WHO IS THE PRIVATE SECTOR?
KEY CONSIDERATIONS FOR MOBILIZING INSTITUTIONAL CAPITAL THROUGH BLENDED FINANCE

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WORKING PAPER
EXECUTIVE SUMMARY

The Blended Finance Taskforce (Taskforce) was launched in 2017 as an initiative of the Business & Sustainable Development Commission (BSDC). Bringing together leaders from finance, business, development, and policy, the Taskforce’s aims are twofold: i) to lay out the economic opportunity inherent in the use of blended finance; and ii) develop an action plan to drive the system-change required to rapidly scale the blended finance market. The Taskforce’s recommendations will initially be presented as a consultation paper at the World Economic Forum in Davos in January 2018, to engage further with external stakeholders before finalizing the concrete action plan. The final version of the Taskforce report (Better Finance, Better World) will be published at the World Bank / IMF Spring Meetings in late April 2018.

Institutional investors make up a diverse group, each operating with different mandates, constraints, and risk-adjusted return preferences. However, they are often mistakenly treated as a homogenous group of investors, while there is value in better understanding the unique investment preferences and regulatory conditions of different segments. Therefore, the Taskforce commissioned Convergence to support in segmenting the private sector ecosystem to better understand how to drive more institutional investment towards the Global Goals in developing countries. Tideline contributed in an advisory role. This resulting report provides an analysis of the investment motivations, requirements, and constraints of six segments of institutional investors: i) pension funds, ii) insurance companies, iii) sovereign wealth funds, iv) commercial banks and investment banks, v) private equity firms, and vi) asset/wealth managers.

OPPORTUNITY OF THE GLOBAL GOALS AND POTENTIAL OF BLENDED FINANCE

There is a significant market opportunity presented by sectors underpinning the Global Goals. According to analysis conducted by the BSDC in Better Business, Better World, the Global Goals have the potential to create at least $12 trillion in opportunities for businesses in four economic systems: i) food and agriculture, ii) cities, iii) energy and materials, and iv) health and well-being. However, the realization of these opportunities will require significant investment. Blended finance is increasingly recognized as an important structuring approach to mobilize new sources of capital towards the Global Goals.

Blended finance most commonly refers to the use of concessional development capital from public and philanthropic sources to create more attractive investment opportunities for the private sector to contribute to the Global Goals. According to Convergence’s database of over 200 historical blended finance transactions, blended finance mobilized over $50 billion in total capital towards the Global Goals in developing countries between 2005 and 2016. The leverage—or amount of commercial capital catalyzed by each dollar of concessional capital—achieved by each blended finance transaction varies greatly across structure types and sizes, focus sectors, and target countries. Initial analysis of 56 blended finance structures with concessional debt/equity catalyzing commercial investment found a median leverage ratio of 2.6, where leverage is calculated as commercial capital divided by concessional capital.

While blended finance has mobilized a significant amount of capital, it still only represents a small percentage of the total financing needed for the Global Goals. The Taskforce will seek to identify the approaches and structures through which private capital – particularly from institutional investors – can be attracted, fully realizing the potential of blended finance. While blended finance is simply a structuring approach, underlying transactions are familiar to institutional investors. Blended finance transactions today are aligned to many alternative asset classes, such as private equity, infrastructure, and illiquid credit.

INSTITUTIONAL INVESTMENT TRENDS

Current institutional investment in blended finance transactions is limited. Many institutional investors have invested in one or two transactions, but few have participated regularly in blended finance transactions. Institutional investment in blended finance is generally diversified across sectors, with financial services and energy & climate finance being the main sectors of focus for blended finance transactions.

If the right structures and incentives are put in place to direct institutional investment to blended finance structures, this investment could potentially meet the annual funding needs for investment-appropriate Global Goals in developing countries. The institutional investors analyzed in this report represent over $200 trillion in assets under management (AUM). AUM in alternative asset classes most relevant to blended finance globally amount to around $6 trillion. Based on our analysis, developing countries comprise around 30% of alternative investment portfolios: institutional investors currently allocate a little over $2 trillion – just over 1% of
their total assets – to alternative asset classes in developing countries relevant to blended finance. Moreover, allocations to alternative assets and developing countries are expected to grow – a trend that offers opportunity to influence capital flows through blended finance.

KEY CONSIDERATIONS AND OPPORTUNITIES FOR SCALING INSTITUTIONAL INVESTMENT IN BLENDED FINANCE

Blended finance structures must create assets that fit within the mandates, constraints, and risk-adjusted return preferences of each institutional investor segment. Based on our research, there are five key considerations that will determine whether and to what extent an institutional investor participates in blended finance: i) communication and messaging, ii) policy and regulation, iii) mandate, iv) allocation and capacity, and v) transactional factors.

For blended finance to attract institutional investment at scale, investments should be communicated in a way that is consistent with asset classes that are familiar to and understood by institutional investors, to appropriately describe the investment opportunities available in developing countries that would also drive progress towards the Global Goals.

A plethora of global and national policies and regulations affect institutional investors, several of which present constraints and disincentives limiting investor appetite for assets created by blended finance transactions. Key policy and regulatory considerations for each segment are as follows:

- Pension funds: Ability to sell illiquid assets; restrictions in some asset classes and geographies.
- Insurance companies: Risk-based capital requirements that impose high capital charges for investments with high levels of risk (e.g., equity and non-investment grade debt).
- Commercial banks: Most constrained relatively; required to allocate high levels of capital when lending to high risk borrowers over medium-term tenors and to incur loss in initial year due to creating reserve in alignment with International Financial Reporting Standard (IFRS) 9.
- Investment banks: Capital charges create restrictions for investing on balance sheet, while underwriting activities are impacted by US regulator’s acknowledgment of credit enhancement products provided by public funders.
- Asset/wealth managers: Regulations applied to their clients (e.g., pension funds and insurance companies).
- Private equity firms and sovereign wealth funds: Typically have the least regulatory restrictions relative to other institutional investor segments.

An investment mandate to support the Global Goals is generally driven by leadership and/or stakeholders at individual institutions as opposed to forces affecting broad segments. There are several examples of pension funds, insurance companies, banks, private equity firms, and asset/wealth managers with strong investment mandates to support the Global Goals. In most cases, this mandate has been directed by senior leadership (e.g., CEO) and/or other stakeholders (e.g., shareholders, client). A strong leadership- or stakeholder-driven mandate enables organization-wide implementation and success.

There is significant variation between segments and within segments regarding allocations to alternative asset classes in developing countries as well as the expertise to analyze and manage alternative assets:

- Pension funds are likely to have an allocation to participate in asset classes in developing countries relevant to blended finance though often have limited capacity and expertise.
- Insurance companies are likely to have an allocation to participate in asset classes in developing countries relevant to blended finance, and tend to have a more developed capacity to invest in these markets driven by large investment teams and expertise in developing country investment.
- Sovereign wealth funds have the most varied allocation and capacity to participate in asset classes in developing countries relevant to blended finance, while allocations and capacity vary greatly from fund to fund.
- Commercial banks and investment banks often have the strongest capacity to participate in asset classes in developing countries relevant to blended finance; banks typically don’t have allocations – rather, they advise their clients on their allocations.
- Asset / wealth managers’ allocations are driven by their clients’ interests and are facing increasing pressure to build out capacity to offer alternative product offerings.
- Private equity firms typically have well-aligned allocations and capacity.
There are several transactional factors that impact attractiveness of blended finance opportunities for institutional investors. Commonly cited developing country risks (e.g., political/country, liquidity, and FX risks) are generally seen as the largest risks to blended finance transactions in developing countries. Many solutions to address these risks, some of them within the definition of blended finance, already exist and should be refined and/or scaled up. There is also a set of additional infrastructure-specific risks, such as sourcing investable infrastructure projects and off-take risks (e.g., ability to secure buyer for power produced by asset). While risk-adjusted return expectations vary by asset class, institutional investors generally expect a premium for alternative asset classes in developing countries. As expected and well documented, institutional investors require large deal sizes. Tenor / investment horizon preferences depend on underlying asset class, with some trends across segments for debt-related investments.

Nearly all institutional investors that have participated in blended finance transaction comment on the need for improved coordination among co-investors, in particular with development finance institutions (DFIs). Blended finance structures are often complex, and the unique nature of each transaction is also a challenge for institutional investors. Institutional investors often prefer to partner with institutions to originate, arrange, and manage investments in developing countries. DFIs are well positioned to play this role, but are not sufficiently incentivized to do so.

**RECOMMENDATIONS FOR SCALING INSTITUTIONAL INVESTMENT IN BLENDED FINANCE**

Based on our analysis, there are several actions that can be taken to mobilize institutional capital at scale for the Global Goals through blended finance. These actions fit into four broad categories:

- **Engaging with institutional investors:** Institutional investors are bound by obligations to their stakeholders to fulfill their investment mandates, including meeting certain financial return thresholds. Absent from most of these mandates today is any explicit focus on the Global Goals or other development objectives. Even where a social, environmental, or impact mandate may be of interest, there is a lack of willingness to sacrifice financial returns in favor of those impacts. Public and philanthropic funders must acknowledge this context and craft appropriate engagement strategies. To this end, public and philanthropic funders should communicate in the language of institutional investors and focus on the credible, commercial investment opportunities that are presented by the Global Goals. Blended finance solutions should focus on producing assets that are familiar to institutional investors and to which they already have allocations. Framing blended finance as a structuring approach within recognized and well-understood asset classes is key to scale.

- **Designing appropriate products and scaling successful solutions:** Public and philanthropic funders should collaborate on a strategic number of well-proven blended finance solutions, while also promoting standardization and reducing complexity. It is critical that this work is undertaken in close consultation with private sector investors to ensure resulting transactions are aligned to institutional investor interests. In addition, more mainstream assets (e.g., investment grade listed bonds and notes) should be created, with the objective of shifting away from stand-alone transactions towards portfolio solutions.

- **Building off DFI capabilities and experience:** DFIs have a comparative advantage in developing country investments and are often trusted by institutional investors. DFIs should increase the number and volume of transactions they arrange with the express purpose of transferring participation in aggregated portfolios of those assets through syndication, or other means, to institutional investors. In addition, DFIs should disseminate and communicate the historical return metrics of their portfolios to overcome varying risk perceptions held by institutional investors.

- **Disseminating return and impact data:** One of the main factors influencing the decision-making of institutional investors is past performance. There is currently a paucity of return data on blended finance transactions, in particular return data for the commercial layers of capital in blended finance transactions, which can be a hindrance for attracting new investors into the field. Further, there is a need for greater transparency in the blended finance market to build the evidence base for institutional investors to justify participation. Institutional investors have no standard frameworks to compare an investment opportunity’s impact on the Global Goals. A trusted industry intermediary could play an important role in collecting return data and impact metrics and reporting trends and benchmarks out to the market.