UNDERSTANDING BLENDED FINANCE IN THE LENS OF INTEGRATED FINANCING

BLENDED FINANCE OVERVIEW

Environmental Policy Unit

https://www.unep.org/resources/policy-and-strategy/environmental-policy-unit

Introduction

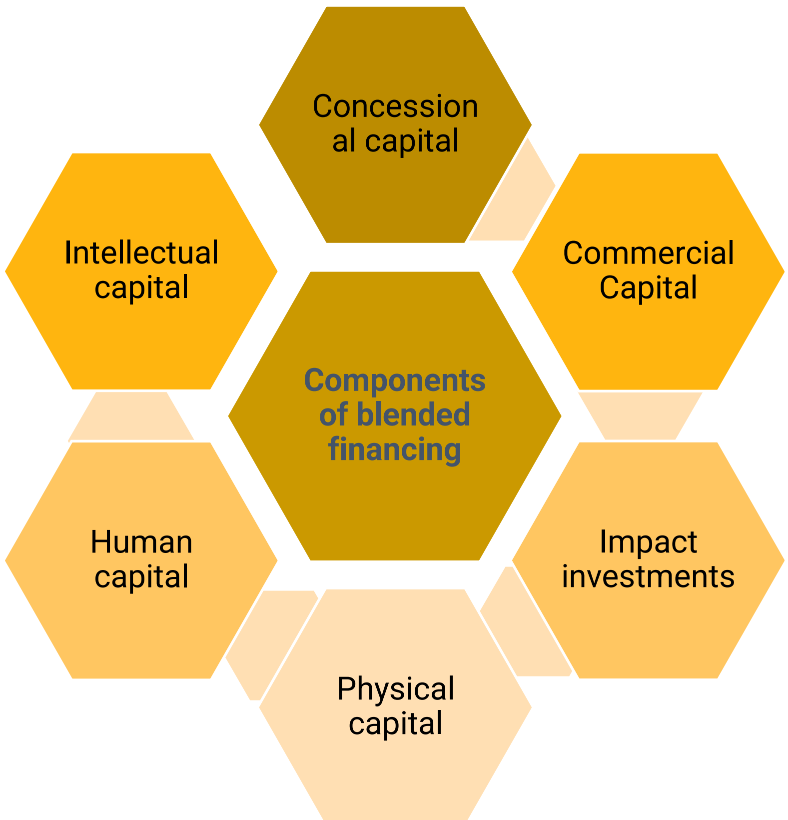
The world today faces the triple planetary crises of climate change, biodiversity loss, and pollution, demanding urgent action to reverse climate change and halt biodiversity loss. The Kunming Montreal Global Biodiversity Framework (KM GBF) indicates an existing biodiversity financing gap of $700 billion that necessitates addressing to halt biodiversity lost and reverse climate change impacts. Additionally, the 2023 adaptation gap report by United Nations Environment Programme identifies a widening adaptation financing gap estimated between $194 billion and $366 billion per year.

Addressing these financing gaps calls for leveraging integrated financing in ocean, biodiversity, and climate financing. However, integrated nature financing faces a myriad of challenges that discourage investments from the public and private sectors. Blended financing provides a pathway to mobilize nature-positive related investments, addressing the prevailing environmental concerns, including the triple planetary crises.

What is Blended Financing

According to the Organization for Economic Cooperation and Development (OECD), blended financing is the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries. It attracts commercial capital towards projects that contribute to sustainable development while providing financial returns to investors. The innovative approach enlarges the total amount of financial resources available to developing countries, complementing their investments and official development assistance (ODA) inflows to their sustainable development goals financing gaps, aiding support of the implementation of the Paris Agreement goals, aligning financing resources to the KM GBF goals and targets, and achieving set environmental goals at the country, regional and global levels.

Components of Blended Financing



1. **Concessional Capital**

Concessional Capital refers to finances issued on better and favorable terms as compared to actual market rates. It can include below market rates, longer payment periods, grace periods, and partial guarantees. Concessional capital may be offered by government agencies, development financial institutions, philanthropic institutions, among others.

2. **Commercial Capital**

This refers to financial resources in businesses e.g assets or money used to run their operations and investments. Commercial capital encompasses financial capital (finances that businesses use to run their operations, acquire assets and investments), which includes both equity and debt.

3. **Impact Investments**

Impact investments refers to investors (Organizations, individuals, or funds) seeking to generate both financial returns and positive environmental impacts through their investments. Their main desire is to make positive contributions to the global sustainable development goals and address the current pressing global challenges while achieving set financial goals and targets.

4. **Physical Capital**

Encompasses tangible assets such as machinery, equipment, among others, that contribute to the production capabilities of a business or organization.

5. **Human Capital**

As the name indicates, human capital refers to expertise workforce who run the general operations of a business or organization.

6. **Intellectual Capital**

This encompasses intangible assets, for example copyrights, patents, and trademarks which enhances businesses competitive advantage.

Characteristics of Blended Finance

I. **Drives Impact:** blended finance aims at delivering positive and measurable socio-economic and environmental impacts.
II. **Leveraging:** blended finance strategically and systematically utilizes development finance to increase resource mobilization and enhance investments from the private and public sectors towards sustainable development.
III. **Increased returns:** blended finance enables investors to gain investment returns that meet their goals and priorities.

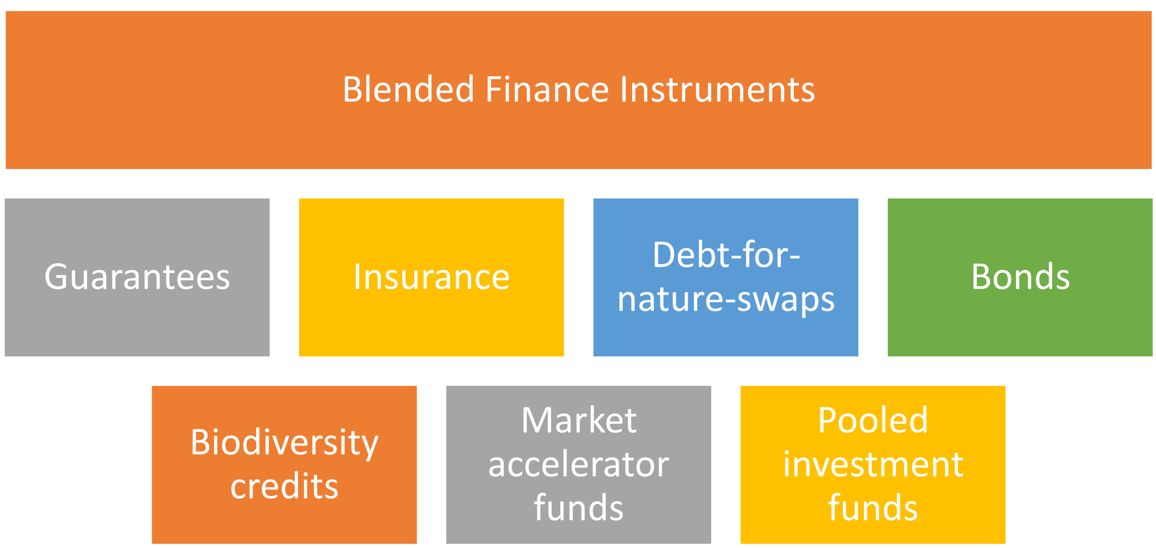
IV. **De-risking-** Increasing investments from the public and private sectors in areas that were presumed to have high-risk profiles, such as emerging and frontier markets mainly found in least developed countries. Blended finance de-risks these challenges.

V. **Better Environmental protection:** promotes sustainable development through catalyzing investments in initiatives and projects that promote sustainable development actions, goals, and targets.

VI. **Promotes partnerships-** blended finance works through creating positive working relationships, including cross-sectoral, bilateral, and multilateral partnerships, to drive positive environmental and socio-economic impacts in developing countries. Additionally, it works with different stakeholders, including local communities, women, and youth, to support implementation of different projects and initiatives.

Blended Finance Instruments

Emerging and frontier markets are presumed to be high-risk investment areas, which are unattractive to investors both in the public and private sectors. Blended financing involves a combination of various financial structures to de-risk investments in these high-risk areas including political risks, undeveloped markets, and limited market structures, offering a pathway to increase investments in these areas.



Some instruments that can be explored in blended financing include.

I. **Guarantees**- commit a guarantor to pay all or part of an underlying financial instrument to the investor on behalf of the primary obligator that has defaulted.

II. **Insurance**- provides compensation if a specific risk materializes. It can compensate for the actual loss subject to assessment or be parametric, which has a predetermined pay-out based on a quantifying event occurring.

III. **Market accelerator funds-** offers support and resources to catalyze growth and development in emerging markets or companies.

IV. **Pooled investment funds (funds and facilities)-** aimed at pooling various capital and deploying it according to a specific investment strategy.

V. **Bonds (green/blue/sustainability/ gender bonds**)- themed debt instruments issued by either public or private organizations to borrow money from investors referred to as bondholders over a certain period and attracts an agreed rate of interest income called coupon rate.

VI. **Debt-for-nature-swaps-** financial mechanism that allow (debt restructuring) portions of a developing country's foreign debt to be restructured in exchange for commitments to invest in climate resilience, reduce emissions, or biodiversity protection initiatives.

VII. **Biodiversity credits-** economic instruments used to finance actions that result in measurable positive outcomes for biodiversity e.g., species, ecosystems, natural habitats, among others, through creation and sale of biodiversity units.

Principles in Blended Finance

I. **Additionality**- means adding value either financially or development-wise beyond what already is available in the market or otherwise absent and crowds in private sector investment.

II. **Catalyzes investment**- contributes to crowding in investments in sustainable development from the public and private sectors and enhances market structure developments.

III. **Strengthening emerging and frontier markets**- contributes towards enhancing strong market structures that are effective and efficient to address prevailing and anticipated risks e.g., political risks and market failures that would discourage investments in the developing countries' markets.

IV. **Promoting and upholding quality standards**- blended finance seeks to promote adherence to set and establish guiding standards cutting across sustainable development, whole of society approach, whole of government approach, transparency, disclosure and contributing to achievement of sustainable development goals, KM GBF, national, regional, and global environmental goals.

V. **Promoting investment in sustainable development-** enhances the sustainability or maturity of investments encompassing environmental goals and targets. Additionally, it increases investments in nature-positive related investments that are unattractive to the private sector.

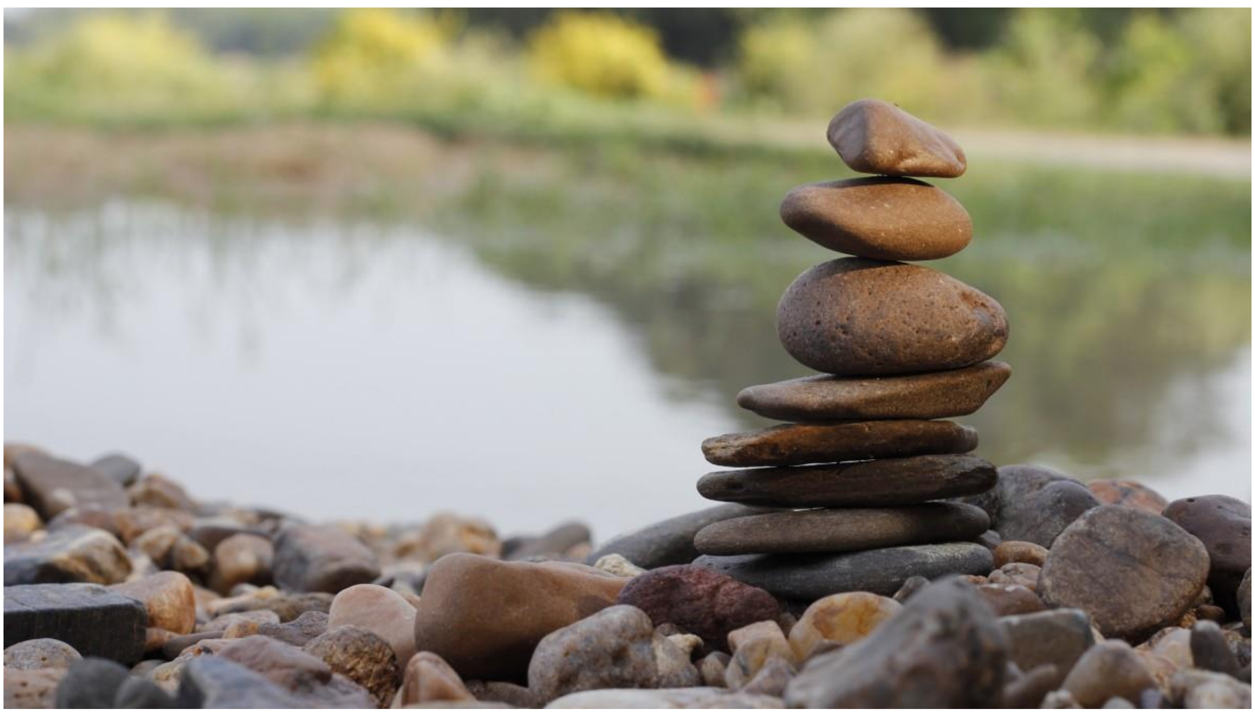
VI. **Alignment with global environmental goals** – blended financing aligns with SDGs, KM GBF, Paris Agreement goals and environmental goals at the country, regional and global level to address the pressing global challenges, including the triple planetary crises.

VII. **Risk mitigation**- de-risking investments in developing countries to attract investments from the public and private sectors e.g., using guarantees and insurance, among others, to catalyze investments.

VIII. **Enhances disclosure and transparency**- through implementing robust metrics and reporting frameworks to increase the availability of data that investors can use as a basis for analysis to decide on when and where to invest.

IX. **Enhance partnerships and collaboration**- facilitates positive collaboration between government, international government organizations, private sector, civil society, and other relevant stakeholders to enhance the implementation and effectiveness of initiatives and leverage on existing and diverse expertise.

X. **Meets the needs of the local context**- implement and deploy blended finance that supports the local priorities, development needs, and capacities to contribute towards the development of the local financial markets.



Approaches in Blended Finance

I. **Technical assistance grants**- allow existing knowledge gaps to be addressed. Examples of technical assistance include skills training, development and analysis of viable products, early-stage financing preparations, and support the development of projects. Technical assistance can be easily set up and accessed through funds and facilities or in another organized modality. Some of the core benefits of technical assistance include.
    - Enhanced institutional and human resources capacity building and development.
    - Cost savings in overall project costs through the provision of upfront costs e.g., training and preparation of the project, which would have been covered by the investors. This can greatly increase the will to invest from relevant investors.
    - Enhanced efficiency of the local markets by creating and enhancing the robustness of the market structures.
    - Enhanced partnerships
    - Enhanced sustainable development- technical assistance encompasses environmental goals and targets that projects need to have in place to access the available funds.

II. **Risk mitigation (underwriting)-** for example, through the provision of guarantees and insurance increases investor confidence to invest in high-risk areas. Investors are more confident that even with negative impacts on their investments, they would suffer negligible losses from their investments.

Benefits of underwriting
    - Boosting investor confidence by addressing the risk-return ratio
    - Creates an enabling Environment for investment in areas presumed to be high-risk areas.
    - Increases the ability of projects and investors to meet their goals and targets by enhancing access to funds in different sectors.

III. **Market incentives**

Market incentives drive investors' decisions in economies to invest in various sectors. Market incentives are particularly important in markets that require innovation to address and drive development and increase viability for investments by commercial markets where they were not in prior existence. Examples in blended finance could include challenge funds, development bonds etc.

IV. **Concessional finance**- blended finance increases access to funds at below-market rates, which in turn reduces the overall implementation costs for a project.

V. **Impact investment**- incorporates different investors' needs. Includes individuals, institutions, and organizations who seek to achieve both financial returns and have positive social and environmental outcomes. Therefore, investors can invest in projects and initiatives that align with sustainable development goals and are more likely to attract blended finance.

VI. **Partnerships-**(including public private partnerships)- partnerships are derived in both private and public entities to collaborate in designing, implementing, financing and operating projects. Investments could be in environmental conservation, sustainable infrastructural development among others.

Mitigating Risks: Types of Risks in Today's Market that Blended Finance Addresses

- Political risk
- Liquidity risks
- Technical risks
- Credit/defaulting risks
- Accessing funds risks (finance risks)
- Lack of pipeline risk- challenges in generating and developing bankable projects
- Off-take risks- risks associated with difficulties in securing long-term contractual commitments to purchase resources.
- Currency risk- risk of depreciation of a currency

Conclusion

Blended finance emerges as a powerful and dynamic mechanism/framework that not only address the prevailing financing gaps for the implementation of global environmental goals and frameworks but also creates a collaborative and comprehensive approach towards the achievement of global sustainable development. As the world grapples with unprecedented environmental challenges, blended finances avail a pathway for mobilizing resources, mitigating investment risks, and fostering positive environmental and socio-economic impacts on a global scale.