Blended Finance: what is it, what it isn’t and how to use it for maximum impact
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Blended finance is the term du jour of impact investing. It’s a panel at every conference, the topic of countless articles, several new courses, and dense white papers. It’s the strategy, often confused with a structure, on which the impact investing industry is pinning its hopes to achieve the elusive goal of scale.

But while it's popular to talk about, it's less popular to practice. One of the fund managers we work with puts it succinctly: “everyone wants to be blended, but no one wants to blend.”

It has several different definitions, but at its core, “to blend” means to mix in concessionary capital that will reduce the difference between the perceived risk and the real risk of a deal, thereby incentivizing additional private investment.

Blended finance is a term that’s used casually but needs to be enacted specifically. Like any investing, it requires a deep understanding of finance and market context. But unlike any investing, blended finance requires investors who are willing and able to provide catalytic capital — capital that will take outsized risk without commensurate return — for the express purpose of crowding in more commercial senior investors. If we as an impact investing community really want to tap private capital at scale and close the $2.5 trillion investment gap to achieve the SDGs, activating catalytic capital is crucial.

The success of blended finance hinges on catalytic capital providers embracing their role and playing it strategically. It is both an art and a science and involves not only structuring for an individual deal effectively, but also for the broader market. It requires understanding how impact markets evolve and knowing the roles that different investors play in spurring that evolution.

Not all investors can provide catalytic capital. In order to realize the potential of blended finance, we have to eliminate confusion and enable investors to use it effectively.

We’ve updated the Financial Supply Chain framework --a map for impact investors to understand their position within the context of growing and strengthening impact markets to unlock traditional capital—to illustrate the role of catalytic capital providers. We hope this framework, along with two questions outlined below, provide clarity on who can practice blended finance and how to do it effectively.

1. **What is the role of catalytic capital and who provides it?**

Catalytic capital providers have a unique ability to fuel the evolution of markets along the financial supply chain. The role of catalytic capital is to reduce the gap between real and perceived risk of an investment for the purposes of activating additional investment dollars that otherwise wouldn't participate due to perceived market failures or barriers. These barriers could be things like investing in a region with a recent history of political instability (e.g. Arab Spring countries), a new, market-specific business model (e.g. paygo solar), or an unfamiliar customer base like low-income consumers in Latin America. Catalytic capital providers can take outsized risk without commensurate return; their primary motivation is not financial return but leverage and scale. They focus on crowding in additional capital to develop new and unproven markets; prove the viability of new markets and new business models to other investors and multiply impact outcomes by leveraging greater volumes of capital than would otherwise be available. They often provide capital in the form of grants, guarantees, low-interest loans or subordinate capital -- particularly the type of capital that is most scarce at the given stage of the investment.

Catalytic capital providers are typically philanthropic investors or public institutions. They have the proper motivation and risk appetite, and face different legal, operating and regulatory realities than other private or commercial investors.

But catalytic capital in itself isn’t enough to blend effectively; it has to be deployed and sized properly.
2. How do you blend?

First, catalytic capital providers need to determine where their capital can be used most effectively to achieve their goals. If an investor’s goal is to catalyze commercial capital, then focusing on the late stage of the financial supply chain is most appropriate. It's important to note that simply providing more concessionary capital at an early stage does not crowd in commercial capital. Commercial capital requires the scale and track record that later stage investments demonstrate. If an investor’s goal is to demonstrate proof of concept for a new business model in a nascent sector, then early stage investments is a better place to focus.

Next, investors must determine the proper amount of catalytic capital. It is important to be clear that catalytic capital is required to lessen the gap between real and perceived risk. It is not used to blend pricing down to a specific rate for either investors or borrowers, but rather to create the right risk entry point for private capital; i.e. to reduce the risk of non-payment so that they can get the risk-adjusted return they require.

The financial supply chain provided below attempts to give some context and examples of how to do this based on our experience investing debt in enterprises, projects and intermediaries at various stages of growth across nine sectors and 100 countries. As markets evolve through the financial supply chain, track records are built and patterns are established that make the unfamiliar become recognizable. The gap between real and perceived risk shrinks and the amount of catalytic capital needed for certain sectors and regions can be reduced.

There are no iron laws governing the exact amount of catalytic capital required to activate additional investment. It is ultimately a function of the specific deal, the market context, and the risks associated. However, there’s much to be learned from existing blended finance vehicles and no need to reinvent the wheel deal by deal. It’s important for the impact investing industry to build on what works to develop the infrastructure, patterns, and structures that commercial investors need to move more capital.

Moving Forward

The current impact investing industry focus on blended finance is positive, but it needs to be redirected. Blended finance is not a silver bullet; no such thing exists. Our challenge is to properly use the many tools and tactics, blended finance included, that we have at our disposal to maximize their utility. Together, we can activate more than enough capital to achieve the SDGs and create a better world.