STATE OF BLENDED FINANCE 2023 TRENDS AND RECOMMENDATIONS FOR ACHIEVING SCALE

Input Paper to the Impact Taskforce prepared by Convergence
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Convergence's State of Blended Finance 2023, which focuses on climate blended finance, finds that blended finance levels are not at the scale needed to fill the SDG financing gap by 2030.

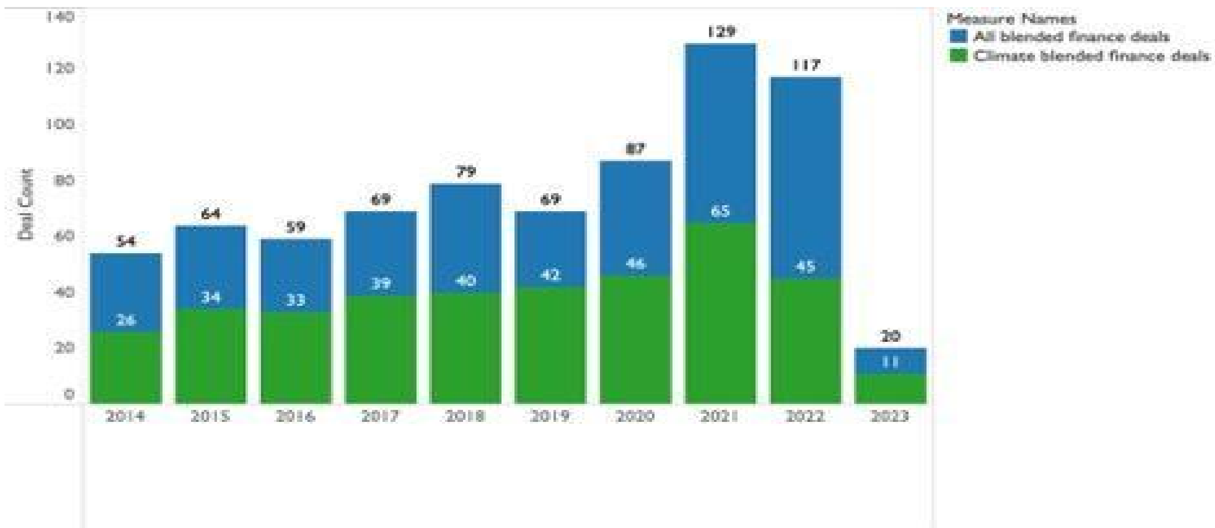

Figure 1: Transaction count, total blended finance market vs. climate blended finance market 2014 – October 2023, Source: Convergence State of Blended Finance 2023

Despite capturing a similar deal count in 2022 compared to 2021, Convergence found that total deal volume decreased by approximately 45% in 2022 and about 55% in climate blended finance, reaching a ten-year low in total financing. Moreover, climate-blended finance transactions accounted for under 40% of all blended finance deals in 2022, while in each of the previous five years, climate-focused transactions accounted for 50% or more of the annual deal count.

Convergence's State of Blended Finance finds that private sector investors are the main source of capital to climate blended finance transactions by volume; the private sector invested an average of $2.3 billion in commercial capital to climate blended finance deals. However, private sector climate financing totals have plateaued. Aggregate financing flows from private sector investors decreased by 45% in 2020-2022 from totals registered between 2017-2019.

Critically, the supply of concessional capital to climate blended finance deals has been stagnating since 2017 (only a minor increase from $967 million per year between 2017-2019 to $1.08 billion 2020-2022) and is nowhere near the levels required to reach key mobilization targets, such as the United Nations Conference on Trade and Development's (UNCTAD) recent estimate that $6 trillion in climate finance to developing economies by 2030 is needed to reach just half of their Nationally Determined Contributions (NDCs).

In view of the above trends, it is apparent that i) mobilization of private investment must be prioritized as an explicit goal of blended finance, and must be championed by the MDBs and DFIs within their operating model, and ii) scarce concessional capital must be deployed efficiently and judiciously in order to maximize its leverage.

Where Blended Finance Can Contribute?

To this end, Convergence identifies the following areas for where blended finance is best positioned to scale and to contribute to overall challenges facing private investment towards EDMEs.

1) Advancing the role of MDBs and DFIs in scaling blended finance, including climate blended finance

Convergence's Action Plan for Climate and SDG Investment Mobilization, co-authored with USAID, outlines how MDBs and DFIs can increase their private sector mobilization targets for blended finance, alongside other development finance actors. Specifically, Convergence recommends that MDB and DFI shareholders establish a set of strategic Key Performance Indicators (KPIs) that would guide MDB/DFI management to prioritize deeper integration with the private capital [1]required to achieve the SDGs and fully embrace a de-risking partnership with donor governments and philanthropic foundations consistent with their existing risk mandates.

MDB/DFI financial contributions to this more integrated approach would be through three types of financial commitments:

a. Originate and arrange higher amounts of financial assets in strong demand by investors, and distribute them to blended finance vehicles and investors.
b. Invest in mezzanine positions in blended finance vehicles aligned with existing MDB/DFI risk mandates, thereby creating more investment assets that meet the fiduciary obligations of private sector investors.
c. Originate and arrange financial assets in low demand by investors, but having high financial and developmental additionality, and hold those assets on their balance sheets when they cannot be distributed to blended finance vehicles and investors.

2) Incorporate and Integrate Philanthropic Capital

The landscape of climate finance has seen an increasing shift towards utilizing various forms of capital to address the monumental challenges of climate change. While traditional donors have always been at the forefront, integrating philanthropic capital offers a fresh, flexible, and innovation-driven approach to

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financing climate solutions. Philanthropic institutions, with their capacity for risk-taking and their commitment to creating social impact, have the potential to act as true catalysts, bridging gaps that other forms of capital can't. Between 2017-2022, philanthropic organizations provided 10% of all concessional capital commitments to climate blended finance, indicating there is a large but unrealized opportunity to expand their participation in blended finance.

3) Mitigate currency risk

In developing and emerging economies, currency volatility has often deterred consistent and substantive investment in climate initiatives. This volatility is accentuated by high-interest environments, contributing to an even greater currency risk. Blended finance can directly address and mitigate these issues in climate and the broader development landscape. By combining public and private capital strategically, blended finance can create a more resilient and risk-mitigated environment for climate adaptation and mitigation transactions in developing economies.

For mitigation projects, like large-scale renewable energy, currency fluctuations can drastically impact viability, given the need for major upfront investments and long-term returns. Introducing first-loss capital tranches, where public funds absorb initial currency shocks, can safeguard private investor capital. Local currency swap facilities, also supported by public capital, shield investments from short-term exchange rate swings. For example, an MDB could offer hedging products and credit enhancements to a solar project facing local currency devaluation and extended payback - reducing perceived risk and ensuring continuity.

4) Optimize the use of Technical Assistance and Design Funding

The provision of technical assistance through blended finance structuring can offer targeted support to various aspects of climate projects, including boosting capacity, facilitating monitoring and reporting, and supporting the enabling environment for climate investments. In an effort to accelerate the market, Design Funding is a targeted type of grant support focused on designing, testing, and scaling innovative blended finance solutions at both the early-stage and market-ready stage to attract capital to under-financed SDGs in developing countries. Design Funding addresses a market need and funding gap in the development process of blended financial vehicles occurring in their incubation and later acceleration stage. Having deployed $12M (from different types of funders including a family office, government agencies, and foundations) across a portfolio of 42 blended finance solutions, Convergence Design Funding grants have mobilized approximately US $1.9B in capital since 2017. Some notable examples of grants include – (i) Aligned Climate Capital for structuring the Climate Finance Partnership with BlackRock that has completed an initial financial close of US$673M; (ii) NatureVest and The Nature Conservancy (TNC) for designing the Blue Bond which has completed the financial close of $364M; and (iii) ADM Capital & ADM Capital Foundation for Tropical Landscapes Finance Facility (TLFF) that completed the close of Asia's first corporate sustainability bond of USD95M. Through this demonstration effect, the concessional capital providers have increasingly acknowledged the catalytic nature of design stage grant funding and its excellent track record for market acceleration. Convergence currently manages three Design Funding Windows, all incorporating climate finance, as well as the Catalytic Climate Finance Facility - a partnership between Convergence and the Climate Policy Initiative (CPI).

In summary, Design Funding is a unique market acceleration program providing early-stage grant funding focused exclusively on the design of innovative blended finance solutions. Despite the significant potential of blended finance, the reality is that often transactions are complex, time intensive, and high-cost to structure and launch. Design Funding is meant to support this process and encourage organizations to design solutions that would otherwise be too risky or complex to pursue, but show high potential to attract private capital at scale if successful. Convergence has traditionally offered feasibility stage and proof-of-concept grants. Feasibility stage grants are to be used to explore the feasibility of a blended finance solution. For example, activities funded under a feasibility study grant could include assessing the investability/bankability of a transaction, conducting market scoping, and developing the vehicle structure. Proof-of-concept grants are to be used for the completion of all design and structuring activities required to get a blended finance solution to launch. For example, activities funded under a proof-of-concept grant could include finalizing the capital structure and financial model, establishing the legal structure, and finalizing key documents. Newly introduced grant types focus on the solution's next stage of growth via scale-up and expansionary grants. Grant amounts and duration depend on the solution's stage of development as well as the Design Funding window under which the grant is awarded.

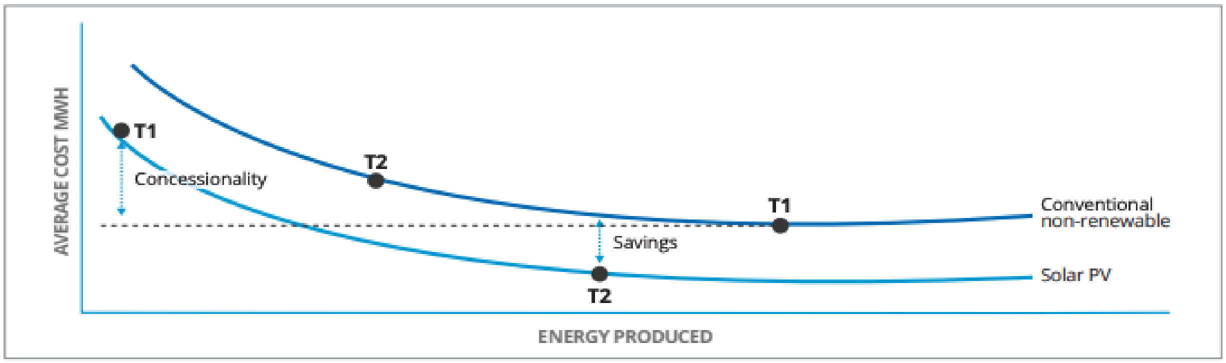
5) Empower LDCs and Champion Bottom-up Approaches

The prevailing top-down approach to country finance platforms often prioritizes global climate transition aspirations and overlooks the unique perspectives and expertise present within Least Developed Countries themselves. Redirecting the focus towards a more grounded, LDC-centric model can yield robust, sustainable, and community-aligned outcomes that better reflect on-the-ground realities and priorities.

Blended finance can directly contribute to the framing of large initiatives like JETPs, which represent a massive interlinked set of actions by a multitude of parties. Blended finance is effectively a structuring approach that places parties into specific roles that line up with their mandates. In thinking of a JETP as a meta-blended finance transaction, those leading their design may find a ready language for identifying the requirements and motivations of each of the players and a smoother pathway toward separating actions and expenditures out into those best taken on by national governments, community leaders, regulated and unregulated investors, and international bodies.

Proactive efforts by LDCs to engage the investment community can also boost pipeline development and attract commercial capital. Showcasing successful initiatives, presenting clear data on returns, and demonstrating government support can serve as potent signals to the broader commercial investment community.

Example Case Study – Developing the Solar Market in Uruguay using Blended Finance



Source: Developing the Solar Market in Uruguay Case Study

In 2013, the Government of Uruguay launched a 200MW tender program to attract private sector participation in the development of solar photovoltaic (PV) power plants and increase the share of renewable energy in Uruguay's energy matrix.

IDB Invest and the Canadian Climate Fund for the Private Sector in the Americas (C2F) addressed the primary market barriers to institutional investor investment in Uruguay's nascent solar market. IDB Invest played a central role in arranging long-term financing and subsequent refinancing for three solar PV projects in Uruguay, creating a demonstration effect for attracting private sector and cross-border investment in renewable energy. They secured a total of US$188.2 million in financing, with a significant portion ($47.4 million) provided by the Canadian Climate Fund for the Private Sector in the Americas (C2F). These projects, located in the Salto, Río Negro, Soriano, Paysandú, and Salto Departments, contributed to the diversification of Uruguay's energy mix and the expansion of its renewable energy capacity.

C2F's concessional funding in the projects was on favorable terms that were otherwise unavailable in the commercial market. This included longer tenors and subsidized interest rates, which improved project viability, enhanced credit profiles, and reduced the overall cost of debt. Importantly, it helped bridge financing gaps that exceeded the requirements of institutional investors. As the risk perception of renewable energy assets improved, IDB Invest witnessed a shift in the market. By 2018, long-term commercial financing became more accessible, and by the end of 2020, all the projects were successfully refinanced in the bond or commercial bank market. Notably, in the initial refinancing of the projects, C2F continued to participate at a reduced subsidy level to achieve an investment-grade rating. However, in all subsequent refinancings, C2F's involvement was fully prepaid, indicating the projects' improved financial standing and reduced reliance on concessional financing.

Key Insights:

- **Blended finance can help bridge the gap to market maturity:** Blended finance, particularly the soft capital from the Canadian Climate Fund for the Private Sector in the Americas (C2F), played a crucial role in bridging the gap to market maturity. C2F's concessional financing helped align borrower credit and project risk profiles with institutional investor expectations. It also allowed for longer tenors on IDB Invest loans, ensuring the bankability of projects. As risk perceptions of institutional investors changed and the cost of solar PV equipment decreased, concessional financing became less necessary. Institutional investors began replacing the subsidization model, making solar projects increasingly attractive in the capital market and outcompeting fossil fuel-fired energy.
- **Blended finance can be an effective tool to incentivize gender impact:** The deals also demonstrated that including performance-based pricing (PBP) schemes in concessional capital structures can effectively incentivize actions for gender impact. By providing monetary incentives for hiring women in the construction sector, IDB Invest motivated project sponsors to prioritize gender equality outcomes. This approach, documented within the legal framework of the transactions, entrenched the importance of gender impact and attracted prospective investors. However, additional interventions are required to address underlying issues that contribute to gender inequalities.
- **Taking a programmatic approach to blended finance can produce greater impact than ad hoc investing:** The energy market outcomes have showcased the success of IDB Invest's programmatic approach. At the beginning of the solar tender in 2013, private ownership of renewable energy assets was low at 5%. However, by 2018, the clean energy sector attracted US$4.5 billion in private-sector investment, with foreign investors contributing 75% of the capital. The share of non-renewable sources in Uruguay's energy supply decreased from 58% to 37% between 2005 and 2018, while energy imports, primarily fossil fuels, virtually ceased. This shift reduced dependence on hydroelectric power and expensive, high-emission fuel imports, leading to improved productivity and resilience in the industry. The replication of proven models for similar transactions will be instrumental in scaling up solar markets elsewhere and achieving broader sustainable energy goals.