provide a source of future claims for policy holders and a profit for the insurer. Insurance |

| | | | |
|----------------|------------------------|--|---|
| | | provide funding for future claims | companies are typically classified into life insurers and property/casualty (“non-life”) insurers. In most countries, life and non-life insurers are subject to different investment regulation, because life insurance is long-term in nature, while non-life insurances usually covers a shorter period (e.g., one year). |
| | Sovereign Wealth Funds | Invest country’s wealth derived primarily from trade surpluses and commodity revenue | Sovereign wealth funds are state-owned entities that are established from various sources, including from a countries’ balance of payments surpluses, official foreign currency operations, proceeds of privatizations, fiscal surpluses, and/or income from resource/commodity exports. When investing, sovereign wealth funds tend to prefer returns over liquidity, and typically have a higher risk tolerance compared to other institutional investor segments, although each sovereign wealth fund has its own unique investment objectives. In this report, public pension funds are not included within the definition of sovereign wealth funds. |
| | Commercial Banks | Lend to small and large businesses | Commercial banks, often business units within diversified financial institutions, provide financial services to a range of businesses, both small and large. The primary offering of commercial banks is loans and other credit products. Commercial banks are unlike other segments, in that they do not invest, but rather provide financing to businesses. Commercial banking activity is highly regulated. |
| | Investment Banks | Invest in and/or arranges large transactions for institutional clients | Investment banks, also often business units within diversified financial institutions, primarily provide services to large businesses and investors. Investment banks specialize in large and complex financial transactions, such as underwriting, acting as an intermediary between a securities issuer and the investing public, facilitating mergers and other corporate reorganizations, and acting as a broker and/or financial adviser for institutional clients. Investment banks may also deploy capital into transactions as an investor, although on a more limited basis than traditional asset owners. Like commercial banks, investment banks are highly regulated. |
| Asset Managers | Private Equity Firms | Invest institutional and own capital into private companies | Private equity firms invest directly in private companies or engage in buyouts of public companies, resulting in delisting of public equity. Institutional clients and accredited individual investors provide capital to private equity firms. Private equity firms typically invest their own capital alongside that of their clients. Private equity firms invest capital over long holding periods, and exit investments through initial public offerings or sales to other companies or funds. |
| | Asset/Wealth Managers | Invest institutional and retail capital in a range of investments | Asset/wealth managers coordinate and oversee investment portfolios for their clients in order to meet specified investment goals. Asset/wealth managers are often hired by institutional investors like pension funds, and insurance companies, as well as high net worth individuals. Asset/wealth managers also act on behalf of retail investors, typically through collective investment schemes such as mutual funds and exchange traded funds. Asset/wealth managers invest in a range of assets, primarily public equities and bonds, but also increasingly in alternative asset classes. |

This report was informed by desk research, a survey, and interviews with institutional investors and includes four main sections. The first section summarizes the business opportunity presented by the Global Goals, as well the potential of blended finance to facilitate investment for the Global Goals. This section also describes the principles of blended finance, as well as which asset classes are most aligned to blended finance. The second section analyzes how much capital from institutional investors is currently allocated to asset classes relevant to blended finance, and also describes relevant blended finance investment trends. The third section describes key considerations for scaling blended finance based on an analysis of institutional investor requirements and preferences. The final section concludes with recommendations for blended finance to attract institutional investment for the Global Goals at scale.

OPPORTUNITY OF THE GLOBAL GOALS AND POTENTIAL OF BLENDED FINANCE

GLOBAL GOALS

The Global Goals represent a compelling market opportunity. The United Nations (UN) and its member states established the Global Goals in September 2015⁵. The 17 Global Goals aim to combat climate change, improve health and education, make cities more sustainable, protect oceans and forests, and end poverty and hunger, among other objectives. Not only do the Global Goals aim to create a world that is comprehensively more sustainable, they also offer real business opportunities. According to analysis conducted by the BSDC in *Better Business, Better World*, the Global Goals have the potential to create at least \$12 trillion in opportunities for businesses in four economic systems: i) food and agriculture, ii) cities, iii) energy and materials, and iv) health and well-being. The figure below outlines the 60 biggest opportunities identified within each economic system.

Figure 2: Market opportunities related to delivering the Global Goals⁶

| Food and Agriculture | Cities | Energy and Materials | Health and Well-Being |
|------------------------------------|-------------------------------------|---|----------------------------------|
| Reducing food waste in value chain | Affordable housing | Circular models – automotive | Risk pooling |
| Forest ecosystem services | Energy efficiency – buildings | Expansion of renewables | Remote patient monitoring |
| Low-income food markets | Electric and hybrid vehicles | Circular models – appliances | Telehealth |
| Reducing consumer food waste | Public transport in urban areas | Circular models – electronics | Advanced genomics |
| Technology in large-scale farms | Car sharing | Energy efficiency – non-energy intensive industries | Activity services |
| Product formulation | Road safety equipment | Energy storage systems | Detection of counterfeit drugs |
| Dietary switch | Autonomous vehicles | Resource recovery | Tobacco control |
| Sustainable aquaculture | ICE vehicle fuel efficiency | End-use steel efficiency | Weight management programs |
| Technology in smallholder farms | Building resilient cities | Energy efficiency – energy intensive industries | Better disease management |
| Micro-irrigation | Municipal water leakage | Carbon capture and storage | Electronic medical records |
| Restoring degraded land | Cultural tourism | Energy access | Better maternal and child health |
| Reducing packaging waste | Smart metering | Green chemicals | Healthcare training |
| Cattle intensification | Water and sanitation infrastructure | Additive manufacturing | Low-cost surgery |
| Urban agriculture | Office sharing | Local content in extractives | |
| | Timber buildings | Shared infrastructure | |
| | Durable and modular buildings | Mine rehabilitation | |
| | | Grid interconnection | |

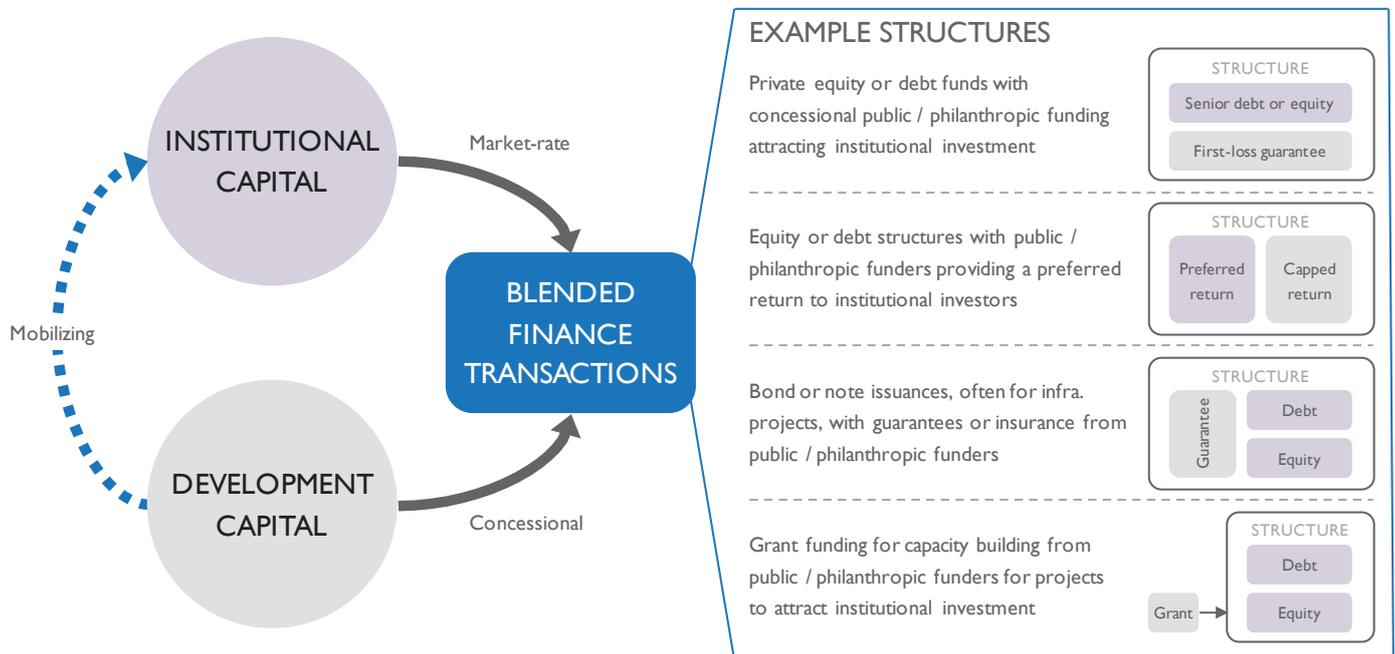
However, to achieve the Global Goals and realize \$12 trillion in economic opportunity, a significant scale-up of investment is required today. The UN estimates that the total financing needed to achieve the Global Goals is nearly \$4 trillion annually. Current levels of development financing – including development aid from development agencies and philanthropic contributions – is not sufficient. There is an estimated \$2.5 trillion funding gap per annum to realize the Global Goals in developing countries⁷.

BLENDED FINANCE

Blended finance is increasingly recognized as an important approach to mobilize new sources of capital for the Global Goals. The UN member countries reached consensus on the importance of deploying public funds to attract private sector investment at the International Conference on Financing for Development in 2015 in Addis Ababa: “An important use of international public finance, including Official Development Assistance, is to catalyze additional resource mobilization from other sources, public and private. It can be used to unlock additional finance through blended or pooled financing and risk mitigation, notably for infrastructure and other investments that support private sector development.”⁸

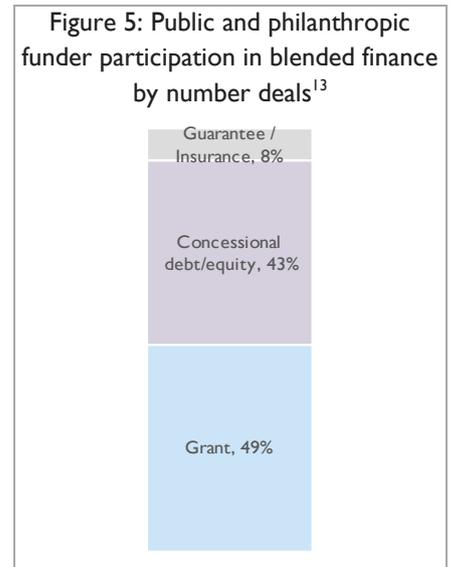
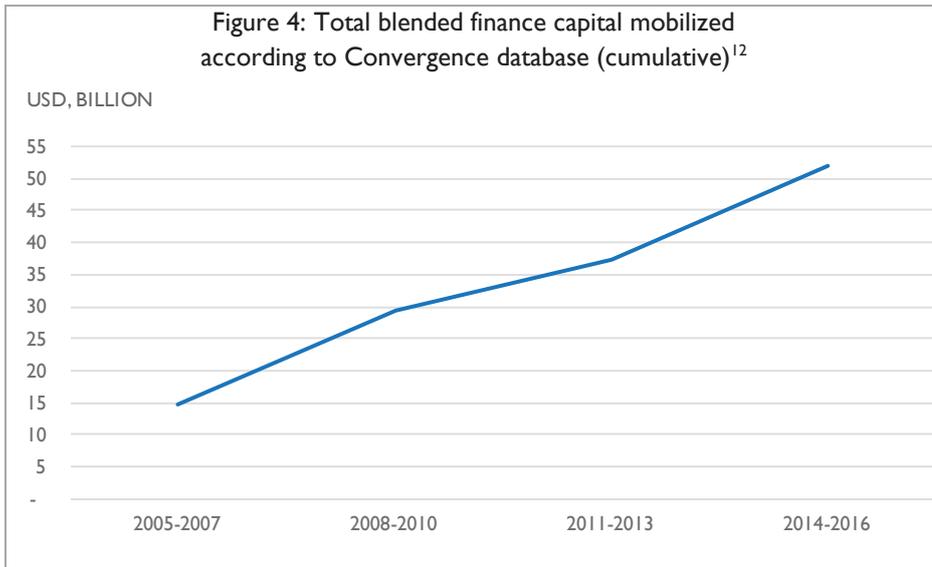
Blended finance commonly refers to the use of concessional development capital from public and philanthropic sources to create more attractive investment opportunities for the private sector that contribute to the Global Goals in developing countries. The Organisation for Economic Co-operation and Development (OECD) recently established a broad definition for blended finance as “the strategic use of development finance for the mobilization of additional commercial finance towards the SDGs in developing countries”⁹. The key financial objective of blended finance is to deploy concessional development capital (from public and/or philanthropic institutions) to create investment opportunities in developing countries that have an acceptable risk-adjusted return for institutional investors. Concessional development capital is typically provided by public funders such as development agencies, as well as philanthropic institutions like foundations. Development finance institutions (DFIs), while public, often invest with a commercial mandate, but may deploy concessional funding on behalf of development agencies, provide credit enhancement or other risk participation, or play an important asset origination and arranging role. In blended finance transactions, all parties achieve their unique objectives. Public and philanthropic parties achieve their development objectives, while institutional investors achieve their risk-adjusted return requirements. The figure below illustrates how blended finance typically works and common blended finance structures. In these structures, institutional investors most commonly invest (or participate) in equity, loans, or bonds. To date, most of these investments have been private investments, rather than publicly listed equities or bonds.

Figure 3: Typical blended finance mechanics and structures¹⁰

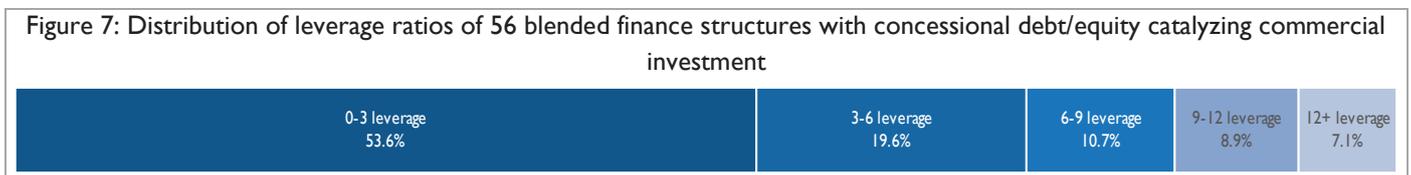
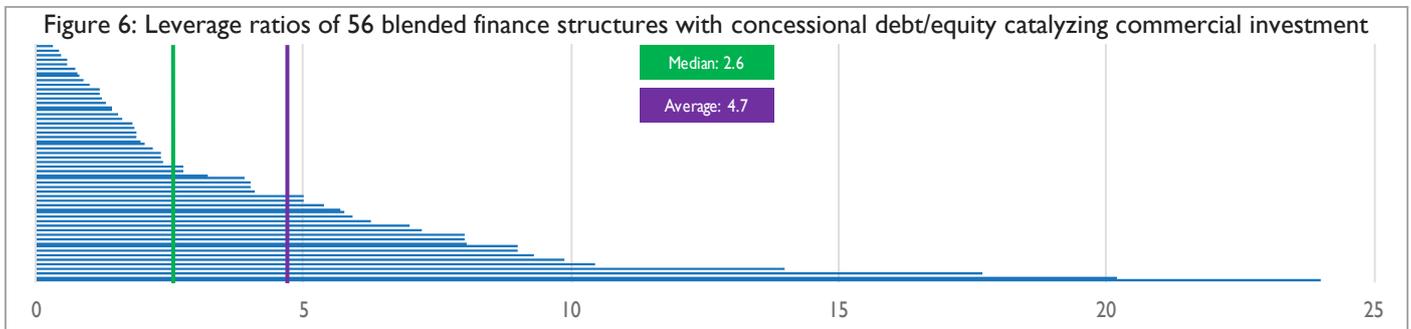


Blended finance cannot address all the Global Goals, only a subset of activities that can be considered investable. That is, blended finance – and other innovative financing mechanisms that attract institutional investors – can only be deployed for activities that can produce cash flows over time in order to repay investors an acceptable return that is comparable, or at a premium, to alternative investment opportunities¹¹. According to analysis conducted by the Sustainable Development Solutions Network (SDSN, a global initiative for the UN), approximately half of the funding required to achieve the Global Goals in developing countries can be in the form of private investment. For example, blended finance is highly aligned with goals such as Goal 7: *Affordable and Clean Energy*, Goal 9: *Industry, Innovation, and Infrastructure*, and Goal 13: *Climate Action*, while less aligned with goals such as Goal 16: *Peace, Justice and Strong Institutions*. The suitability of blended finance also varies significantly within goals, particularly areas where both investment and policy action are required, such as education, health, and conservation.

According to Convergence’s database of over 200 historical blended finance transactions, blended finance mobilized over \$50 billion in total capital towards the Global Goals between 2005 and 2016, which is a significant amount but still a small percentage of the funding needed for the Global Goals. In this database, concessional debt or equity and grant funding are the most common form of public and philanthropic funder participation in blended finance transactions. While the total amount of capital mobilized by blended finance can be assumed to be significantly higher than \$50 billion, since this is an indicative dataset only, blended finance still only accounts for a small percentage of the funding needed for the Global Goals. For blended finance to have a material impact on supporting the Global Goals by 2030, blended finance must achieve much greater scale. The figures below illustrate capital mobilized by blended finance over time and public and philanthropic funder participation in blended finance transactions.



The amount of commercial investment catalyzed in blended finance structures varies greatly across structure types and sizes, focus sectors, and target countries. Leverage – the volume of commercial capital catalyzed by \$1 of concessional capital – varies significantly across structure types and sizes, focus sectors, and target countries. For example, the leverage calculation for concessional debt/equity catalyzing commercial investment in a capital structure is different to the calculation for guarantees/insurance on senior debt. Convergence conducted an initial analysis of 56 blended finance transactions that use concessional debt/equity to attract commercial investment and found a median leverage of 2.6, with a minimum leverage ratio of 0.32 and a maximum leverage ratio of 24. On average, each dollar of concessional capital attracted approximately \$4.70 in commercial investment. In this analysis, commercial investment includes both private investment and commercial DFI investment and calculations are based on multiple estimates. These figures should be taken as indicative trends only and further analysis is required to understand leverage ratios across structure types and sizes, focus sectors, and target countries¹⁴.

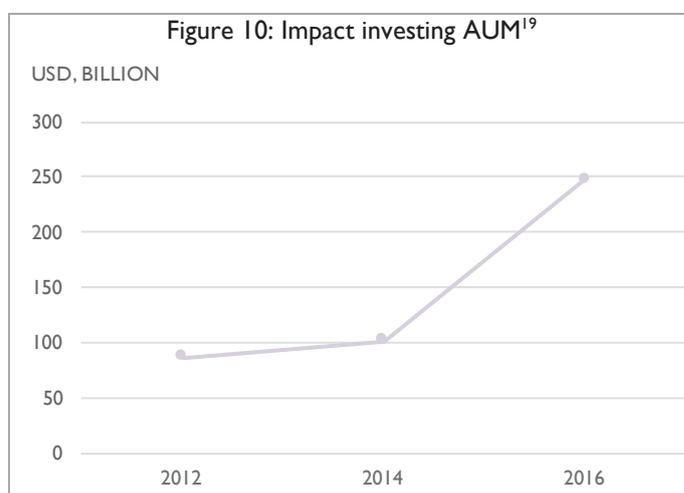
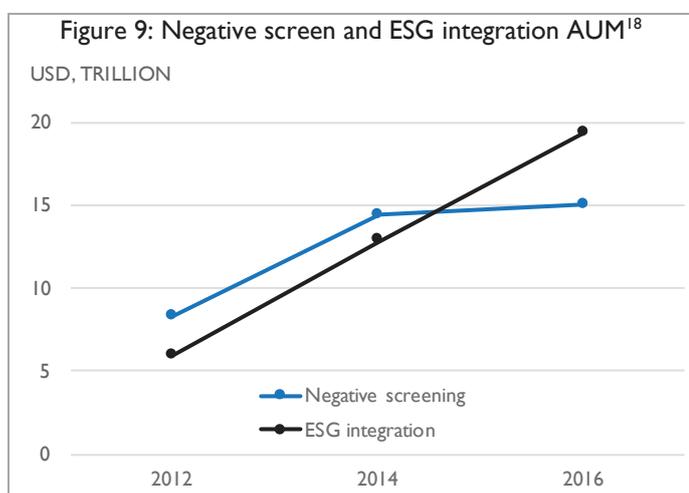


Current blended finance transactions are already well aligned to certain alternative asset classes in which institutional investors have a demonstrated preference. Blended finance does not represent a new investment class for investors, but rather blended finance transactions can and should be aligned to existing asset classes. In current form, blended finance transactions are best-aligned to alternative asset classes, especially private equity, infrastructure, and illiquid credit¹⁵. Blended finance structures are not currently well-aligned to traditional asset classes like listed equity and listed bonds. In the future, blended finance should also aim to create assets that fit within traditional asset classes such as listed bonds. The figure below details the relevance of blended finance to traditional and alternative classes.

Figure 8: Current alignment of blended finance to common asset classes¹⁶

| Asset Class | Relevance |
|----------------------------------|--|
| Traditional Asset Classes | |
| Listed equity | ○ |
| Listed bonds | ◐ Emerging examples of listed bonds or notes for assets with steady cash flow streams |
| Cash | ○ |
| Alternative Asset Classes | |
| Private equity | ● Substantial number of private equity funds investing in a range of sectors |
| Real estate | ◐ Emerging examples for affordable housing structures |
| Infrastructure | ● Substantial number of structures (bonds, loans, funds) financing infrastructure projects |
| Illiquid credit | ◐ Many examples of private debt funds or bonds / loans for a range of sectors |
| Hedge funds | ○ |
| Commodities | ○ |
| Insurance-linked investments | ○ |

Blended finance should be understood within the broader landscape of sustainable investing. The growing sustainable investing trend began with negative screening, where investments with characteristics that conflict with investor’s values or worldview are avoided. The next iteration, environmental, social, and governance (ESG) integration, went further than negative screens, “positive” screening for opportunities that monitored and minimized negative externalities, including environmental and social outcomes. Negative screen and ESG integration are now common, often embedded, investing approaches within institutional investment portfolios, especially for traditional asset classes such as listed equity. Over 1,800 institutions are signatories to the Principles of Responsible Investment (PRI), including the California Public Employees' Retirement System (CalPERS), the Canadian Pension Plan Investment Board (CPPIB), Munich Re, Storebrand, and the Norwegian Government Pension Fund¹⁷. Now, there is impressive growth in impact investing, where investors actively look for opportunities to create positive social or environmental impact alongside financial returns. The figures below illustrate negative screen investing, ESG integration investing, and impact investing assets under management (AUM) between 2012 and 2016.

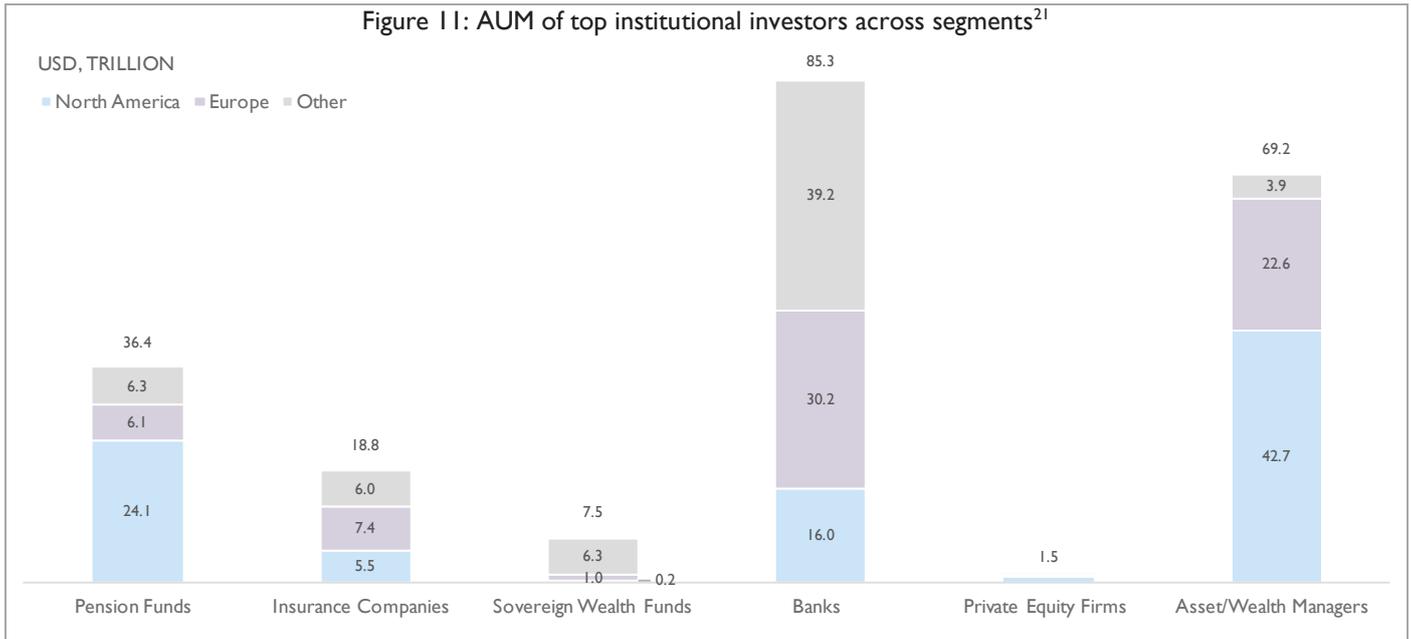


Blended finance is distinct from other sustainable investment trends. While blended finance can benefit from the momentum behind sustainable and impact investing trends, blended finance is uniquely different. Blended finance is not intended to be a separate asset allocation, as in impact investing, but rather an approach that can help diversify investment opportunities for institutional investors by improving the risk-adjusted return profile of less accessible or less compelling investment opportunities in developing countries. Moreover, blended finance structures do not require each investor to have the intent to create positive social and environmental impact. Blended finance helps public and philanthropic parties achieve their development objectives while institutional investors achieve their risk-adjusted return requirements. This is key to blended finance’s potential to attract institutional investment at scale.

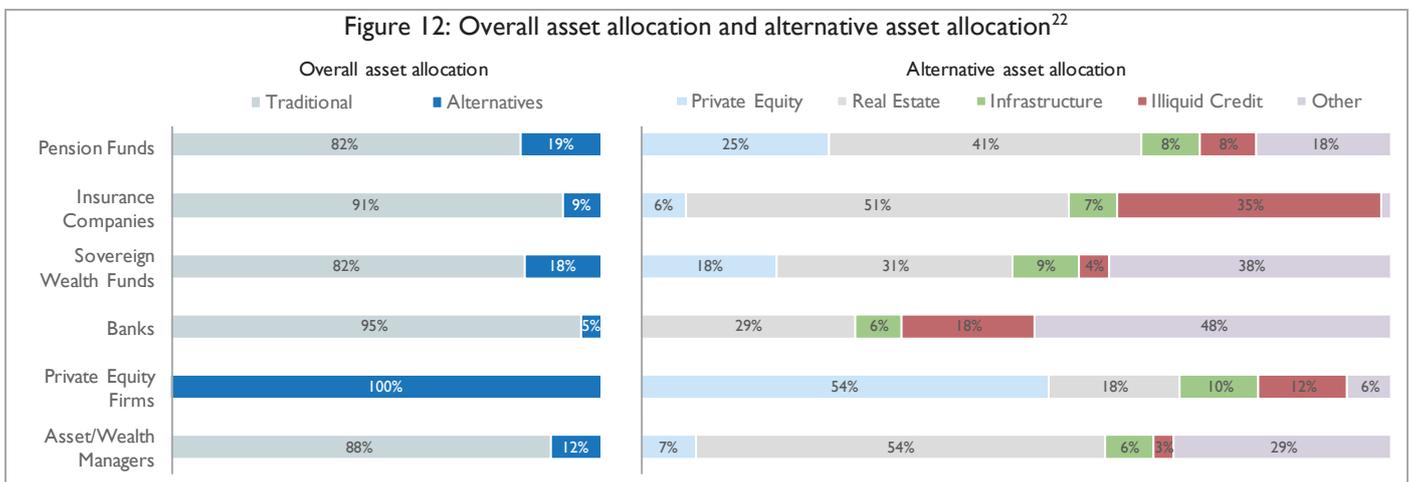
INSTITUTIONAL INVESTMENT TRENDS

Note: Figures in this section are derived from multiple data sets that are not directly comparable. All figures are not exact and should be interpreted as indicative.

The six institutional investor segments explored in this report represent approximately \$200 trillion in AUM²⁰. Banks and asset/wealth managers are the largest segments by AUM, followed by pension funds and insurance companies. Sovereign wealth funds and private equity firms are the smallest segments and both tend to operate with specialized / narrow investment mandates. Most of the largest institutional investors are based in North America and Europe, except for banks, since many of the world’s largest banks are now based in China, and sovereign wealth funds (some of the biggest sovereign wealth funds are based in the Middle East and Asia). The figure below details indicative total AUM for each segment across key geographies.

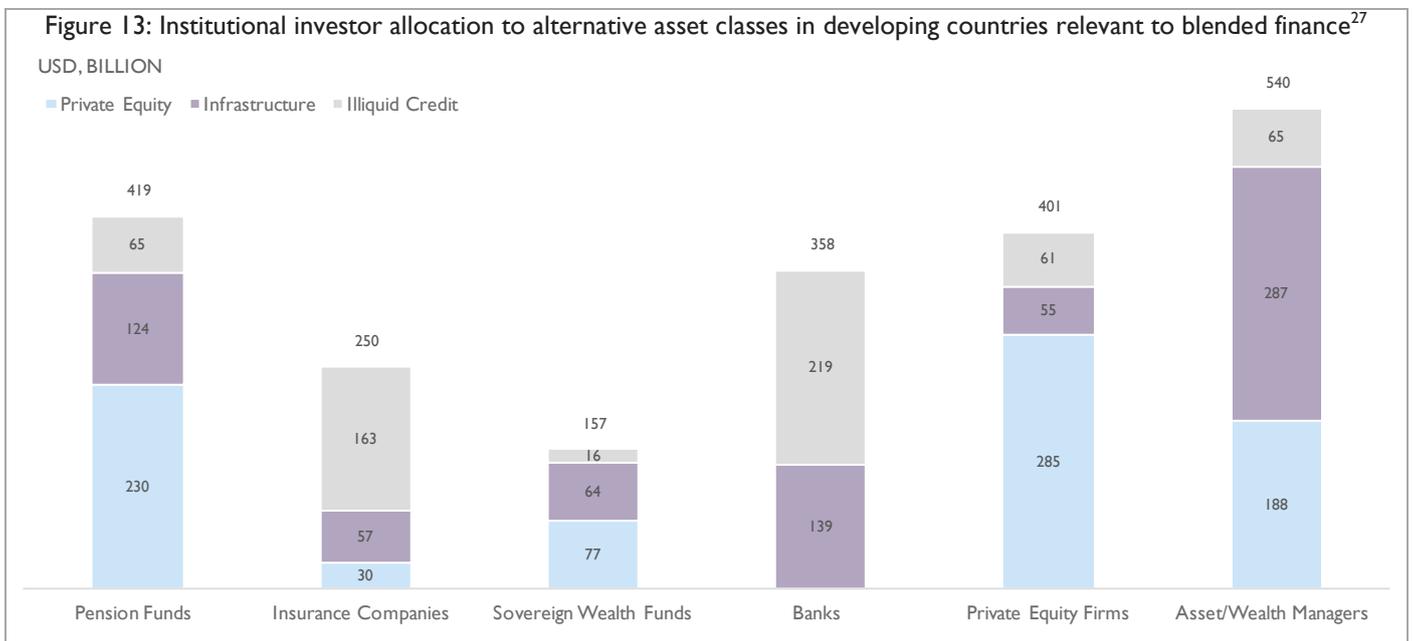


Investments made by these six segments in alternative asset classes that are aligned with blended finance comprise \$6 trillion globally. Pension funds and sovereign wealth funds have the largest average share allocated to alternatives at 19% and 18%, respectively, followed by asset/wealth managers (12%) and insurance companies (9%). Sovereign wealth funds are the most heterogeneous group, with some funds having large allocations to alternatives, while others have small allocations. Private equity firms, by nature, are fully dedicated to alternative investments, while banks have the lowest allocation to alternatives. Within alternative investment portfolios, real estate generally represents the largest average allocation (37%), followed by private equity (19%) and illiquid credit (13%). Most often, infrastructure is the smallest allocation within alternatives portfolios (8%). The figure below illustrates average overall and alternative asset allocations for each segment.

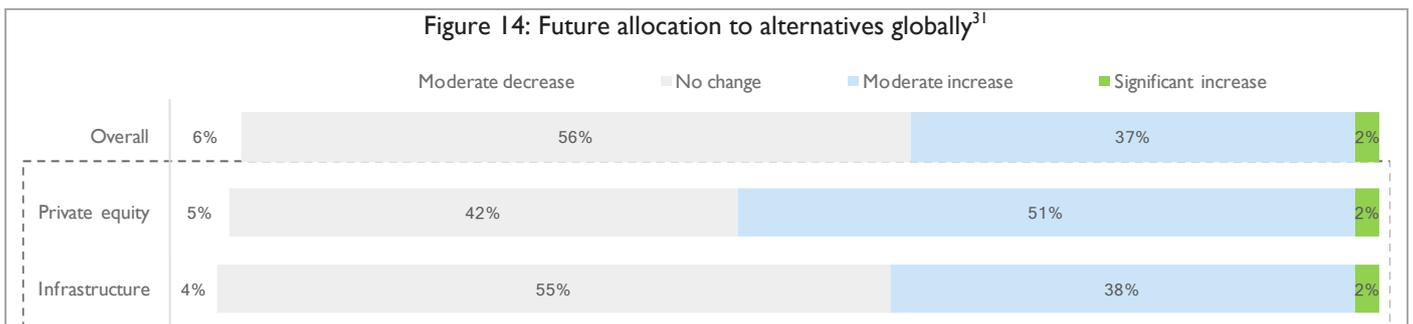


Developing countries comprise approximately 30% of alternative investment portfolios across each of the six segments. Excluding private equity firms, the institutional investor segments, on average, allocate 31% of their alternative investment portfolios to developing countries²³. Private equity firms on average allocate 34% of their portfolios to developing countries²⁴. While this could suggest that institutional investors may not require additional incentives to invest in developing countries, it should be noted that here developing countries are the larger middle-income countries²⁵ or countries with sovereign risk ratings of investment grade and higher. Little institutional investment is directed to low-income countries or countries with sovereign risk ratings below investment grade.

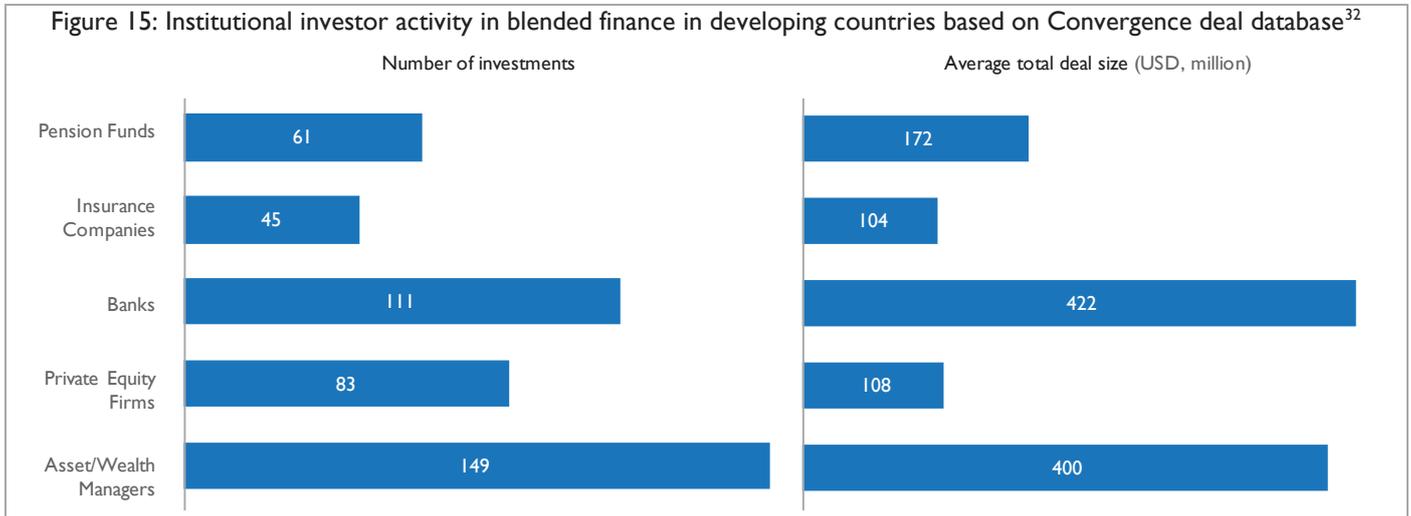
Institutional investors currently allocate over \$2 trillion – just over 1% of their total assets – to alternative assets in developing countries relevant to blended finance. It is not unrealistic to suppose that this scale of private investment could be directed towards the Global Goals with the right investment opportunities, incentives, and enabling environment, which could go a long way towards reducing the annual Global Goal financing gap. All institutional investor segments have immense potential to invest in blended finance transactions, particularly asset/wealth managers, pension funds, and private equity firms with a strong interest in both private equity and infrastructure. Also promising, sovereign wealth funds are increasingly shifting their investment strategies from conservative debt instruments to higher risk/reward investments in private equity and infrastructure investments. The figure below illustrates institutional investor allocation to alternative asset classes in developing countries relevant to blended finance.²⁶



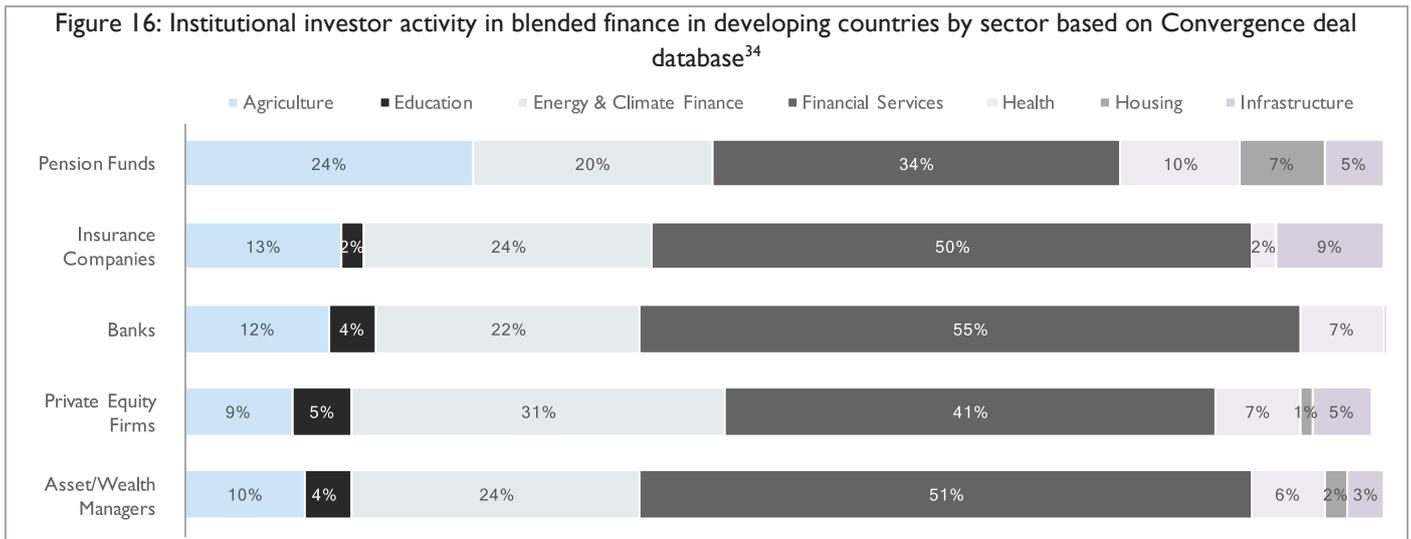
Institutional investors are looking to increase allocations to both alternative asset classes and developing countries – offering an opportunity to influence capital flows toward blended finance. Alternative investments are increasingly viewed as an attractive way to generate strong returns and further diversify portfolios, with a strong growth trajectory currently forecasted. Approximately 39% of institutional investors expect to increase future allocation to alternative investments moderately or significantly²⁸. Developing country markets have a more mixed outlook, especially since the 2008 financial crisis, but have taken an upturn since 2015. Investors are pointing to improvements in growth, lower inflation, and contracting current account deficits – particularly in middle-income countries – as evidence of the resilience of developing countries to global shocks²⁹. Institutional investors, on average, expect to increase alternative investment allocation in developing countries from 31% to 34%³⁰. Both trends offer opportunity to influence capital flows toward blended finance. The figure below illustrates future allocations to alternatives.



Current institutional investment in blended finance transactions is somewhat limited with no sustained movement from institutional investors towards active and scaled investment in blended finance. Based on Convergence data, banks, asset/wealth managers, and private equity firms are the institutional investor segments most active in blended finance, followed by pension funds and insurance companies. Banks and asset/wealth managers tend to participate in large transactions (i.e., over \$400 million in total size), while other segments, like insurance companies, participate in relatively smaller transactions (i.e., between \$100-200 million in total size). Institutional investors tend to invest no more than 20% of total deal size. The figure below details the level of activity of each institutional investor segment in blended finance transactions, as well as the average total deal size each segment participates in. Sovereign wealth funds are excluded below, given the small sample size.



Institutional investment in blended finance is generally diversified across sectors, with a majority of blended finance transactions focused on the financial services and energy & climate finance sectors³³. Pension funds are the most diversified across sectors and have participated in high-impact sectors, including agriculture, more frequently compared to other segments. Infrastructure projects have attracted a relatively small portion of institutional investments in blended finance, with insurance companies participating most often (9% of their total activity). Unsurprisingly, financial services comprise a significant portion of institutional investment in blended finance, comprising between 30% and 55% of blended finance activity across the six segments. Energy and climate finance is the next most common blended finance sector for institutional investors, comprising between 20% and 31% of blended finance activity. The figure below details institutional investor activity in blended finance by sector.



Blended finance needs to attract institutional investors at scale – growing participation from one or two transactions to more regular investment activity. The top institutional investors in blended finance in each segment have invested in six to eight transactions. The prominent pension funds are either based in Europe (e.g., ACV-CSC Meta, PensionDanmark, PKA) or faith-based (e.g., Christian Super, The Church Pension Fund). Prominent insurance companies and banks are based either in the US (e.g., Prudential Financial, MetLife, JP Morgan) or Europe (e.g., AXA, Deutsche Bank, Storebrand, Achmea, Triodos Bank).

Prominent private equity firms and asset/wealth managers are well known in the impact investing / socially responsible investing space (e.g., Abraaj, Leapfrog, LGT Impact Ventures, Responsibility, Calvert Investments). The figure below details the top blended finance institutional investors in each segment.

Figure 17: Top institutional investors in blended finance in developing countries based on Convergence deal database

| Pension Funds | Insurance Companies | Sovereign Wealth Funds | Banks | Private Equity Firms | Asset/Wealth Managers |
|--|---|--|---|--|--|
| <ul style="list-style-type: none"> • ACV-CSC Metea • Christian Super • PensionDanmark • PKA • The Church Pension Fund | <ul style="list-style-type: none"> • Achmea • AXA • KLP • MetLife • Prudential Financial • Storebrand • Swiss Re | <ul style="list-style-type: none"> • State Oil Fund of the Republic of Azerbaijan | <ul style="list-style-type: none"> • BNP Paribas • Credit Suisse • Deutsche Bank • JP Morgan Chase & Co • Standard Chartered • Triodos Bank | <ul style="list-style-type: none"> • Abraaj • Gray Ghost Ventures • Leapfrog • LGT Impact Ventures • Persistent Energy Capital • Sarona Asset Management • Treehouse Investment | <ul style="list-style-type: none"> • Calvert Investments • Incofin • Oikocredit • responsAbility • Sanlam |

Blended finance has great potential to increase institutional investment into the Global Goals, but to achieve this potential, blended finance structures must create assets that fit within the mandates, constraints, and risk-adjusted return preferences of each institutional investor segment.

KEY CONSIDERATIONS AND OPPORTUNITIES FOR SCALING INSTITUTIONAL INVESTMENT IN BLENDED FINANCE

Based on our research, there are five key considerations that will determine how much an institutional investor participates in blended finance at scale:

1. **Communication and messaging:** Communicating investment opportunities using clear and familiar language, and framing blended finance as a means to structuring opportunities.
2. **Policy and regulation:** Global and national constraints and disincentives for investing in certain asset classes or regions.
3. **Mandate:** Organizational-wide mandate from the top to support the Global Goals through investment
4. **Allocation and capacity:** Allocation of capital to, and expertise to participate in, alternative asset classes in developing countries relevant to blended finance.
5. **Transactional factors:** Investment attractiveness based on an opportunity’s risk-adjusted return profile, structure, and co-investors.

The materiality of each consideration varies among and within each institutional investor segment. For example, policy and regulation is relatively more important for banks than private equity firms. Considerations are often interlinked or interdependent – the most effective communication approach will depend on the organizational mandate.

Figure 18: Key considerations for unlocking additional institutional investment in blended finance



COMMUNICATION

Investment opportunities should be communicated using clear and familiar language. This applies across all institutional investor segments. Blended finance transactions today are most aligned with alternative asset classes such as private equity, infrastructure, and illiquid credit. DFIs and development agencies still need to refine their pitch to institutional investors. Too often the investment opportunity is framed solely around a development objective, rather than highlighting the underlying business opportunity upfront as the priority. Blended finance, for institutional investors, is a structuring approach that allows investors to access a wider, more diverse range of investment opportunities in developing countries.

Further, blended finance should not be confused with other sustainable investment trends nor slow their momentum. While blended finance has benefited from the momentum behind sustainable and impact investing, efforts should be made to distinguish blended finance. Compared to sustainable and impact investing, blended finance does not require each investor to have the intent to create positive social and environmental impact. Blended finance helps public and philanthropic parties achieve their development objectives while institutional investors achieve their risk-adjusted return requirements. This is an important distinction for institutional investors who may have come to associate sustainable or impact investing opportunities as concessional.

POLICY AND REGULATION

Institutional investors face a plethora of global and national policies and regulations, which have strengthened following the 2008 financial crisis. The objective of this oversight is to ensure a stable global financial system and reduce unnecessary risk-taking by institutions that have a fiduciary responsibility to their shareholders and/or policyholders. Nonetheless, policy and regulation can be a barrier to increasing investment flows to developing countries, reducing investor appetite to take risks in markets with high perceived and real risks. Blended finance transactions should be structured with policy and regulatory conditions in mind. Considerations around policy and regulation are particularly important for certain institutional investor segments, like commercial banks. The figure below illustrates select regulations and their impact on institutional investor segments in the US, EU, and the UK.

Figure 19: Select regulations and their impact on institutional investor segments in the US, EU, and UK³⁵

| | Legislative Region | Leverage limits | Collateral req. | Liquidity req. | Central clearing | Private equity limits | Trading tax | Brokerage fee limits | Deposit and reporting req. | Compensation limits | Pension funds | Insurance companies | Banks | Asset/wealth managers | Private equity |
|---|--------------------|-----------------|-----------------|----------------|------------------|-----------------------|-------------|----------------------|----------------------------|---------------------|---------------|---------------------|-------|-----------------------|----------------|
| Dodd-Frank Wall Street Reform and Consumer Protection Act | US | | | | | | | | | | | | | | |
| 619 (12 U.S.C. 1851) of the Dodd-Frank Act (Volcker Rule) | US | | | | | | | | | | | | | | |
| Foreign Account Tax Compliance Act | US | | | | | | | | | | | | | | |
| Third Basel Accord / Capital Requirements Directive | All | | | | | | | | | | | | | | |
| Undertakings for the Collective Investment of Transferable Securities V | EU | | | | | | | | | | | | | | |
| Alternative Investment Fund Managers Directive | EU | | | | | | | | | | | | | | |
| Solvency II Directive | EU | | | | | | | | | | | | | | |
| Markets in Financial Instruments Directive II | EU | | | | | | | | | | | | | | |
| European Market Infrastructure Regulation | EU | | | | | | | | | | | | | | |
| European Commission’s Liikanen proposals | EU | | | | | | | | | | | | | | |
| Financial Transaction Tax | EU | | | | | | | | | | | | | | |
| Packaged Retail Investment Products | EU | | | | | | | | | | | | | | |
| International Financial Reporting Standards | EU/US | | | | | | | | | | | | | | |
| Retail Distribution Review | UK | | | | | | | | | | | | | | |

The scope and impact of policy and regulation on institutional investors’ appetite for investments supporting the Global Goals varies by segment. Banks and insurance companies face the most regulatory constraints, including capital charges for risky assets and/or assets with longer tenors, requirements for investment grade risk ratings, and liquidity requirements. These regulatory constraints and disincentives limit appetite for the types of assets created by blended finance transactions. In some situations, blended finance can help navigate certain regulatory requirements through smart structuring – for example, by providing assets that are rated investment grade. The figure below illustrates to what degree policy and regulation impact each institutional investor segment.

Figure 20: Impact of policy and regulation on each institutional investor segment

| Pension Funds | Insurance Companies | Sovereign Wealth Funds | Banks | | Private Equity Firms | Asset/Wealth Managers |
|---------------|---------------------|------------------------|------------------|------------------|----------------------|-----------------------|
| | | | Commercial Banks | Investment Banks | | |
| | | | | | | |

Least constraints and disincentives

Key constraints and disincentives for pension funds: ability to sell illiquid assets; restrictions in some asset classes and geographies. Pension funds have traditionally been subject to investment limits in certain asset classes and geographies, as a means to mitigate potential risks for shareholders. These limits have been further reduced in many jurisdictions in recent years³⁶. For example, pension funds must be able to show assets can be sold in the event of a market downturn. Pension funds have the relative flexibility to allocate a material proportion of assets to alternative asset classes in developing countries, but face key challenges around tradability and liquidity. This is a key barrier for current blended finance transactions, which typically do not provide sufficient liquidity to meet this requirement. However, blended finance can offer solutions. For example, there are potential learnings from developed markets approaches to creating liquidity through the establishment of secondary markets. Many institutional investors cite the creation of the secondary market for mortgages in the US as key to creating liquidity and an entirely new asset class for institutional investors. The box below describes this at a high level.

Box 1: Secondary mortgage market in the US³⁷

The secondary mortgage market in the US allows banks to sell mortgages to investors such as pension funds and insurance companies. The liquidity that is created through this market provides banks with funds that can be deployed to offer additional mortgages. Before the secondary market was established, only larger banks had the ability to tie up funds for the life of the loan (typically 15-30 years). As a result, homebuyers struggled to obtain mortgages from mortgage lenders. In an attempt to raise levels of home ownership and the availability of affordable housing in the wake of the Great Depression, the US Government set up Fannie Mae (with Freddie Mac subsequently established). These organizations provided liquidity and affordability through the creation of a secondary market in the following ways:

- Fannie Mae and Freddie Mac buy mortgages from lenders and either hold these mortgages in their portfolios or package the loans into mortgage-backed securities that may be sold. Lenders use the funding raised by offloading their mortgages to Fannie Mae and Freddie Mac to engage in further lending. By packaging mortgages into mortgage-backed securities, investors who might not otherwise invest in mortgages are attracted to the secondary market, which thereby expands the pool of funds available for housing.
- Fannie Mae and Freddie Mac also guarantee the timely payment of principal and interest on the underlying mortgages that were part of the mortgage-backed securities (the guarantee was implicit up until the Financial Crisis of 2008). The guarantee was backed by the full faith and credit of the US government, and therefore investors were not only relying on the credit standing of each government-owned corporation. Investors valued these credit guarantees and purchased securities at a lower yield. This benefit in-turn flowed to mortgage borrowers in the form of lower interest rates.

The subsequent evolution of the mortgage-backed securities market, in particular investment banks packaging subprime mortgages into structures sold as investment grade to investors, was a key contributor to the Financial Crisis of 2008, and also presents a cautionary tale. This approach by the US Government addressed several key market constraints, ultimately creating liquidity and an entirely new asset class for institutional investors.

Key constraints and disincentives for insurance companies: risk-based requirements that impose a higher capital charge for investments with a higher level of risk. Insurance regulation has evolved to risk-based requirements for capital³⁸. In contrast to strict quantitative limits, risk-based requirements do not impose hard restrictions on investment, but instead impose a higher capital charge for investments with a higher level of risk. Equity and non-investment grade debt result in significant capital charges. For example, Solvency II, an EU law that codifies and harmonizes EU insurance regulation, has established a tougher capital-adequacy regime that may force insurers to seek shorter-dated debt to meet regulatory solvency requirements. Further, Solvency II creates constraints on insurance companies outsourcing investment decisions and portfolio management to entities that are not regulated, making it difficult for European insurance companies to participate in transactions that are managed by DFIs/MDBs, which are not regulated. The US requires debt to be rated – even though insurance companies typically have internal rating models and therefore a rating from a rating agency is not an absolute requirement. The figure below details the capital charges for different asset classes for insurers in the EU and US.

Figure 21: Capital charges for select investments by insurance companies³⁹

| Asset Class | EU Solvency II | US Risk-Based Capital Requirements |
|--------------------------------------|-------------------------------|------------------------------------|
| Listed equity | 22% | 15% |
| Private equity | 49% | 30% |
| Non-investment grade corporate bonds | Up to 37.5% for 5-year tenors | 30% |
| Real estate | 25% | 15% |

Key constraints and disincentives for commercial banks: most constrained relatively; required to allocate high levels of capital when lending to high risk borrowers over medium-term tenors. Under Basel III (a global regulatory framework on bank capital adequacy, stress testing, and market liquidity risk), commercial banks are required to allocate high levels of capital when lending to high risk borrowers, particularly in countries with non-investment grade sovereign risk ratings. Many institutional investors comment that using the sovereign risk rating as the ceiling for investments may unduly penalize individual investment opportunities that present a better risk profile than the sovereign itself. In addition, International Financial Reporting Standard (IFRS) 9 (an international financial reporting standard accounting for financial instruments) requires the full expected loss of a loan to be recorded to profit and loss immediately, as opposed to over the life of the loan. This further incentivizes commercial banks to hold lower risk assets. Given the weak credit risk ratings of developing countries – most developing countries on the OECD Development Assistance Committee list are rated non-investment grade with a median rating of B – Basel III and IFRS 9 indirectly place severe restrictions on commercial banks allocating medium and long-term funds in developing countries.

Key constraints and disincentives for investment banks: capital charges create tenor restrictions for investing on balance sheet, while underwriting activities are impacted by regulators acknowledgment of credit enhancement products provided by public funders. When investment banks invest on balance sheet, tenor restrictions driven by capital charges are a key constraint. Beyond lending, investment banks also play an important role underwriting blended finance transaction, primarily debt issuances. Typically, investment banks will only underwrite if appropriate guarantees or insurance from public funders are in place; however, certain jurisdictions do not recognize guarantees or insurance from multinationals (e.g., the US regulator does not recognize Multilateral Investment Guarantee Agency (MIGA) political risk insurance).

Key constraints and disincentives for asset/wealth managers: regulations applied to their clients (e.g., pension funds and insurance companies). Asset/wealth managers are indirectly yet strongly impacted by policy and regulations, depending on the type and nature of the clientele. This limits the ability of this institutional investor segment to champion investing in the Global Goals through blended finance. For example, asset/wealth managers will struggle to find client demand for investments in non-investment grade countries given current regulatory conditions and fiduciary duties.

Key constraints and disincentives for private equity firms and sovereign wealth funds: typically have the least constraints and disincentives relative to other institutional investor segments. While asset owners like pension funds and insurance companies are restricted in how much can be allocated to private equity, once that allocation is determined, private equity firms have relative freedom in their investment activities. Sovereign wealth fund regulation is typically dictated by the country of domicile, which makes comparisons across countries difficult. In some cases, sovereign wealth funds are subject to similar regulations as local pension funds (e.g., investment limits in certain classes of assets and geographies), but generally sovereign wealth funds have more freedom to invest alternative assets in developing countries relevant to blended finance.

MANDATE

An investment mandate to support the Global Goals is generally specific to individual institutions as opposed to forces affecting broad investor segments. There are many examples of institutional investors – across the six segments – demonstrating an appetite to explore investment approaches aligned to the Global Goals. The Danish pension funds are often cited as leaders in the space, especially with their commitment to investing in climate-related Global Goals. There is a growing number of asset / wealth managers, such as UBS, that are responding to client interests in the Global Goals by offering impact products. Several large banks have also recently made bold commitments. HSBC has pledged to provide \$100 billion in sustainable financing and investment globally by 2025, in particular for clean energy and lower-carbon technologies⁴⁰. JPMorgan Chase has committed \$200 billion to clean financing, with investment in solar installations, wind farms, and other renewable energy resources to cover all the organization's power needs by 2020⁴¹. The boxes below profile Credit Suisse's new impact investing initiative and Abraaj's approach to supporting the Global Goals.

Box 2: Credit Suisse's impact investing initiative⁴²

Credit Suisse is a diversified financial institution with \$900 billion in assets. Credit Suisse recently launched a new department – Impact Advisory and Finance. The new department will be headed by Marisa Drew, who will report directly to CEO Tidjane Thiam. The division will direct, coordinate, and facilitate activities across Credit Suisse which lead to impact investing while also supporting sustainable finance and philanthropic advisory services on behalf of private wealth, institutional, and corporate clients. The division will therefore coordinate activities across investment banking, private banking, and asset management groups. This new department, and mandate direct from Credit Suisse's CEO, will allow Credit Suisse to play an important role in the blended finance space going forward.



Box 3: The Abraaj Group⁴³

The Abraaj Group is one of the largest private equity firms focused on emerging markets, and unique in its focus on investing to support the Global Goals. Abraaj is headquartered in the Middle East, and has over \$12 billion AUM. Abraaj has four business units – impact investing, private equity, credit strategies, and real estate. Impact investing is currently \$2 billion of Abraaj's total portfolio. The \$1 billion Abraaj Growth Markets Health Fund is a landmark blended finance transaction, with preparation grant support provided the Bill & Melinda Gates Foundation. Abraaj is a leader in the space because it has a clear mandate and also strong internal expertise investing in developing countries and investing for the Global Goals.



Mandate should be driven by senior leadership (e.g., CEO) and/or other stakeholders (e.g., shareholders, clients) to promote organization-wide implementation and support. Here, there is an important differentiation between asset owners (i.e., pension funds, insurance companies, sovereign wealth funds, and banks) and asset managers (i.e., private equity firms, asset/wealth managers) because the mandate of asset owners drives the mandates of asset managers. That is, buy-in from senior leadership is relatively more important for asset owners, while stakeholder (i.e., shareholder) buy-in is relatively more important for asset managers. At the same time, there are good examples of asset managers playing a market championing role in demonstrating the financial success of investments aligned with the Global Goals. Beyond senior leadership and stakeholders, it is also important for there to be “internal champions” within the institution who promote activities aligned to the Global Goals and ensure this mandate is executed.

ALLOCATION AND CAPACITY

Allocation of capital to, and capacity to participate in, alternative asset classes in developing countries is an important consideration influencing institutional investor’s willingness and ability to participate in blended finance at scale. Allocation and capacity (i.e., expertise) are interrelated – a greater capacity is required for a greater allocation – and both vary significantly between and within each segment. The figure below illustrates allocation and capacity to participate in blended finance across institutional investor segments.

Figure 22: Allocation and capacity to participate in blended finance across institutional investor segments

| | Pension Funds | Insurance Companies | Sovereign Wealth Funds | Banks | | Private Equity Firms | Asset/Wealth Managers |
|------------|---------------|---------------------|------------------------|------------------|------------------|----------------------|-----------------------|
| | | | | Commercial Banks | Investment Banks | | |
| Allocation | | | | | | | |
| Capacity | | | | | | | |

Less well-aligned

Pension funds are likely to participate in asset classes in developing countries relevant to blended finance, but capacity may be a barrier in the short-term. Pension funds have strong fiduciary duties to their policyholders and can face significant levels of public scrutiny. While pension funds have the highest allocation among asset owners to alternatives, pension funds often have few investment staff that are familiar with developing country investment environments. However, there are several examples of pension funds that are increasingly investing in alternative assets, primarily infrastructure, in developing countries. In Denmark, multiple Danish pension funds (e.g., PensionDanmark, PKA) have gained exposure to investing in developing countries through blended finance vehicles (e.g., Danish Climate Investment Fund, Danish Agricultural Investment Fund), driven by strong appetite from senior leadership to support the Global Goals, as well as close working relationships between government officials and senior leadership of institutional investors in Denmark.

Insurance companies are likely to allocate to asset classes in developing countries relevant to blended finance and tend to have stronger capacity to invest in these markets. The allocations of life insurers, particularly, are well-aligned to blended finance given their desire to match long-term liabilities with long-term assets and there are multiple examples of insurers participating in emerging market investments and investments aligned to the Global Goals. While insurance companies currently have a relatively small allocation to alternatives, trends indicate an uptick in allocation going forward⁴⁴. Insurance companies often have relatively large investment teams and expertise in developing country investing.

Sovereign wealth funds are the segment with the most varied allocation and capacity to participate in asset classes in developing countries relevant to blended finance. Sovereign wealth fund allocations vary significantly across funds, according to the specific mandate and directives provided by the sovereign. While sovereign wealth funds are increasingly investing in alternatives in search of growth, their preference for very large transaction size is often not well-aligned to blended finance transactions in existence today.

Commercial banks and investment banks often have the strongest capacity to participate in asset classes in developing countries relevant to blended finance. Banks typically don't have allocations but rather advise their clients on their allocations. Generally, banks have a strong capacity to participate in blended finance transactions as arrangers and distributors, with the ability to leverage expertise from various divisions (e.g., debt capital markets, asset management, research) as well as broader global networks and subsidiaries.

Asset / wealth managers' allocations are driven by their clients' interests and face increasing pressure to build out capacity to offer alternative product offerings. Asset/wealth managers often have a relatively good understanding of developing country investments because they have dedicated teams – a factor of their large size. Therefore, asset / wealth managers can be leveraged by asset owners to allocate resources to alternative investments where the asset owner does not have the capacity to execute themselves. Moreover, there is growth among asset / wealth managers that specialize in alternative assets, assets in emerging markets, and even investments aligned to the Global Goals (e.g., Abraaj Group, Blue Orchard).

Private equity firms typically have well-aligned allocations and capacity for participating in blended finance. Most private equity firms tend to focus either on developed or developing markets. Therefore, it is a question of how to harness the potential of developing country focused firms – growing their investments in developing countries – as well as larger firms, like KKR, that traditionally focused on developed markets but are increasingly investing in developing countries. All private equity firms have strong capacity to participate in alternative asset classes in developing countries relevant to blended finance.

TRANSACTIONAL FACTORS

There are seven transactional factors that influence the attractiveness of blended finance opportunities for institutional investors: absolute risk, risk-adjusted return, size, tenor/investment horizon, coordination, structural complexity, and originating, arranging, and managing of assets. Risk considerations and risk-adjusted return expectations typically vary by asset class as opposed to segment. Coordination, structural complexity, and originating, arranging, and managing of assets considerations are generally similar across segments. Size, and tenor/investment horizon considerations differ by segment, as well as by asset class.

ABSOLUTE RISK

Common developing country risks – such as political/country, credit, liquidity, and foreign exchange (FX) risks – are also seen as the largest risks in blended finance transactions in developing countries. These risks apply to both debt and equity investments, with exit risk a compounding risk on equity. Institutional investors cite multiple risks when investing in these markets, but particularly political/country risk, credit risk, liquidity risk, and FX risk. While these risks exist in all markets, there is a tendency for these risks to be either harder to measure and/or more acute in developing countries.

Solutions already exist, many within the definition of blended finance, to address these key risks and should be refined and/or scaled up. Blended finance structures can support investments in developing countries – untested or otherwise risky markets – by structuring credit enhancements and/or other de-risking mechanisms that can overcome not only measurable risks (e.g., FX risk), but also perceptions of risk. Examples of solutions include political risk insurance (e.g., the World Bank Group Multilateral Investment Guarantee Agency (MIGA)) and credit guarantees (e.g., the Swedish International Development Cooperation Agency's (SIDA) guarantee instrument), which are either benchmarked to the market or intentionally concessional. The Currency Exchange Fund (TCX) is one of the few FX risk solutions, which provides hedging products at market pricing.

While many of these solutions are considered effective, there is still room for improvement and scale. As noted above, MIGA political risk insurance needs to be acknowledged by local regulators for US investment banks to participate in an underwriting capacity. As another example, guarantees that are strippable or tranchable would allow a portion of a structure to be fully guaranteed (i.e., AAA or similarly rated). This would enable more efficient marketing to buying centers within institutional investors seeking AAA risk or clean risk. Insurance companies often have their own internal rating models, and therefore do not require ratings. However, as clients of insurance companies often require ratings given their own regulatory constraints, ratings are often preferred. Finally, while the TCX is considered effective, only certain institutions can access TCX hedging products and TCX pricing – while presented as market-rate – is expensive enough that investors often prefer to take uncovered FX risk. Investors comment on the need to scale TCX by making products more accessible, while also leveraging concessional development funding to provide pricing that is affordable for projects. The box below details how TCX operates.

Box 4: The Currency Exchange Fund (TCX)⁴⁵

Business opportunity: Local currency financing in low- and middle-income countries across sectors, including financial services, energy, and infrastructure.

Investment barrier: Foreign lenders face significant FX risk providing local currency loans in emerging markets and therefore require affordable hedging options (e.g., cross currency swaps, currency forwards, interest rate swaps) that do not negate targeted financial returns.

Blended finance solution: TCX offers hedges for currencies and tenors not served by commercial banks because of innovative macro-risk pricing tools and blended capital. TCX has two tiers of capital: common equity contributed development agencies (first-loss capital) and subordinated convertible debt contributed primarily by DFIs. First loss capital contributes to capital stability and increases risk bearing capacity by guaranteeing a minimum return of USD Libor to equity holders over lifetime of TCX. TCX uses market / risk-reflective pricing to minimize distortions and to improve risk allocation, and shares “easier” parts of its risk portfolio with the private sector. TCX is rated A- by S&P.

Leverage: TCX leverages ~\$700 million of capital to support \$2 billion of currency exposure.

Shareholders: European Bank for Reconstruction and Development (EBRD), KfW (German DFI), FMO (Dutch DFI), EIB, Japan Bank for International Cooperation (JBIC), Development Bank of Southern Africa (DBSA), IFC, African Development Bank (AfDB), Inter-American Development Bank (IDB), OPEC Fund for International Development (OFID), BIO Invest, MFX Currency Solutions, Proparco (French DFI), European Fund for South-east Europe (EFSE), COFIDES (Spanish DFI), Oikocredit, Oxfam/Novib Fund, BlueOrchard Microfinance Fund, German and Dutch Governments.

There is an additional set of risks for infrastructure investments specifically, with investability and pipeline flow at the forefront. Investability is less a risk and more of a challenge cited amongst nearly all infrastructure investors. That is, there are simply not enough investment-ready (or “bankable”) projects for the strong supply of capital that is willing and able to invest in infrastructure. This challenge has been well documented and there are a plethora of project preparation facilities that support early-stage infrastructure projects move from concept to investment. However, these solutions are deemed either ineffective or simply not working at scale. Now, new innovative blended finance solutions are trying to address the challenge of investability, including Climate Investor One described in the box below.

Box 5: Climate Investor One⁴⁶

Business opportunity: Investment in renewable energy infrastructure in emerging markets, including solar, wind, and run-of-river hydropower.

Investment barrier: Projects can fail or face severe delays due to lack of expertise and prolonged negotiations with financiers; renewable energy projects involve high amounts of capital expenditure, debt costs at construction can have a disproportionate effect on their financial viability; and attracting new investors remains a challenge.

Blended finance solution: Climate Investor One is three funds under one end-to-end financing facility to finance renewable energy projects at specific stages of project lifecycle: i) development fund provides loans for project preparation, ii) equity fund finances construction with equity only, iii) debt fund provides gearing once the project is operational. The first fund creates investable projects for the second fund to invest in. Each fund de-risks projects for the next. Further, the equity fund has 3 tiers of capital: junior equity from donors in tier one attracts commercial and institutional investors in tier two and three.

Leverage: In the equity fund, just over \$100 million of concessional financing will catalyze over \$400 million in institutional capital (leverage ≈ 4)

Returns: Expected return between 15-20% for equity investors in equity fund

Private Investors: Aegon Asset Management (Netherlands), Royal Berkshire (UK pension fund), Sanlam (South African pension fund), KLP (Norwegian pension fund/insurance provider), among others

Off-take risk is the risk of securing a long term contractual commitment from a buyer/user of the infrastructure asset such as a state utility in the case of renewable energy products and is a pervasive challenge across developing countries. Addressing off-take challenges require broader enabling environment interventions and government involvement. Finally, there is a need for subordinated liquidity facilities that support projects when revenues at certain points in the lifetime of the project are not sufficient to cover service on senior debt. There are good examples of these structures in developed countries that could be replicated in developing countries. The joint European Commission – European Investment Bank (EIB) Project Bond Credit Enhancement Product for infrastructure project bonds is one commonly cited example, detailed in the box below.

Box 6: European Commission – European Investment Bank Project Bond Credit Enhancement Product⁴⁷



Business opportunity: Investment in large-scale trans-European infrastructure projects in the sectors of transport, energy, and information and communication technology.

Investment barrier: Post 2008 financial crisis, insurance companies were less likely to guarantee full credit risk of senior lenders of infrastructure projects and pressure on commercial banks' balance sheets from higher regulatory requirements constrained other sources of long-term infrastructure financing.

Blended finance solution: To improve the credit profile of infrastructure projects, EIB provides subordinated loans to increase the credit quality of senior loans (where institutional investors participate) for infrastructure projects. The subordinated tranche – which is known as Project Bond Credit Enhancement – can take the form of a loan or a contingent credit line, which can be drawn upon if the revenues from the project are not sufficient to ensure senior debt service. EIB's exposure in the program is supported by the European Commission.

Leverage: €750 million of subordinated funding, aiming to leverage €4 billion of institutional capital (leverage ≈ 5.3)

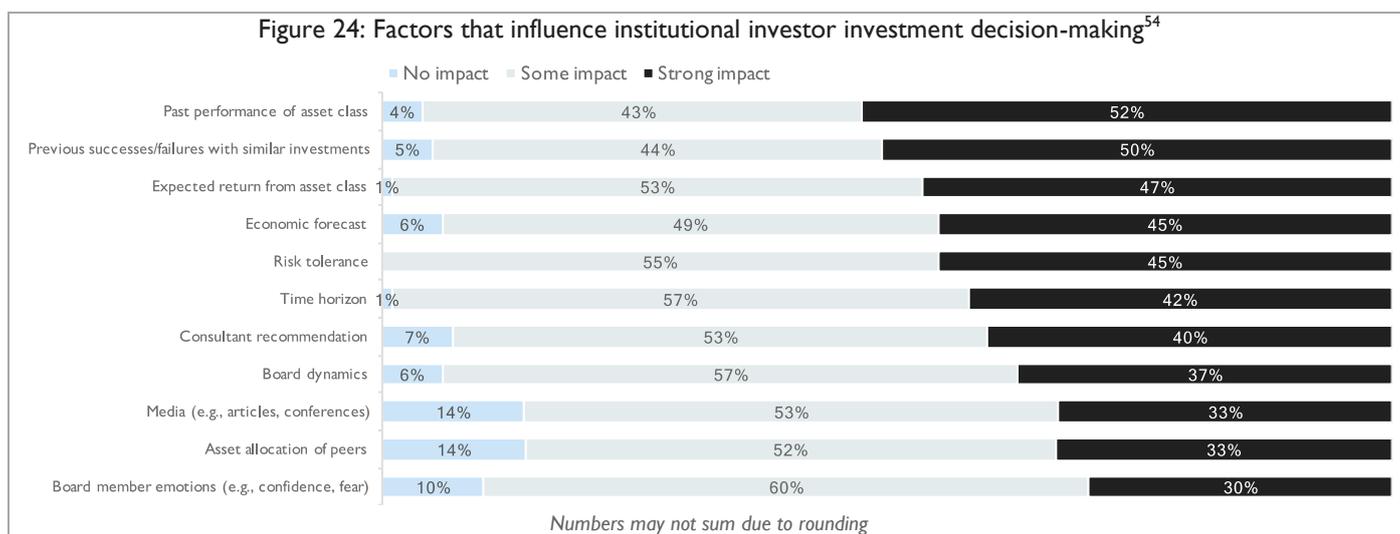
RISK-ADJUSTED RETURN

Risk-adjusted return expectations vary by underlying asset class and region. Institutional investors generally seek higher returns in developing countries. In developed countries, institutional investors typically expect returns between 10-14%⁴⁸ for both private equity and infrastructure investments. Return expectations on illiquid credit in developed countries are much more diverse, with the illiquidity premium for illiquid credit investments ranging between 20-80 basis points⁴⁹. Both private equity⁵⁰ and infrastructure⁵¹ return targets are generally 16%+ in developing countries, while the illiquidity premium for illiquid credit investments ranges between 50-100 basis points⁵². The figure below illustrates general return expectations by underlying asset class and region.

Figure 23: General return expectations by underlying asset class and region⁵³

| Asset class | Return expectation |
|-----------------------------|--|
| Developed countries | |
| Private equity | 12-14% |
| Infrastructure | 10-14% |
| Illiquid credit | 20-80 basis point illiquidity premium |
| Developing countries | |
| Private equity | 16%+ |
| Infrastructure | 16%+ |
| Illiquid credit | 50-100 basis point illiquidity premium |

Risk-adjusted return expectations are based on past performance of an asset class, which is problematic given the paucity of return data for blended finance transactions. Indicative return expectations can be established by evaluating returns in alternative asset classes in developing countries that are aligned to blended finance, but there is a great need for the disclosure of target or actual returns for blended finance transactions, particularly those with tranching capital stacks and/or other risk-adjusting mechanisms like guarantees. Ideally, deal arrangers and institutional investors should report return data to a trusted industry body to report aggregate return data, which could be used to establish fair market expectations. In the short-term, historical returns and losses for DFI loans to private sector borrowers in developing countries are captured in the 25+ year Global Emerging Markets (GEMs) database – and suggest that performance has been better than credit rating agency data and market perceptions suggest. If institutional investors and rating agencies incorporated this data into analysis, premiums associated with investments in developing countries would likely decrease. In addition, standardized reporting on impact metrics could also help institutional investors as they compare investment opportunities that contribute to the Global Goals. The figure below illustrates factors that influence institutional investor investment decision-making



Blended finance solutions offer attractive risk-adjusted returns to institutional investors, aligned with risk-adjusted return expectations for each alternative asset class. Ultimately, blended finance transactions are structured such that the risk-adjusted returns for institutional investors – the senior tranches – meet, or exceed, market expectations, using various concessional mechanisms. The Danish Climate Investment Fund and Danish Agribusiness Investment Fund are two good examples of one of these mechanisms – a preferred return structure – that catalyzed institutional investor participation in climate and agriculture investments in developing countries. These structures are detailed in the boxes below.

Box 7: Danish Climate Investment Fund⁵⁵



Business opportunity: Investments in climate mitigation and climate adaptation, including disaster preparedness, coastal management, and climate change information.

Investment barrier: Target investees are small and medium-sized enterprises (SMEs) located in emerging markets that are difficult to access and require specialized risk capital (e.g., equity or mezzanine investments).

Blended finance solution: The Danish Climate Investment Fund (KIF) was established by the Danish State and IFU (the Danish DFI) to invest in low-carbon and climate-resilient projects in developing countries. KIF uses a unique preferred return structure, where i) all parties receive distributions until principal returned, ii) LPs (institutional investors) receive returns up to 6% per annum, iii) Danish state benefits from a catch-up period after LPs receive 6% per annum, until all parties have received 12% per annum, iv) Returns above 12% per annum distributed pro rata.

Returns: Overall target internal rate of return (IRR) is 12%

Private Investors: Danish pension funds – PensionDanmark, PKA, PBU, and Dansk Vækstkapital

Box 8: Danish Agribusiness Investment Fund⁵⁶



Business opportunity: Investments to increase the production of much-needed food in developing countries through investment in projects throughout the entire value chain from farm to fork.

Investment barrier: Both the projects and markets are often considered high risk.

Blended finance solution: Private equity fund established by the Danish State and IFU to invest in agribusinesses and food companies in developing countries. Preferred return structure, where i) all parties receive distributions until principal returned, ii) LPs (institutional investors) receive returns up to a pre-determined level of returns, iii) Danish state benefits from a catch-up period, until all parties have received a pre-determined level of returns, iv) Returns beyond distributed pro rata

Private Investors: PensionDanmark and PKA each contributed DKK 200 million

SIZE

As expected and well documented, institutional investors require large deal sizes. Institutional investors have significant AUM and require large deal sizes to avoid the high relative transaction costs associated with considering many more small deals. Sovereign wealth funds, banks, and asset/wealth managers prefer to participate in transactions of \$400+ million in total size. Pension funds, insurance companies, and private equity firms have more flexibility to consider smaller transaction of \$100+ million in total size.

Across all segments, institutional investors generally prefer a minimum investment size between \$10-15 million and for their investment to be no more than 20% of total transaction size. However, adequately sized transactions are relatively rare in developing countries. Pooling assets is one way to overcome this challenge. Further, DFIs already hold commercially attractive developing country debt assets and have the capacity to originate and structure portfolios of assets that are commercially attractive to institutional investors. The box below illustrates IFC's recently announced Managed Co-Lending Portfolio Program (MCP) for Infrastructure, a potential break-through blended finance transaction that will attract around \$1.5 billion of private sector commitments. Funds are also a tested approach to aggregation, and the box below illustrates the success of Deutsche Bank's Universal Green Energy Access Programme.

Box 9: IFC Managed Co-Lending Portfolio Program (MCP) Infrastructure⁵⁷



Business opportunity: Financing for infrastructure in developing countries, with an emphasis on building a modern day "Silk Road", connecting emerging markets across Africa, Asia, and Europe.

Investment barrier: Large institutional investors require pooled investment opportunities to meet their investment requirements, including size and target returns.

Blended finance solution: IFC and Sida are engaged in an innovative partnership to mobilize private capital for infrastructure. IFC will support the creation of new private sector infrastructure debt vehicles to create an emerging market loan portfolio for institutional investors. The loan-syndication program enables third-party investors to participate passively in IFC's senior loan portfolio – specifically in greenfield infrastructure projects that IFC originates going forward. MCP will have a first-loss tranche of up to 10% of the portfolio. This is supported by guarantees from the Sida.

Leverage: IFC and Sida aim to leverage each dollar invested to mobilize \$8-10 from institutional investors (leverage ≈ 9).

Returns: Institutional investors receive return of ~200 basis points over Libor.

Private Investors: Institutional investors including Allianz, AXA, and Eastspring Investments have committed \$500 million each.

Box 10: Deutsche Bank – Universal Green Energy Access Programme (UGEAP)⁵⁸



Business opportunity: Investments in renewable energy to achieve universal access to electricity in Sub-Saharan Africa

Investment barrier: Insufficient scale of local and international investment for renewable energy projects in Sub-Saharan Africa

Blended finance solution: UGEAP will partner with local and regional financial institutions to invest in on and off-grid green electrical energy and green energy supply for mini- and micro-grids. UGEAP is structured as a debt investment fund managed by Deutsche Bank. UGEAP has a two-tiered capital structure consisting 1/3 of B-Capital from public sector investors/guarantors and 2/3 of A-Capital from private sector investors. Sida provided a partial credit guarantee and the Green Climate Fund provided concessional B-Capital. Investments also receive co-investment from private sector investors.

Leverage: UGEAP leveraged \$100 million in concessional capital to achieve a total fund size of \$302 million (leverage ≈ 2). UGEAP aims to raise \$500 million in the long-term.

Returns: Target IRR on Class A is 6.8%; target IRR on Class B is 6.6%

Private Investors: Deutsche Bank and multiple undisclosed institutional investors

TENOR / INVESTMENT HORIZON

Tenor / investment horizon considerations for increasing institutional investor participation in blended finance are dependent on underlying asset class, with some differences across segments for debt investments. For private equity and other equity investments (e.g., equity investment in infrastructure projects), institutional investors across segments prefer investment horizons of 5-10 years, which can be a restrictive time horizon for many Global Goals-aligned projects in emerging markets, including largescale infrastructure projects and smaller direct investments in SMEs. For illiquid credit, infrastructure debt, and other debt investments, banks and insurance companies generally prefer shorter tenors (1-3 years), while pension funds, sovereign wealth funds, and asset/managers can hold these assets for longer periods (5-10 years).

COORDINATION

Nearly all institutional investors that have participated in blended finance transactions comment on the need for improved coordination among co-investors, particularly DFIs. Most institutional investors engaged for this report expressed concerns around

the timeliness and bureaucracy of working with development agencies, compared to the time efficiency expected by the private sector. For example, many blended finance transactions can take multiple years to design, structure, and fundraise and it can be difficult to manage investor appetite over such a time horizon. Further, the nature of decision-making varies between public and private institutions, with meaningful decisions at DFIs taken by committee and consensus, with broad consultation with numerous departments and/or partners required. Finally, the landscape of development funders is diverse and can be difficult to navigate. Even the DFIs vary significantly in mandate, scope, and capabilities, which can make identifying the appropriate partners and co-investor(s) difficult. Generally, products currently offered by DFIs and other development funders are not adequately flexible and do not meet the investment requirements of institutional investors. As detailed above, guarantees often are not strippable.

STRUCTURAL COMPLEXITY

Blended finance structures are often complex and the unique nature of each transaction is a challenge for institutional investors. While blended finance transactions fit well into existing asset classes such as private equity, infrastructure, and illiquid credit, each blended finance transaction has unique terms. For example, there are currently few standard approaches and terms for first-loss guarantees and preferred return structures. While institutional investors may spend 40 hours researching the operational aspects of a standard private equity fund structure, a blended finance transaction can require many more hours in understanding the unique nuances and intricacies of the structure. For blended finance to achieve scale, the approach and terms of individual transactions need to be standardized as much as possible and resources should be established to support investor education on blending mechanisms and standards.

ORIGINATING, ARRANGING, AND MANAGING ASSETS

Institutional investors often prefer to partner with institutions who have the capacity to originate, arrange, and manage investments in developing countries. Most often, institutional investors do not have the capacity to originate and manage investments in developing countries and prefer to be passive investors, partnering with an active investor with comparative advantage in developing countries. DFIs are the best placed institutions to play this role, but they are not sufficiently incentivized to work with the private sector and to attract institutional investment to their transactions. The success of DFIs is primarily measured around capital deployed, as opposed to co-investments catalyzed. The originating, arranging, and managing of assets and work-out capabilities of the DFIs are arguably the most under-deployed public sector resource to achieve the Global Goals.

RECOMMENDATIONS FOR SCALING INSTITUTIONAL INVESTMENT IN BLENDED FINANCE

Based on the five key considerations laid out above, there are eight actions that can be taken to mobilize institutional capital at scale for the Global Goals through blended finance. These eight actions fit into four broad categories: i) engaging with institutional investors, ii) designing appropriate products and scaling successful solutions, iii) building off DFI capabilities and experience, and iv) disseminating return and impact data. These recommendations are directly linked to specific key considerations as summarized in the figure below.

Figure 25: Recommendations for scaling institutional investment in blended finance

| Recommendation | Alignment to key considerations | | | | |
|--|---------------------------------|-----------------------|---------|-------------------------|-----------------------|
| | Communica-tion | Policy and regulation | Mandate | Allocation and capacity | Transactional factors |
| Engaging with institutional investors | | | | | |
| Understand institutional investor mandates and the implications of catalyzing institutional capital | ✓ | | ✓ | | |
| Simplify messaging and communicate in the language of institutional investors | ✓ | | ✓ | | |
| Designing appropriate products and scaling successful solutions | | | | | |
| Collaborate on scaling up well-proven blended finance solutions, while also promoting standardization and reducing complexity | | | | ✓ | ✓ |
| Create mainstream assets such as investment grade, listed bonds and notes | | ✓ | ✓ | ✓ | ✓ |
| Develop portfolio solutions in preference to stand-alone transactions, in particular for debt | | ✓ | ✓ | ✓ | ✓ |
| Building off DFI capabilities and experience | | | | | |
| DFIs should increase the number and volume of transactions they arrange with the express purpose of transferring participation in aggregated portfolios of those assets to institutional investors | | | | ✓ | ✓ |
| Disseminate DFI return metrics to overcome perceptions by institutional investors | ✓ | | ✓ | ✓ | ✓ |
| Disseminating blended finance return and impact data | | | | | |
| Collect and report on blended finance return data and impact metrics | ✓ | | ✓ | ✓ | ✓ |

ENGAGING WITH INSTITUTIONAL INVESTORS

1. **Understand institutional investor mandates and the implications of catalyzing institutional capital:** Institutional investors are bound by obligations to their stakeholders to fulfill their investment mandates, with the priority of meeting certain financial return thresholds. Absent from most of these mandates today is any explicit focus on the Global Goals or other development objectives, and even where this may be of interest, there is no willingness to trade-off on financial returns in favor of those impacts. As a result, public and philanthropic funders should not expect institutional investors to make financial sacrifices to support the Global Goals, as that is not in the best interests of their stakeholders or those groups to whom they owe a fiduciary responsibility. Further, public and philanthropic funders should understand the implications of attracting institutional investment towards the Global Goals. Care must be taken by public and philanthropic funders to ensure international institutional investment is not catalyzed at the expense of local institutional investment, or that funding for end-beneficiaries does not become unaffordable.

2. **Simplify messaging and communicate in the language of institutional investors:** Blended finance is tantamount to structured finance where public and philanthropic funders deploy capital to create a risk-adjusted return profile attractive for private sector investment in developing countries. Blended finance is not an asset class, rather a structuring approach for asset classes such as private equity, infrastructure, and illiquid credit. Institutional investors already understand these asset classes and have allocations to them. Public and philanthropic funders should frame blended finance as a structuring approach with underlying asset classes that are understood by institutional investors. This framing should also focus on the credible investment opportunities presented by the Global Goals, which will provide important evidence to institutional investors when justifying mandates to support the Global Goals through investment. Further, blended finance should not be confused with other sustainable investment trends. There is already confusion in the market, and introducing a new term can only create more confusion, while also potentially slowing the momentum of other trends.

DESIGNING APPROPRIATE PRODUCTS AND SCALING SUCCESSFUL SOLUTIONS

3. **Collaborate on scaling up well-proven blended finance solutions, while also promoting standardization and reducing complexity:** There are many effective public and philanthropic funder instruments and blended finance solutions that address many of the risks most pertinent to institutional investment in developing countries. Focus should shift away from creating new solutions, and towards scaling up or refining existing solutions. Terms and structures of existing instruments, such as first-loss guarantees, should be standardized as much as possible across public and philanthropic funders to reduce transaction costs. It is critical that institutional investors are engaged early and continuously in this process to ensure solutions are aligned to their interests.
4. **Create mainstream assets such as investment grade, listed bonds and notes:** While most blended finance transactions to date have been private equity, infrastructure, or illiquid credit related, many blended finance transactions to date have a risk-adjusted return profile that will not attract institutional investors at scale. The best opportunity to achieve scale will be to create assets for which institutional investors have the largest allocations, which include traded fixed income products. Blended finance structures should be explored as a means to produce more investment grade debt products. Blended finance structures should also focus on producing capital market instruments like investment grade notes and bonds that are listed and provide sufficient liquidity. It is also critical that these structures be developed in collaboration with institutional investors. In parallel, it is valuable to work with policymakers to seek rule changes that provide balance sheet relief to lenders / underwriters for blended finance deals.
5. **Develop portfolio solutions in preference to stand-alone transactions, in particular for debt:** While portfolio solutions for equity are common (e.g., private equity funds), debt portfolio solutions are less common. Debt solutions are often dependent on risk ratings, and sovereign risk ratings for almost all developing countries are non-investment grade. Transactions in these developing countries are nearly always rated below the sovereign rating. Institutional investors are more inclined to invest in a portfolio of high risk, high return transactions than in similar transactions on a stand-alone basis, due to reduced probability of default and lower expected and unexpected losses. Debt assets derived from portfolios of underlying debt transactions when combined with blended finance support (e.g., credit enhancement through subordinated funding from public and philanthropic funders) can lead to investment grade profiles.

BUILDING OFF DFI CAPABILITIES AND EXPERIENCE

6. **DFIs should increase the number and volume of transactions they arrange with the express purpose of transferring participation in aggregated portfolios of those assets to institutional investors.** DFIs have the strongest comparative advantage to originate, arrange, and manage underlying transactions in developing countries that will attract institutional investment at scale. DFIs should be leveraged; in particular, their portfolio, presence, and capacity to pool assets and risk transfer should be optimized. This will be difficult however, as it requires the shareholders of DFIs to change the DFI's mandate and incentives. Only then can they become financial institutions that can be leaders in intermediating the higher flows of financing to developing countries required to achieve the Global Goals.
7. **Disseminate DFI return metrics to overcome perceptions by institutional investors.** The historical returns and losses for DFI loans to private sector borrowers in developing countries captured in the 25+ year GEMs Database have been better than credit rating agency data and market perceptions suggest. DFIs must make this data available to the private sector and rating agencies.

DISSEMINATING RETURN AND IMPACT DATA

8. **Collect and report on blended finance return data and impact metrics.** The main factor influencing investment decision-making of institutional investors is past performance of an asset class, previous success/failures with similar investments, and expected return from the asset class. There is currently a paucity of return data on blended finance transactions – in particular target or actual return data for commercial tiers of capital in blended finance transactions. In addition, there are no standard frameworks to compare an investment opportunity’s impact on the Global Goals. There is a need for greater transparency in the blended finance market to build the evidence base for institutional investors to justify participation. While returns on a transaction by transaction basis are unlikely to be reported publicly, a trusted industry intermediary could play a similar role to the Emerging Market Private Equity Association (EMPEA) by collecting return data and impact metrics and reporting to the market in aggregate.

NOTES AND SOURCES

¹ Business & Sustainable Development Commission (2017), *Better Business, Better World*. Retrieved from <http://report.businesscommission.org>

² Business & Sustainable Development Commission and Convergence (2017), *The State of Blended Finance*. Retrieved from <http://businesscommission.org/our-work/working-paper-the-state-of-blended-finance>

³ Note: While out of scope of this report, local institutional capital in developing countries is critical for blended finance. The barriers to entry for local institutional investors in developing countries are lower given certain risks may not be as acute (e.g., currency, political, foreign exchange) compared to international institutional investors. To illustrate their importance, pension funds in Africa are expected to double in size by 2020 – to \$620 billion – as a result of the continent’s growing workforce and expanding economies. However, Africa pension funds currently allocate only 1% of their assets to domestic private equity investment³, representing a largely untapped opportunity for blended finance.

⁴ Note: Many institutions fall into multiple segments. For example, diversified financial institutions often have a commercial banking arm, investment banking arm, as well as an asset/wealth management arm. Similarly, insurance companies often have asset/wealth management arms.

⁵ United Nations (2015), *General Assembly resolution 70/1 – Transforming our world: the 2030 Agenda for Sustainable Development*. Retrieved from http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/70/1&Lang=E

⁶ Business & Sustainable Development Commission (2017), *Better Business, Better World*. Retrieved from <http://report.businesscommission.org>

⁷ United Nations Conference on Trade and Development (2014), *World Investment Report 2014 – Investing in the SDGs: An Action Plan*. Retrieved from http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf

⁸ United Nations (2015), *General Assembly resolution 69/313 – Addis Ababa Action Agenda of the Third International Conference on Financing for Development*. Retrieved from <http://undocs.org/A/RES/69/313>

⁹ OECD (2017), *Blended finance – Mobilizing resources for sustainable development and climate action in developing countries*. Retrieved from <http://www.oecd.org/cgfi/forum/Blended-finance-Policy-Perspectives.pdf>

¹⁰ There are a number of definitions of blended finance. The OECD definition is the broadest, including both concessional and non-concessional funding from public and philanthropic funders mobilizing non-concessional funding from either private or public sources. In this broad definition, concessional funding from a donor (e.g. European Commission) to mobilize funding from a DFI (e.g., the European Investment Bank) would be considered blended finance. This report focused on the mobilizing of institutional private capital, and structures where concessional funding is provided from public and philanthropic funders.

¹¹ United Nations Sustainable Development Solutions Network (2015), *Investment Needs to Achieve the Sustainable Development Goals*. Retrieved from <http://unsdsn.org/wp-content/uploads/2015/09/151112-SDG-Financing-Needs.pdf>

¹² Convergence historical deal database as of November 2017

¹³ Ibid

¹⁴ This dataset includes 56 transactions with concessional debt/equity catalyzing commercial investment in the capital structure.

These calculations are based on multiple estimates and should be taken as indicative trends only. Leverage varies greatly across structure types and sizes, focus sectors, and target countries, and therefore overall leverage ratios should be interpreted with caution.

Only transactions with relatively robust data on committed concessional investment amounts are included in the analysis.

Commercial investment includes both private investment and commercial DFI investment; private and commercial DFI investment is not disaggregated because of a lack of data.

Leverage is calculated as commercial capital divided by concessional capital. This calculation does not include indirect leverage – for example at the project level for funds.

¹⁵ Illiquid credit is defined as debt securities that do not have an active secondary market in which they can be traded

¹⁶ Based on analysis of Convergence database of over 200 historical blended finance transactions

¹⁷ PRI (2017), *Annual Report 2017*. Retrieved from https://annualreport.unpri.org/docs/PRI_AR-2017.pdf

¹⁸ Global Sustainable Investment Alliance (2014), *2014 Global Sustainable Investment Review*. Retrieved from http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf.

Global Sustainable Investment Alliance (2016), *2016 Global Sustainable Investment Review*. Retrieved from http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf.

Definitions according Global Sustainable Investment Alliance:

Negative screening: the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria

ESG integration: the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis

Impact investing: Targeted investments, typically made in private markets, aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose

¹⁹ Ibid

²⁰ Assets under management is used for simplicity across all segments, even though the term is less common when referring to banks.

²¹ Pension Funds: Willis Towers Watson (2017), *Global Pension Assets Study 2017*. Retrieved from <https://www.willistowerswatson.com/en/insights/2017/01/global-pensions-asset-study-2017>. Data includes pension funds in 22 major pension markets.

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Sovereign Wealth Funds: Sovereign Wealth Fund Institute (2017), *Largest Sovereign Wealth Funds by Assets Under Management*. Retrieved from <https://www.swfinstitute.org/sovereign-wealth-fund-rankings/>.

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[Future defined as in the next 12 months](#)

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