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RESEARCH BRIEF

Blended Finance

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Blended finance aims to blend philanthropic and public capital to help mobilize private capital investments. This study analyzes recent IFC blended-finance deals to show that DFIs use perceived project impact and risk to make decisions on concessionality, with implications for how to optimize deployment of this important finance tool in the sustainability domain.

ABOUT THE PRIZE

The Moskowitz Prize recognizes research that exhibits empirical excellence and the potential to inform responsible business and investing practices in the real world.

SUMMARY OF FINDINGS

What are the decision-making dynamics behind blended finance?

Blended-finance deals are those offered by development finance institutions (DFIs) like the International Finance Corporation (IFC) to improve the risk-return profile of sustainability projects and attract private capital—through use of below-market interest rates, risk-mitigation components, and other concessionary mechanisms.

The authors developed a framework representing the tradeoffs DFIs face among concessionality, expected societal impact, and potential risk in choosing how to allocate limited resources to blended-finance deals. They predicted DFIs would provide more concessionality to (1) projects with higher expected sustainability impact and (2) those with higher risk such as political risk. To test the predictions, they analyzed the concessionality (proportion of total investment cost represented by the DFI's blending subsidy) of 173 recent IFC blended-finance deals.

As expected, concessionality was linked with both larger anticipated impact and higher perceived risk. For example, a one-standard-deviation increase in expected sustainability impact corresponds to a 1.9–2.3–percentage-point higher blending subsidy. The results suggest DFIs use perceptions of impact and risk to make blended-finance decisions, with implications for how to wield this valuable tool effectively to drive meaningful societal change.

Blended Finance: Decision-making and Dynamics

Mitigation of climate change and biodiversity loss—and the existential threats these cause—is financed primarily by public funding and private philanthropy, leaving a large funding gap. “Blended finance” merges private capital with public or philanthropic capital to subsidize and de-risk the private capital, catalyzing such investment for renewable energy, climate-tech, nature-based solutions, and other projects worldwide. But blended finance remains nascent and thus its dynamics are not yet well-understood.

To address this, the authors developed a conceptual framework for the tradeoffs development finance institutions (DFIs) like the World Bank’s International Finance Corporation (IFC) encounter in decision-making related to the provision of blended-finance solutions. They also analyze data from recent IFC blended-finance deals to provide empirical evidence for how such transactions come to life and perform in the real world.

Core to the work is the idea that DFI-backed blended-finance deals use below-market interest rates, risk-management facilities (like cross-currency swaps), and other concessionary mechanisms to improve the risk-return profile of private capital, attracting such capital for sustainability projects that might not otherwise be funded.

A Predictive Framework for Blended Finance

The authors’ framework takes the perspective of DFIs with limited budgets from funds received from governments and donors—specifically, that selection of projects involves tradeoffs among concessionality, expected societal impact, and potential risk. The primary prediction is that a DFI is more willing to

provide concessionality for projects with higher perceived sustainability impact, but must also increase concessionality for projects it opts to fund that are associated with higher risk (such as country-specific political risk), to attract private capital.

The researchers tested those predictions using details disclosed by the IFC on the degree of concessionality of recent blended-finance deals, expressed as a percentage of the total investment cost representing the blending subsidy. They studied 173 blended-finance deals—in both industrial and finance sectors—over the period from 2018 to 2023. About half the projects were based in Africa, with the remainder in Asia and the Pacific, Latin America and the Caribbean, Eastern Europe, and the Middle East.

Potential sustainability impact was measured mainly by the number of UN Sustainable Development Goals (SDGs) to which the target project was expected to contribute; public information on political risk and information asymmetries was used to assess the project's degree of risk.

Impact, Risk, and Concessionality in the Real World

The research delivered several key findings aligned with predictions.

First, there's a positive association between a project's expected sustainability impact and degree of concessionality: a one-standard-deviation-higher sustainability impact is linked to a blending subsidy that is higher by 1.9-2.3 percentage points.

Second, perceived project risk is also associated with greater concessionality, as predicted. That is, concessionality was higher for projects based in countries with greater political risk and/or information asymmetries. In such cases, the blended-finance deal structures were more likely to include risk-management provisions.

Finally, the researchers find that the IFC is more likely to use blended-finance deals—versus market-rate investments without partners—for projects with higher expected sustainability impact and country-specific risk, in line with the findings above.

Overall, while the results suggest DFIs grant concessionality to projects with greater expected impact, the authors note that this doesn't necessarily mean organizations select the highest-impact projects, as selection may be influenced by donor-imposed restrictions and other factors.

KEY DATA

- Degree of concessionality (IFC's disclosed subsidy percentage of total investment cost for each blended-finance deal from 2018 to 2023)
- Number of UN Sustainable Development Goals (SDGs; 17 total) to which project expected to contribute
- IFC qualitative assessment of project-related environmental and social risk
- Country-specific political risk (based on data from World Bank's world development indicators)
- Country-specific information asymmetries (based on data from Open Data Inventory)
- IFC choice of blended-finance versus market-rate deals for sustainability projects

PRACTICAL IMPLICATIONS

- *Blended-finance deals by DFIs can be potentially effective tools in attracting private capital to sustainability projects by improving risk-return profiles for private investors, with project choice based on expected impact and risk*
- *The IFC, other DFIs, and private investors can use the framework and findings here to better inform decision-making around whether to enter blended-finance deals and what degree of concessionality to use for prospective sustainability projects*
- *Blended-finance structures are especially valuable in high-risk contexts such as countries where political risk or information asymmetries are a key impediment to private investment*

QUESTIONS FOR FUTURE RESEARCH

On the relationship between concessionality and realized project impact:

Do DFIs tend to use blended-finance deals with higher concessionality for sustainability projects that ultimately deliver higher actual impact on environmental and social dimensions?

On the potential "dark side" of blended finance:

Do DFIs use blended finance disproportionately for sustainability in certain industries or regions over others? Is this more likely to make these deals backfire or perform poorly?