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Blended Finance

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Blended finance is a strategic approach that combines public and private funding to mobilize private capital flows towards emerging and frontier markets. It aims to attract commercial capital to projects that benefit society while providing financial returns to investors. This approach is particularly useful in situations where private investments are not commercially viable due to high risks or noncommercial returns. By blending public finance with private investment, blended finance mechanisms can help bridge the financing gap for various development objectives, including green finance and renewable energy investments. Blended finance has become an essential tool for mobilizing private capital to support infrastructure development, particularly in emerging markets where financing gaps are most pronounced. By strategically using public or concessional funds, blended finance aims to attract private investment to projects that are deemed too risky or unprofitable and therefore not occur under normal market conditions. The key objective is to de-risk investments and catalyze private sector participation, often through the provision of financial protections such as concessional loans, risk guarantees, and equity contributions.

Blended finance?has emerged as a an important tool to attract private investment for sustainable infrastructure development, especially in low-and middle-income countries (PPIAF/GIH 2024). Despite their ample resources, private financiers often view infrastructure investment as high risk due to various factors, including larger asset sizes, long project life cycles, complex structuring, large initial irrecoverable costs, political and regulatory changes, wariness of citizens to accept privately run services due to perception of higher prices, and the lack of tradability of infrastructure assets. Blended finance addresses these issues by improving risk-adjusted returns and mobilizing private capital to close infrastructure financing gaps (WB 2024a).

As a result, they are increasingly being used for PPPs that address global challenges, particularly in infrastructure development, climate change mitigation, or social impact initiatives. This includes PPP projects that advance climate change mitigation and adaptation and channel capital toward renewable energy expansion, climate-resilient infrastructure, and nature-based solutions. Blended finance solutions can also play an important role in lower-income and fragile and conflict-affected situations (FCS), where political instability and credit risk may deter private investment and innovative and pioneering projects can be critical to economic growth, market creation, and poverty reduction.

Characteristics of Blended Finance

Blended finance combines concessional finance and commercial finance to mobilize private capital flows towards emerging markets and developing economies by improving the risk-return profile of investments, typically in support of projects that have a positive social, economic, or environmental developmental impact and that can be scaled. One of the primary roles of concessional finance is to reduce the risk for the private investors. This can typically be achieved by financing instruments with terms are more favorable than those available from commercial financial institutions, such as below-market interest rates, longer maturities, grace

periods, or flexible repayment profiles that would not normally be offered by private lenders (IFC 2021). Blended finance typically involves several financial instruments such as:

- **Concessional finance** is financing on terms and/or conditions that are more favorable than those available from the market.?It is generally sourced from governments or other development partners, for example, development agencies, multilateral development banks or funds, or philanthropic organizations (such as foundations, charitable organizations) that require less of a return than the market.
- **Senior or subordinated loans** provided at below-market interest rates or other non-commercial terms.
- **Guarantees or risk-sharing facilities**, which transfer all or part of the financial risk of a loan or group of loans to the guarantor, with fees charged at below-market rates; this could be, for example, in the form of a first-loss protection, where the donor guarantees a portfolio of investments of a financial; intermediary and pays out before the senior guarantor in case there is a payment default.
- **Equity**, an ownership stake in a company or participation in a fund, with return expectations below what market investors would expect.
- **Grants**, either finance with no expectation of repayment, or performance grants that are paid if a project reaches specified milestones.

Role of Multilateral Development Banks in Deploying Blended Finance

Multilateral Development Banks play a critical role in this process, leveraging their unique expertise, resources, and mandates to address the market failures and risk aversion that typically discourage private investment in infrastructure. They can structure blended finance vehicles that combine public capital with private sector funds, providing the right mix of equity, debt, and grant financing to make projects financially viable. he involvement of MDBs in PPPs is particularly crucial in emerging markets, where infrastructure needs are significant but private investment is often deterred by high perceived risks. MDBs are adept at structuring risk-sharing arrangements and offering concessional finance to encourage private sector participation (WB 2023a). Their expertise enables them to provide the patient capital required for long-term infrastructure projects, an essential feature of many PPPs.

Maximizing Finance for Development (MFD) Strategy: The World Bank's Maximizing Finance for Development (MFD) strategy prioritizes the mobilization of private capital through blended finance and PPPs. Through this strategy, MDBs have developed methodologies for calculating and reporting private investment in infrastructure projects, providing a clear pathway for investors to participate (WB 2018).

The Private Sector Window (PSW) offer innovative financial products to catalyze private investment, particularly in low-income and fragile countries. Mechanisms such as the **Blended Finance Facility** and the **Risk Mitigation Facility** help reduce the risks faced by private investors, making large infrastructure projects more attractive and feasible.

Risk Mitigation Facility (RMF): IFC's Risk Mitigation Facility (RMF) has been instrumental in attracting private capital to projects that would otherwise be considered too risky, such as major energy or transportation infrastructure. By providing guarantees without sovereign indemnity, the RMF mitigates risks like political instability or currency fluctuations, enabling private sector participation in critical development projects (IDA 2023). The latest mid-term review provides lessons on the allocation of concessional and private capital mobilization through PSW (WB 2023b).

Blended Finance Facility (BFF): IFC's Blended Finance Facility (BFF) combines support from the IDA Private Sector Window with strategic IFC investments in sectors that offer significant development impact, such as small and medium enterprises (SMEs), agribusiness, healthcare, education, affordable housing, infrastructure, and climate change mitigation and adaptation. By addressing a range of financial risks linked to investments in SMEs, agribusiness, and other pioneering sectors, the BFF helps unlock private sector opportunities that drive productivity gains and innovation. It builds upon and broadens IFC's existing

blended finance initiatives—including the Blended Climate Finance programs, the private sector window of the Global Agriculture and Food Security Program (GAFSP), and SME Finance facilities—while also expanding into new, high-impact areas (IDA 2024).

IFC's Blended Finance Instruments and Facilities

At IFC, blended finance is a financing package of concessional funding from development partners, blended with commercial funds from IFC's own resources, other development finance institutions, and the private sector. For close to 20 years, IFC has used blended finance to enable private sector development in innovative and nascent sectors in emerging markets. Blended finance supports high-impact transformational projects in new sectors, technologies, and challenging markets or market segments. IFC Blended Concessional Finance has been supporting private sector investment by IFC and others in key development areas, including climate change, agribusiness and food security, gender, SMEs, health, and low-income and fragile and conflict-affected markets, especially through the IDA Private Sector Window.

Blended Finance Products: IFC's and other DFI's blended finance products are market-linked instruments, including senior and subordinated debt, guarantees, and equity, along with others related to local currency. The choice of instrument depends on participation or behavioral constraints limiting the flow of private capital. Blended finance co-investments can be structured to:

1. Mitigate investment risks and re-balance risk-reward through "de-risking" to crowd-in commercial and DFI investors.
2. Provide pricing discounts to enhance returns and help make the project sustainable.
3. Align incentives and maximize development impact.

The 5 DFI Enhanced Blended Finance Principles

When IFC considers providing a co-investment for blended finance in a particular project, it reviews the project based on the DFI Enhanced Blended Finance Principles. IFC chairs the DFI Working Group on Blended Concessional Finance, consisting of over 20 DFIs. In 2017, the group agreed on the set of 5 enhanced principles to have a common approach to using blended concessional finance in the private sector. These principles include:

1. **Economic Rationale for using Blended Concessional Finance:** the project must have strong development impact, clear DFI additionality, and blended finance additionality.
2. **Crowding-in and Minimum Concessionality:** concessional funds should be used in a targeted and catalytic manner, ensuring only the minimum support necessary to make projects viable.
3. **Commercial Sustainability:** projects and sectors need to become commercially sustainable to contribute to market development.
4. **Reinforcing Markets:** concessional funds should help create markets and reinforce market reforms.
5. **Promoting High Standards:** strong governance processes and high transparency are required to ensure the effective application of these principles.

Impact of Blended Finance and Private Capital Mobilization

Blended finance infrastructure deals attracted 40 percent of private capital for every $1 worth of public or philanthropic money during 2021-2023, and around 10 percent of them mobilized more than $2 for every $1, according to the Infrastructure Monitor 2023 report based on Convergence database (GI Hub 2023). However, most blended finance currently used to mobilize private capital heavily relies on government financial support and collaboration between public and private sectors (WB 2024a).

In addition to blended finance, MDBs also employ sophisticated financial instruments like project bonds, syndicated loans, and structure equity investments to facilitate the flow of private capital into infrastructure projects. These tools help scale up financing by bringing together a mix of public, private, and institutional investors to pool resources for large-scale projects. MDBs are essential for mobilizing private capital, particularly in the infrastructure sector. They enhance the marginal productivity of capital in developing countries, thus encouraging private investors to commit funds. Additionally, MDBs create innovative financial structures that go beyond traditional financing methods, which helps to unlock the potential for large-scale private investments. PPPs are critical mechanisms in this effort, facilitating the flow of private capital (WB 2024b).

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