Blended finance—an underutilized approach with great potential?

Authored by:

Mike Hayes
Head of Global Renewables, KPMG International

Laura Frigenti
Global Head of the International Development Assistance Services Institute, KPMG International

Ravi Suri
Partner, KPMG in the U.A.E.

Success in meeting the Paris Climate goals and reducing societies' carbon footprint depends on mobilizing additional private finance, as public funding will go nowhere near the required levels of investment, particularly for developing countries where climate change poses the most serious risk.

Economies in the developing world face twin challenges: the outsized impact of climate events on their populations and the greater policy uncertainty surrounding regulation and the macroeconomic environment that undermine access to long-term private capital. This makes mobilizing green capital for sustainable energy deployment in low-income economies a key challenge. Here we discuss the role of blended finance to help address the needs of developing economies.

Is it all about the money?

The starting point should be recognition that the costs of not adapting to climate change are high. We are already seeing the impact on agriculture, health, and economic development in emerging countries. Recurring headlines highlight the devastating social impact of climate events and the enormous costs of disaster relief and rebuilding communities. In addition, developing economies have large unmet energy needs that add further layers of complexity and vulnerability: 1.2 billion people globally are without access to electricity.[1]

Against this background of urgent needs, it is noteworthy that there is no shortage of available capital worldwide seeking long-term investment opportunities. Capital in pension fund insurance firms, sovereign wealth funds, and capital markets totals in the trillions of dollars. Already, private capital flows to the developing world average roughly US$1 trillion/year from direct investment, loans, and portfolio investment. At issue is how to tap these resources for climate change mitigation, particularly given the perceived level of risk.

Blended finance

Even in the best policy environment, however, there are inherent risks that can inhibit investment. Investors must bear these "first-mover" risks in the hope of making profits, if these are to be overcome. In most developing economies, this type of risk-taking is constrained by insecure property rights, uncertain government policy environments, and the limited appetite of early-stage risk capital or robust capital markets to provide equity for growth.

One approach to reduce the investment deficit is to blend private and public capital. A blended finance approach uses public sector resources—whether from international donor agencies, multilateral banks, or

[1] https://www.visualcapitalist.com/mapped-billion-people-without-access-to-electricity/

© 2020 KPMG International Cooperative ("KPMG International"), a Swiss entity. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved. NDP054804-2E

national entities—to finance riskier mezzanine tranches that can catalyze additional private investment. When designed properly, this approach can ensure adequate longer-term finance for bankable projects, create an arm's-length relationship with investees for the public sector, protect intellectual property, and successfully leverage private capital.

There are many effective ways of implementing a blended finance structure, including the following:

— The public investor takes a first-loss position, which enables all cash generated from a project to flow to the private investor until a hurdle is reached.

— The public investor provides cash-backed guarantees to protect the downside position of a private investor.

— The public investor accepts submarket returns for its investment with compensating superior returns available for the private investor.

The key point is that while this structure has begun to be used frequently by various multilateral players, its full potential has not yet been exploited, and this is principally down to a local communication and connectivity between the public and private sectors. This needs to change.

The development of early-stage funding should not be viewed in isolation of the entire financing ecosystem. Additional sources of equity finance, mezzanine debt, and long-term debt are needed to meet the needs of firms throughout their growth cycle. The innovations in the green bond market and the establishment of green banks show promise that lifecycle funding will be available as the sustainable energy markets mature.

New partnerships

Efforts to carry out policy reform and build effective risk-taking investment models should be based on effective long-term partnerships. Where these partnerships address the market failures, the results are more likely to be positive and more durable.

To identify the appropriate policy framework, governments can partner with international agencies, donors, and technical advisers who can benchmark their arrangements against successful leading practices. In the transformation to new investment-ready policies, there is a need to derisk projects through the use of seed capital and project preparation funding to jumpstart sustainable energy markets and other climate change solutions.

Entities within the private sector at large—businesses, asset owners, fund managers, and investors—also have important roles in embracing these new financing solutions.

Conclusion

Today, it is widely recognized that our survival depends on achieving a low-carbon world. In response, markets are already mobilizing capital, and there is a paradigm shift as businesses and investors incorporate climate risk into their investment decisions. There is also a growing realization that new technologies and business approaches are needed, and this is why blended finance is an ideal example. If successful, we can accelerate the shift to a low-carbon world by making sustainable energy accessible across all countries, all geographies, and all levels of society.

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2020 KPMG International Cooperative ("KPMG International"), a Swiss entity. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved. NDP054804-2E