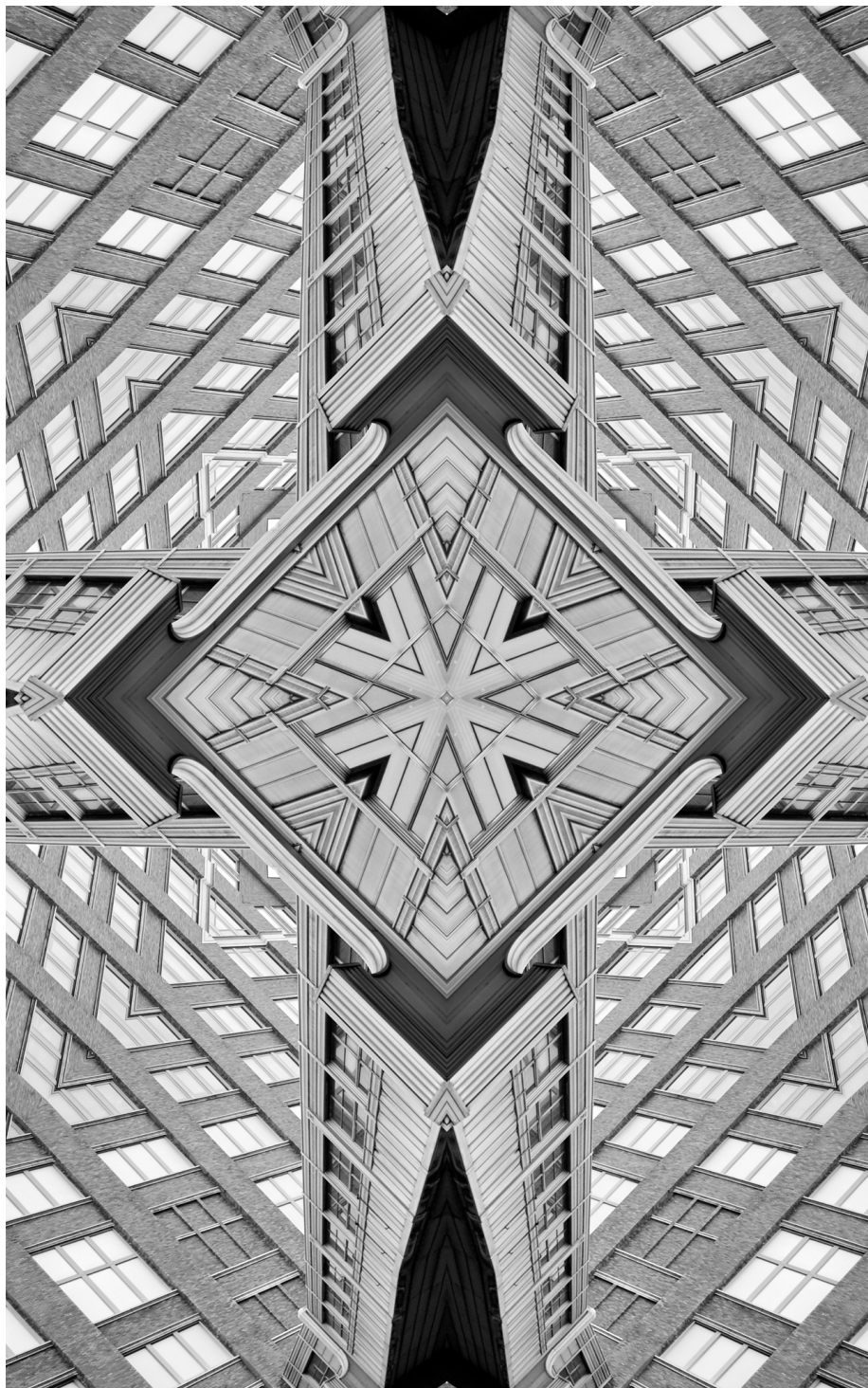


Issue Brief

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Enhancing Blended Financing for a Sustainable Future: Challenges and Potential Solutions

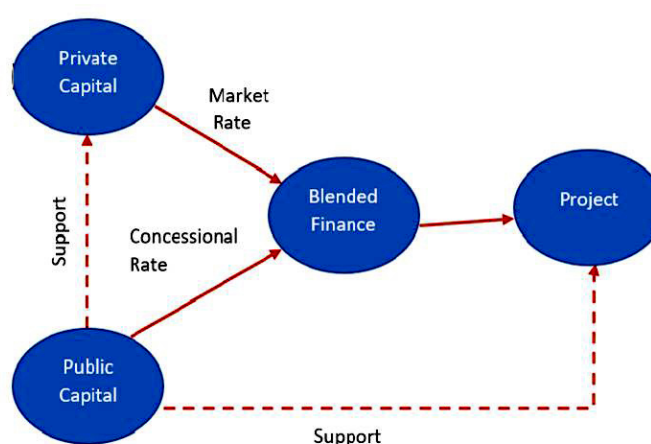
**Labanya Prakash Jena and
Amlan Bibhudatta**

Abstract

An enormous amount of capital is required for climate change mitigation and adaptation globally, but especially in emerging markets that have the dual burden of achieving development and meeting national climate goals in the coming decades. Although it is tough to estimate the precise amount of capital required to achieve these goals, it is anticipated to be in the range of trillions of dollars. However, the flow of capital into green sectors is plagued by many challenges. The quantum of public capital will be inadequate to meet these needs, and while private financiers hold large assets under management and can bridge this gap, they hesitate from investing in sustainable activities due to a perceived and real higher financial risk. Higher risks scuttle any interest from low risk-seeking financiers. Innovative financing instruments and business models can be used to meet the needs of financiers and borrowers, thereby attracting private finance for climate action. Blended financing, which uses public capital as leverage to attract large-scale private investment, is one promising instrument. This brief identifies challenges associated with existing blended financing structures and offers solutions. To scale-up blended finance to meet the funding needs for climate actions, development finance institutions must shed their risk aversion to attract large private financing.

Blended financing is the strategic use of public finance to mobilise much-needed private capital for projects that create positive externalities but may face market failure (see Figure 1).¹ The concept of blended financing originates from public economics. Though blending of capital is an old practice, the formal definition of blending for developmental purposes, as it is known today, has been formulated recently.² For example, climate-friendly economic activities generate positive externalities, while carbon-intensive and polluting activities generate negative externalities. However, fully internalising the costs and benefits of these externalities is significantly challenging, suggesting a market failure. Hence, there is a need for a correction through financial policies and regulations, including using public capital for climate-friendly projects, thereby addressing market failure in climate change.³ Additionally, even green technologies that may offer market return (such as solar energy in India) have a lukewarm rate of adoption and are growing slower than desired due to several challenges, including financial. A judicious blend of public and private capital can improve the expected return of such projects, thereby attracting a large amount of capital and resulting in the rapid adoption of green technologies.

Figure 1:
Structure of Blended Finance Mechanisms



Source: Authors' own, based on various sources

The usage of public capital depends on the level of market development. The amount of public capital depends on the intensity of market failure and the need for public subsidies to attract private capital. Blended financing uses public capital to attract private capital, which is currently used at a suboptimal level for climate actions.⁴ It is a mechanism that can be used to incentivise the private sector to invest when it is not willing to do so. Blended finance puts together concessional and risky finance from the public sector with private finance in projects with higher risk.⁵ The idea is to mix concessional funds and commercial capital in a risk-sharing arrangement with aligned incentives to ensure public capital can be leveraged as much as possible to attract private capital.⁶ It also includes the use of grants from private and/or public sources to provide financing on terms that would make certain projects financially feasible and/or sustainable (see Table 1).⁷

Table 1:
The rationality of blended financing

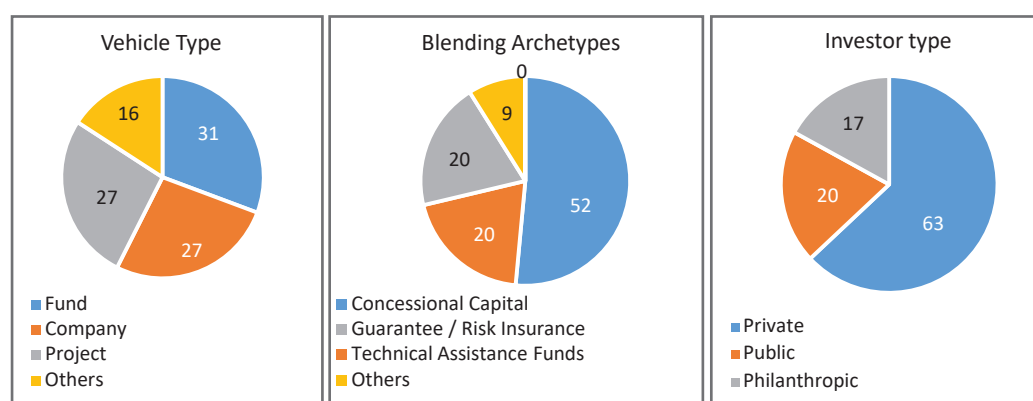
Social Vs. Private Returns	The distinction between social and private returns is important in public finance. As blended financing combines public and private finance, it is generally used for critical development activities missed by the private sector. The use of public capital in a blended financing mechanism is considered legitimate when the social returns derived from the projects exceed private returns.
Financial Additionality	Blended finance should be used only where financial additionality is observed. One key element of additionality is private financial additionality. When purely private investments are not realised due to high risks, public contributions (whether voluntary or otherwise) are required to attract private financiers.
Development Additionality	Developmental additionality is an outcome of blended financed projects. It means to investigate whether blending yielded superior results (i.e., would development outcomes be better in the absence of commercial capital in the project). The additionality is the impact of crowding in commercial capital for social welfare.
Lower perceived risk	Sustainable development projects are seen as risky by private financiers. But they lack the knowledge to assess such projects. The successful implementation of a blended financing mechanism in sustainable projects could address asymmetric information risk and send a positive signal to private financiers.

Source: Authors' analysis, based on various sources

Blended financing is dynamic in nature—i.e., the need for public capital lowers as the market develops and the riskiness of projects reduces. It includes a combination of instruments such as grants, guarantees, debt, and equity through appropriate structuring that can reduce risks in these projects and, consequently, the cost of capital.⁸

The novelty of a blended finance structure is its flexibility, allowing for differentiated financial payoffs. For example, public financiers such as foundations, governments, and multilateral agencies can provide grants with the expectation of no or below-market return.⁹ Private financiers such as commercial banks and private equity funds can provide capital with market return expectations. By blending public and private capital, large-scale capital can be sourced from private financiers for climate projects. This will also help attract low-risk-seeking financiers by reducing the risks of projects and lowering the cost of capital, making the project commercially viable.¹⁰ Besides, public capital is also used at the early stages of many infantile sectors, including sustainable activities, enabling these sectors to attract private capital till they are independently ready. Several blended finance vehicles/platforms have been structured globally and in India, with public capital deployed as grants, concessional loans, and junior equity/patient equity instruments.¹¹ Figure 2 provides an overview of the composition of blended financing instruments.

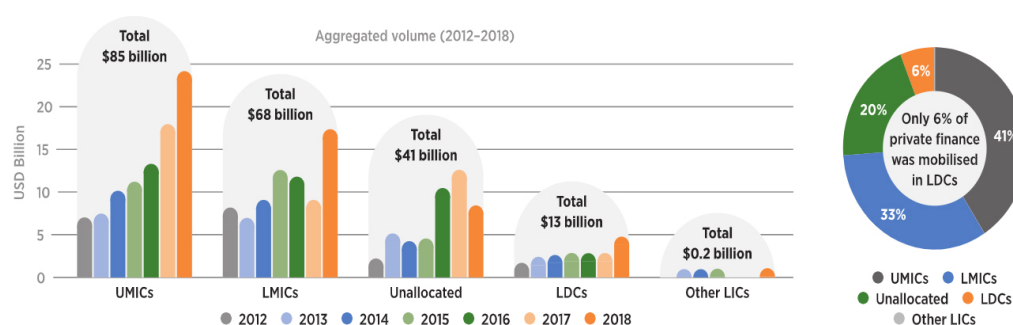
Figure 2:
Blended Finance mechanism by vehicle type, sector type, and instrument type



Source: Authors' analysis, based on Convergence data

The primary reason for the growing acceptance of blended finance is its speculated potential to raise enormous amounts of money for development from the private sector with considerably lesser official development assistance.¹² Blending was part of a wave to exploit development finance to generate opportunities for investment in ‘frontier’ economies.¹³ Figure 3 demonstrates that the concentration of blended finance (i.e., private finance mobilised through development financial interventions) is disproportionately high in upper middle-income countries and missing in lower income countries and least developed countries, which is precisely where it is needed the most. It can be used for sectoral purposes, such as the development of a critical nascent industry (for instance, electric vehicles, public transport, and agriculture) or project-specific purposes, such as improving sanitation at the local level.

Figure 3:
Usage of public capital for private
finance mobilisation



Source: OECD¹⁴

Although blended finance strategies offer evident advantages, their market has experienced sluggish growth globally. According to Convergence, a worldwide network for blended finance, the total blended finance flows have reached nearly US\$180 billion as of 2022, with an average annual capital flow of around US\$9 billion since 2015. This amount is considerably inadequate compared to the substantial capital needed to attain the Sustainable Development Goals (an estimated US\$4.2 trillion annually in developing countries).¹⁵

Public financiers are not taking adequate risk

A key component of a blended financing mechanism is risk sharing to reduce the exposure to a level where private investors feel comfortable participating in transactions. Still, there has been limited participation from private financiers in blended financing transactions for sustainable projects as these are not yet financially attractive due to the readiness and riskiness of such projects. This also suggests that public financiers have failed to reduce the riskiness and increase the readiness of sustainable projects to a stage where they can attract private capital. The aspirations of DFIs and multilateral banks (MDBs) to maintain an AAA rating may be the reason for them to not take higher risks; consequently, private investors must bear a significant level of risk.¹⁶ The AAA rating, assigned by credit rating agencies to borrowers, is widely considered as the gold standard of credit rating and denotes an extremely low expectation of default risk. MDBs are risk averse and mostly provide debt capital, which is significantly less catalytic than guarantees. They are reluctant to provide risky capital as it may hamper their credit rating, which allows them to tap international bond markets at lower rates. However, MDBs are almost always backed by capital commitments from developed countries and can thus afford to take additional risks without a decline in credit rating. Also, the functioning and ratings of MDBs cannot be equated to that of commercial banks. An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks, conducted during Indonesia's G20 presidency in 2022, noted that the financial risks faced by MDBs have been overestimated by stakeholders and rating agencies, and suggested that there is sufficient headroom for organisations like the World Bank to relax capital adequacy ratios and/or lending limits/ratios.¹⁷ Credit rating agencies have also confirmed that relaxations can be made without hampering existing ratings. In December 2022, the International Bank for Reconstruction and Development (IBRD) increased its sustainability lending limit, and is reconsidering its equity-to-lending ratio to unlock more capital.¹⁸ These are

only early steps towards more comprehensive MDB reforms to unlock more capital and channelise international debt securities to support the development agenda in lower- and middle-income countries.

Institutional and regulatory challenges

Domestic banks and commercial investors are typically conservative in nature, and their risk profiles are governed by regulations and fiduciary responsibilities. Since several sustainability-related projects are perceived to be financially risky, domestic banks and institutional investors do not lend or invest in such projects. Besides, domestic institutional investors rarely invest in the alternative asset class as they face a regulatory ceiling here. They prefer to invest only in high-quality liquid financial instruments listed in the stock market. They also do not have experience in investing in unlisted projects or the ability to assess risks associated with project financing, including in sustainable projects.^{19,20} Development banks are not entirely serious in their consideration of climate change in the lending or risk management operations, and their engagement is limited. Even though climate change action, climate adaptation, and development are closely related, development banks are not taking proactive measures to provide capital for climate actions. Besides, they rarely consider the financial additionality of their own capital deployment, a key component of blended financing.

Lack of transparency

There is a lack of available meaningful information on blended financing, which restricts stakeholders from making informed decisions. From the public financiers' perspective, there is a lack of evidence on the development impact of blended financing transactions to prove the efficiency and efficacy of the instrument. There needs to be an evidence-based justification of why the project needs grants or concessional capital and how private investors can enjoy market returns from the project. Although several public finances, including MDB, DFIs, and donors, evaluate the impact of their concessional financing or grants, the information is confidential.²¹ There is a lack of benchmarking information available to assess the effectiveness of public finance from a comparative perspective, for example, whether public financiers over-subsidise private finance in any transaction. Private investors have limited awareness of the terms and conditions of public financiers, especially donors. Additionally, there is limited information available on the historical performance (returns and

risks) of a blended transaction, which limits their ability to assess the riskiness of projects.^{22,23} Addressing this evidence gap in development performance and results is key to boost blended financing.

Absence of intermediaries

There is a disconnect between opportunities in sustainability and investors as the opportunity size is small and complex. Moreover, private financiers find it extremely difficult to find the right investment opportunities—that match their investment risk and return objectives—as blended financing is a new and novel mechanism. Generating investment deals, due diligence exercises, and structuring deals will be expensive for private investors, particularly if the deal size is small. DFIs and MDBs are the primary financial intermediaries in the sustainability space as they source deals, perform due diligence, and structure deals, but largely for themselves. The absence of intermediaries in sustainability projects makes it hard for private financiers.²⁴

High cost of structuring

Blended financing needs a bespoke transaction structure—a tailoring structure to suit the needs of several financiers. The laws, regulations, and tax issues associated with blended financing transaction structures are expensive. The burden of this should ideally rest on the intermediary, which could aggregate the requirements of many firms of a smaller size to form a sizable investment opportunity. Investors usually note that the development community should advocate for deals above US\$500 million through aggregation platforms to unlock economies of scale among private participants.²⁵ Additionally, there is no common repository for various types of like-minded investors—small, medium, or large sizes—to collaborate for investments, and build a familiarity with the regulatory frameworks and financial conditions of a country. Eventually, the standardisation of deals rather than spontaneous transactions will be the key to reducing transaction costs significantly, which will help small-size deals. Intermediaries could intervene in these loopholes. These intermediaries can standardise contracts and structures to reduce the transaction cost and time. They can also aggregate small projects and make them sizeable enough to attract a large amount of capital at a competitive rate.

Regulatory challenges to merging different types of capital

There are rules and regulations that prevent the mixing of various sources of capital, which limits the blending of financing. Laws and regulations also prevent public investors from providing certain kinds of capital. For example, charities in India cannot invest in debentures and shares in the country, and corporate social responsibility funds cannot be used to provide low-cost capital^{26, 27} since the concept of capital implies a financial return, which is strictly associated with investments and not philanthropy. At the same time, corporates find it difficult to receive grants because of tax inefficiencies that make it impossible to crowd in investments. There is a general conservatism on the regulatory front towards mixing capital in the developing world. One potential reform is for the Securities and Exchange Board of India to allow social venture funds to give loans directly to for-profit and non-profit entities, and allow charities in certain cases to participate as guarantee-providers to leverage private capital. These reforms need to be held to extremely high regulatory enforcement standards or they will be prone to misuse.²⁸

“There are several challenges to blended financing, such as the risk-averseness of public financiers, institutional and regulatory issues, lack of transparency, absence of intermediaries, and high cost of structuring.”

Addressing the Challenges

Public capital providers—primarily governments, publicly funded institutions, and MDBs—have the most critical role in scaling the adoption of blended financing. They need to take adequate risks in projects to improve risk-adjusted return that can attract a large amount of private capital. They must also create an enabling condition, such as a conducive legal and regulatory framework, to ease the use of the blended financing instrument. Public capital is also required to create bespoke financial structures and set up new institutions to focus on blended financing transactions. While bespoke models will meet the mandate of distinct types of investors, a new institution can connect investors and investees, and create a database to demonstrate the performance of blended financing transactions. The database will not only demonstrate the financial performance of transactions to private investors, but also positive externality to justify the usage of public capital.

Pushing public financiers to take higher risk

Since public financiers have a higher appetite to take risks compared to private capital, they should focus on derisking projects to attract private capital. They should change their capital deployment strategy and use risk-mitigating financial instruments such as guarantees, insurance, and local currency hedging, which can derisk project or financial risks. These mitigating risk instruments can bridge projects and private capital, thereby crowding in the much-needed private capital to green projects. Public finance can be used to attract private financing in green projects in the following ways:

Guarantee

Guarantee mitigates different forms of risks to protect private financiers against capital losses. There are two ways guarantee mechanisms can be deployed: market incentive and risk underwriting. Market incentive is appropriate where the normal market fundamentals do not exist (such as for new products or services or a distressed market).²⁹ Risk underwriting is more appropriate for improving the credit profile of projects to attract cheaper commercial debt capital or reducing risk to match investors' appetites. It addresses the concern of private capital providers to ensure their capital can be preserved in relation to macro or project/company-specific risks. Guarantees are mostly used for facilitating and anchoring in the stage when there is a financial risk for equity and debt investors.

Addressing the Challenges

The use of guarantees can be more catalytic compared to debt and equity financing. Underwriting a particular risk or a bucket of risks can reduce the exposure and can improve the risk-adjusted returns of the project. As public capital (including international climate finance) will not be locked in a project, it will only be called in when there is a realisation of the risk. This means the capital deployment for guarantees will be lower than debt and equity capital, but financial additionality is high. For example, a partial credit guarantee facility by MDBs can improve the credit profile of bonds issued by renewable energy developers. The improvement of the credit rating of bonds can attract a massive pool of long-term and low-cost private capital from low risk-seeking institutional investors such as pension funds and insurance companies. Public capital can be used as a guarantee that can be structured with individual financial transactions or at a portfolio level to attract large-scale private capital.

As guarantees can target a specific risk in a project rather than the entire risk, international climate finance can be optimally used.³⁰ Even the public capital (international climate finance) will not be locked in a project, it will only be called in when there is a realisation of the risk. International climate finance providers are in the best position to assume the risk as they have the mandate to deploy a substantial portion of capital for climate action. As the capital of MDBs and DFIs are diversified across sectors and countries compared to domestic financial institutions, they are in a better position to diversify these risks. It is also important to design guarantee mechanisms as an effective way to attract private capital. The burdensome administrative work, delay in payment to creditors, default or any other risk event, and excessive guarantee fees discourage private financiers. MDBs have limited workforce to examine and structure guarantee products that do not allow them to fully use the instruments to achieve higher leverage of their proprietary capital. The higher use of guarantees by MDBs could make their portfolio risky and they could lose their AAA rating. Hence, MDBs do not use guarantees as a financial instrument to attract a large pool of private capital. However, a firm financial commitment by developed countries to MDBs can assure rating agencies and help MDBs retain their AAA rating.

Equity

Equity capital from public financial institutions can be blended with private capital (equity or debt) and can be used for new technology where the probability of failure is high, or for matured technologies where equity investment is the

Addressing the Challenges

riskiest. At both stages, equity investment can attract large private capital at the stage when the technology matures or at subsequent stages.

The challenge in the net-zero path is the development and large-scale deployment of new technologies that have huge carbon-scrubbing potential. Zero fossil fuel energy systems are impossible, particularly in the hard-to-decarbonise industries. Carbon sequestration through forestry alone is not going to be sufficient. This means there is a need to finance the development and deployment of new technologies.

The high-risk profiles, information asymmetry, prohibitive cost of due diligence, and uncertain exit opportunities discourage financiers from funding new technologies. There are two such funding gaps in the pre-commercialisation stage—the technology ‘valley of death’ at the research stage and the commercialisation ‘valley of death’ during the pre-commercialisation stage. International climate finance can provide seed investment through early growth commercialisation, thereby addressing the early-stage risk investment shortfall and stimulating private investment. In such a scenario, international climate finance can play a significant role by funding at the pre-commercialisation stages. Equity infusion through equity funds can play a key role in product development. These funds can be blended with the domestic government’s grant and equity funding at a pre-commercialisation rate. Other capital providers, such as angel investors and venture capitalist, can provide follow-on funding when the technology crosses the early high failure hurdles.^{31,32}

Several developing countries are carrying huge debt burdens and are in no position to take on additional debt. International public financiers can provide equity capital instead of debt capital, which can help countries avoid a debt crisis. Also, a limited amount of risky equity capital can attract a large amount of debt capital. For example, debt-equity ratio in clean energy projects varies between 2:1 to 4:1 depending on the risk profiles of the country and the project. However, a small equity capital contribution by public capital financiers can attract a large amount of private debt capital for climate-friendly projects. The leverage could be in the range of 2X to 4X. The leverage ratio could be greater if public financial institutions are the cornerstone investors and can attract other equity capital providers.

Addressing the Challenges

Historically, MDBs have focused on providing loans and grants and occasionally investing in equity. Equity investments carry a higher level of risk compared to loans. MDBs typically have a conservative approach to risk management to protect their capital. MDBs are better equipped to provide loans and grants than to engage in equity investments. They have extensive experience in project finance, loan administration, and technical assistance, which aligns with their core activities. Engaging in equity investments requires additional expertise, such as equity valuation, due diligence, and managing ownership stakes in companies, which may not be the primary focus or strength of MDBs. MDBs should shed their risk-averse investment approach and add workforce for equity investment without compromising their sustainable development mandate.

Unsecured debt

Closer to the commercialisation stage, technology ventures often lack access to institutional debt finance that can be availed at lower interest rates and longer repayment periods due to the absence of a business track record, technology risk, and the lack of collateral. Similarly, the industrial sectors struggle to get debt financing from banks and financial institutions for energy-efficient (and less-carbon intensive) equipment due to the perceived risk of inadequate financial savings from the replacement of carbon-intensive equipment. Besides, it is challenging to detach the new equipment and ring-fence for collateralisation, which banks and financial institutions need for debt financing. Seniority in the capital structure, third-party credit guarantee, and other credit enhancement products will offer banks adequate protection.³³

Given their commitment to climate change actions, international climate finance providers can take more risks in these projects and can provide long-duration unsecured or junior debt financing.^a This credit enhancement mechanism in the form of junior or subordinate debt offers additional protection from the seniority position, and mainstream financiers will be more comfortable providing credit to these projects. The blend of commercial and concessional

a Junior or subordinate debt is a type of debt that has a lower priority of repayment than senior debt. Basically, junior or subordinate debt is riskier than senior debt. In this context, subordinate debt decreases the riskiness of senior debt thereby attract private investors to invest in senior debt.

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capital can make the projects commercially viable through the reduction of the cost of capital. This blended structure can attract private capital that would not have come without the support of concessional capital.³⁴

MDBs rarely invest in subordinate debt as they have a lower level of security and higher risk compared to subordinate debt. A conservative lending approach and prudent risk management to maintain creditworthiness restricts MDBs from investing in subordinate debt. MDBs need to drop their extreme prudential investment policy to invest in subordinate debt, which has higher leverage than senior debt.

Grants

The provision of grants by MDBs and DFIs is small, which constraints the adoption of blended financing. In 2017, grants accounted for only 1 percent of concessional commitment by volume and of concessional project count.³⁵ Grants can be used in multiple ways, including as support for early-stage projects and viability gap funding. As the risk of failure is extremely high at an early stage, grants can be used as an incentive to attract private financiers. Grants can be used in combination with private capital (corporates or venture capital) to support early-stage innovations and proof of concept. Similarly, grants can also be blended with public and/or private capital to make the project attractive enough for commercial financing. There are several climate-friendly projects that cannot stand on their own without grants due to technology or demand risk. For example, projects related to drinking water, air pollution, and protecting biodiversity cannot attract private capital without viability funding, at least in developing countries. So, grants can be blended with other sources of capital to make the project commercially viable.^{36, 37}

Setting up an intermediary

One solution to attracting private financing is to establish a specialised financial intermediary that connects investors and investees, conducts due diligence, and creates an open database of impact data. The specialised financial intermediary will facilitate private sector investments by identifying suitable investment opportunities and structuring deals that benefit both investors and investees. It will also create an open database of impact data, which will help public financiers make informed decisions about providing

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capital at a concession rate. The intermediary will also create an open database on the risk and return profile of blended financing transactions, which will help investors make informed decisions.

The intermediary can function as an aggregating agency to bring together the investment opportunities of multiple smaller companies for larger deals, thereby attracting private capital at scale. It can develop standardised templates for deals to reduce transaction costs and benefit smaller deals. Additionally, the intermediary can conduct preliminary due diligence on the basic financial and legal parameters of investments to reduce search and transaction costs to benefit smaller private investors.

Regulatory and institutional reform

Scaling up blended financing will require a conducive institutional and regulatory regime that provides private players with the flexibility to blend different forms of capital. For example, grants can be converted into equity if the project becomes successful, which will result in a better use of the grant. Governments could treat blended finance instruments as a distinct asset class and allow convertibility among financial instruments. They could begin by setting up taskforces on blended finance to engage with regulatory authorities, domestic banks and financial institutions, private financiers, philanthropic investors, and multilateral institutions, and arrive at a consensus regarding regulatory reforms. Some of these regulatory changes could be a distinctive treatment of blended finance instrument, transparency in policy decisions, allowing more flexibility and convertibility between asset classes, relaxation on foreign investments (especially in critical sectors), and the efficient implementation of these policies. Also, specific tools need specific attention to detail; for instance, guarantees are a popular blending tool, but their complexity will need a special regulatory approach.

MDBs must increase risk appetite

Given the nature of the problem, international development finance should provide long-term and patient capital, and take higher risks compared to private investors to accelerate large-scale private capital for climate actions. However, the choice of financial instruments and terms of capital are not helping the adoption of blended financing. In principle, additionality and leverage should be the two principles of MDBs' capital deployment strategy.

Addressing the Challenges

Since MDBs are funded by sovereign governments, additionality created by MDBs is an important criterion. In green projects, additionality is more critical for MDBs as these projects mitigate carbon emission, which is a global problem. Although MDBs and other DFIs have a dual mandate of generating a positive financial return and developmental obligation, the inclination towards more financial returns sacrifices the developmental mandates of MDBs.

International climate finance mostly provides loans and equity to developmental projects, including climate-friendly projects in developing countries, rather than credit enhancement instruments such as guarantees or subordinate debt, which have a greater ability to crowd in private capital. Blended financing needs various kinds of capital from diverse sources of capital. The heavy reliance on only two kinds of capital, mostly debt, does not help the adoption of the blended financing approach. The onus of maintaining an AAA rating makes MDBs risk averse and conservative. For instance, the portfolio of the International Finance Corporation (IFC) has become less risky over time, which is slowing down capital flows to sectors that need public financial support. Data suggests that MDBs and DFIs are principally using less risky senior debt rather than credit enhancement instruments such as guarantees, subordinated debt, grants, and equities.³⁸ Although all the major MDBs use guarantees for facilitating private capital in developing countries, they represent a small portion of their total investment portfolio. One study suggests that, in 2018, guarantees represented 8 percent of the European Bank for Reconstruction and Development's commitments, around 4 percent of the IFC's commitments, and 2.9 percent of that of the IBRD.³⁹ Since MDBs treat guarantees on the same basis as a loan in their books, there is no financial benefit for using guarantees instead of a loan from the shareholder perspective. Notably, the IBRD was envisaged as a guarantee institution, not a lending institution.


Subordinated or junior debt is another credit enhancement instrument to attract private capital. However, DFIs take senior debt positions in the capital structure of sustainable projects. One study suggests that in FY21 senior-debt accounts for 42 percent of blended concessional investment by MDBs/DFIs, meaning their position in the capital structure is similar to private financiers. This was followed by risk sharing mechanisms and guarantees comprising close to 20 percent and small proportions of equity (16 percent) and subordinated debt (11 percent).⁴⁰

Addressing the Challenges

Blended financing needs public capital, including international public finance concessional and risky capital, which can bring down the risk to be commensurate with returns for private investors. If MDBs continue to be conservative in lending and equity investment and treat their investment strategy as private investment, it will be challenging to attract private capital. Leverage is essential since the total amount of MDBs capital is too low to meet all the development projects. For example, by the end of 2022 the combined asset size of the IBRD and Asian Development Bank was about US\$600 billion, while India's total capital needs from 2015-30 to meet its nationally determined contribution commitments is estimated at US\$2.5 trillion.^{41,42} MDBs must reposition themselves and take on new responsibilities, and increase their risk appetite to tackle the challenge presented by the sheer scale of capital required for sustainable development activities.

“Public capital providers—primarily governments, publicly funded institutions, and MDBs—have the most critical role in scaling the adoption of blended financing.”

Conclusion

Blended finance instruments have a key role to play in attracting private capital towards sustainable activities, especially in the context of emerging markets and low-income countries. However, there are certain challenges that pose a threat to the scalability of such financial instruments, such as the risk-averseness of public finance institutions, institutional and regulatory challenges, lack of transparency in and absence of data on current projects, lack of an intermediary, and excessive cost of structuring. Additionally, blending requires collaboration between multiple stakeholders whose incentives might differ. Consequently, blended finance instruments do not achieve the optimum level of investments. To tackle these barriers, a multi-stakeholder approach is needed. DFIs or MDBs should be ready to shed their risk averseness and invest in risky asset classes and sectors. At the same time, sovereign entities should allow for a more conducive institutional and regulatory environment and take investors into confidence in all decisions. 

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