

Blended Finance: When to use which instrument?

Clusters and 12 key questions
for decision-making

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Intro

These slides provide a summary of the white paper [Blended Finance: When to use which instrument](#), and highlight the key findings:

- Clearer conceptual clusters of the various instruments
- 12 key questions that need to be asked before making decisions

This publication focuses on the findings from the first phase (Oct 2020 to Aug 2021) of the research based on a case study of 33 best practice transactions, and will be followed by a second phase of research resulting in a final decision-making tool.

The findings primarily target **donors, intermediaries, or others representing catalytic capital** because these are the actors who initiate a transaction and make decisions on the instrument.

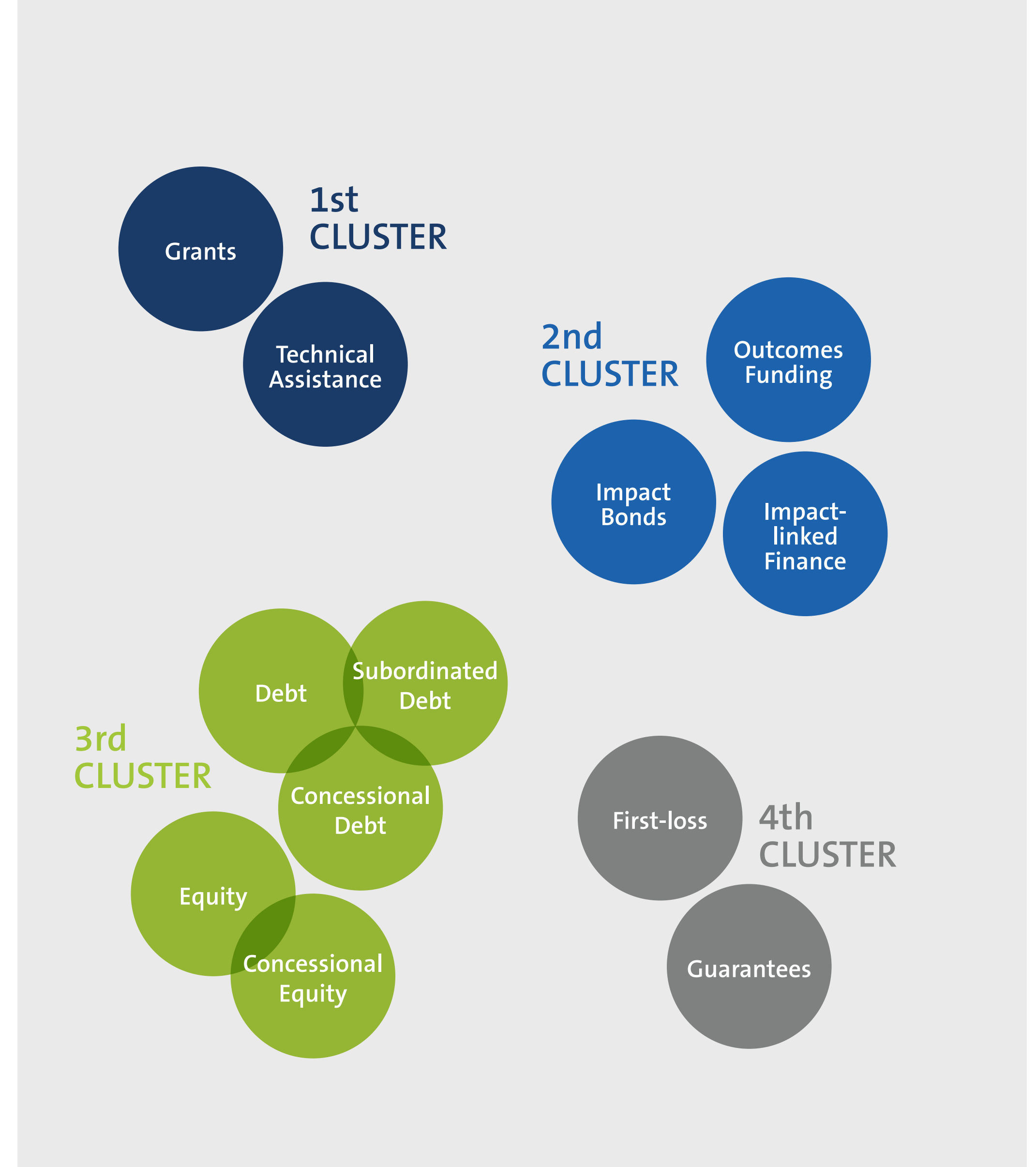


Clustering Instruments

Instrument Clusters

The various instruments can be clustered into four groups, enabling more effective decision-making by comparing conceptually similar instruments.

- **Cluster 1** - Grant, Technical Assistance
- **Cluster 2** - Outcome Funding, Impact-Linked Finance, Impact Bond
- **Cluster 3** - Market-Rate Debt and Equity, Subordinated Debt, Concessional Debt and Equity
- **Cluster 4** - First-Loss, Guarantee



First Cluster:

Grants & Technical Assistance



General Explanation

Grants and technical assistance come from the same source of capital, which are usually development and philanthropic actors.

The biggest characteristic that sets these instruments apart is that the capital is provided with no intention of seeking any financial return.



Reasons for choosing

- Primary intention is to support the achievements of impact goals.
- Often used for market research and market development.
- Used to improve the risk and return profile of transactions through mapping opportunities, developing pipelines or providing operational expertise.



Characteristics

- Capital with no financial return expectation.
- Require less financial knowledge.
- Supporting instruments, used in combination with other instruments to support and ensure that impact goals are achieved.



Point of caution

- Difficult to strike the balance between ensuring the capital having the intended impact and not burdening the recipient with bureaucratic reporting.
- Historically criticized for their lack of effectiveness.
- Use in combination with different instruments in other clusters offers a path to being more catalytic.

Second Cluster:

Outcome Funding, Impact-Linked Finance, Impact Bond



General Explanation

The second cluster can be seen as a collection of instruments falling into outcome funding or results-based financing category. These instruments link impact creation directly to financial rewards.

Due to their focus on structuring a transaction leading to an outcome pre-agreed by all parties, these instruments allow various stakeholders with different interests to be aligned.



Reasons for choosing

- Primary reason is to directly create impact.
- Strengthen the relationship between the impact created and the financial payment.
- Demonstration effect of the instrument - needs to be scrutinized.

Second Cluster:

Outcome Funding, Impact-Linked Finance, Impact Bond



Characteristics

- Financial incentives directly rewarding positive impact.
- Requires clear impact measurement - used in sectors with easily obtainable impact measurement.
- Rigorous impact reporting - leading to learning and knowledge sharing among stakeholders.
- Benefits from knowledgeable stakeholders in sectors/regions.
- Smaller transaction size.
- Combination possibilities with other clusters.



Point of caution

- Effectiveness in incentivizing entrepreneurs to create more impact is contested among practitioners. It largely depends on the materiality of the amount being paid out.
- Scalability potential - can be complex to scale because structures get complicated with an increasing number of stakeholders.
- Might require more education and training of stakeholders to overcome misconceptions.

Third Cluster:

Market-Rate, Subordinated, Concessional Debt & Equity



General Explanation

While there are various instruments bundled together within this cluster, there is a clear distinction between debt and equity capital and investors.

Equity takes higher risk and is required at earlier stages of the company to scale. It allows companies to invest capital for growth.

Debt takes lower risk and is required at later stages of the company. It provides capital to the company without diluting ownership.



Reasons for choosing

- Multiple motivations that range from directly creating impact and developing the market to crowding in private capital.
- Established instruments - financial sector understands how to structure them, assess their risk and return profile, and thus it requires less effort for educating stakeholders.

Third Cluster:

Market-Rate, Subordinated, Concessional Debt & Equity



Characteristics

- Terminology can be confusing.

| | Equity | Debt |
|--|---|--|
| Market-Rate Traditional risk-return expectation | Market-Rate Equity <ul style="list-style-type: none"> Higher risk, higher return expectation Earlier stage of a company Ownership | Market-Rate Equity <ul style="list-style-type: none"> Lower risk, lower return expectation Later stage of a company No ownership |
| Subordinate Taking junior position Taking higher risk | — | Subordinated Debt / Junior Debt <ul style="list-style-type: none"> Higher risk, higher return expectation |
| Concessional Accepting lower return Accepting longer time horizon | Concessional Equity <ul style="list-style-type: none"> Lower return and/or longer time horizon (patient capital) Lower risk expectation | Concessional Debt <ul style="list-style-type: none"> Lower return and/or longer time horizon (patient capital) Lower risk expectation |

- Choice within cluster is influenced by legislative environment.
- Requires financial knowledge.



Point of caution

- Impact not explicitly built into the structure - the impact is not always measured ex-post and there is little accountability for not achieving impact goals.
- Lack of evidence of financial and impact additionality - subordinated or concessional capital often face the criticism of displacing or crowding out other investors, instead of crowding in.

Fourth Cluster:

First-Loss, Guarantee



General Explanation

First-loss and guarantees are instruments primarily chosen for de-risking a transaction and crowding in capital. Guarantees and first-loss capital are not provided with the intention to seek return.



Reasons for choosing

- To de-risk the transaction and crowd in further capital.
- Better suitable for later stage investments, since private capital requires a financial track record and scale.
- Established instruments - financial sector understands them, and thus it requires less effort for educating stakeholders.



Characteristics

- Requires large asset size.
- Requires financial knowledge.



Point of caution

- While de-risking instruments help, they do not solve the problem of needing capital in the first place, especially in the case of guarantees. As an initiator, you still need to go fundraising and secure capital.

12 Key Questions for Decision-Making

Questions to Guide Practitioners

Organizational context

1. What is my institutional set-up or mandate?
2. Which role do I play in the transaction and what can I bring to the table?
3. How much capital can I deploy?
4. What is my target financial return / what are my financial requirements?

Purpose of the transaction

5. What is my primary motivation?
6. What kind of impact problem am I addressing?
7. How do I want to assure impact?

Investee context

8. What is the level of maturity of the target market (sector/region)?
9. How does the investee want to scale? What is their growth trajectory?
10. What is the stage of maturity of the intervention?

Cost & resources

11. What are the costs required and resources available?

Risk & return

12. What are the kind of risks I need to consider for what kind of return?

Key Questions for Instrument Selection

Organizational Context

Organizational features such as mandate and resource availability anchor or constrain instrument selection. Instruments that build on an initiators' organizational context are more likely to gain internal buy-in and resource support.



Q1. What is my institutional setup or mandate?



Institutional setup relates to the initiator’s organizational type, mission, and operational structure. Alignment with initiator’s mandate influences selection of blending instrument, outlined in the table below.

| Attributes | | Selection Preferences |
|-----------------------------|--|---|
| Financial Intermediaries | <ul style="list-style-type: none">• Commonly an advisory firm or fund manager responsible for coordinating instrument development and fundraising. Role may extend to implementation.• Often experienced with specific financial tools, possibly with a sector lens.• Often interested in instruments that attract traditional investors over the long term.• Possess limited internal funding for project development. | <ul style="list-style-type: none">• Prioritize tools that they have used before.• Eager to include market-rate debt/equity.• Seek grants/TA for development costs. |
| Philanthropic Organizations | <ul style="list-style-type: none">• Private sector donors, typically with sector-related sustainable development mandates.• Aim to achieve strong multiplier effects with their giving.• Often more capacity to make grants than invest for sustainable development. | <ul style="list-style-type: none">• Seek grant-based involvement in blended facilities.• Prioritize options with clear, measurable ties to improved funding and impact. |
| Impact Spinoffs | <ul style="list-style-type: none">• New blended facility managers established by existing fund managers or development-focused organizations.• Focused on establishing commercially sustainable facilities to address ecosystem funding gaps.• Often need to establish complementary operational capabilities and experience.• Primarily influenced by parent’s priorities and organizational attributes. | <ul style="list-style-type: none">• Grant/TA for establishment.• Concessional funding to attract external investment. |
| Development Actors | <ul style="list-style-type: none">• Aid agencies and development banks focused on large-scale deployments.• Subject to public sector determined development priorities and mandate.• Face elevated governance and reporting requirements that reduce flexibility.• Development banks subject to commercial investment standards. | <ul style="list-style-type: none">• Preference for larger transactions.• Development banks: limited use of concessionality.• Aid agencies: provision of conditional grants. |

Blended Finance: When to use each tool?

Q2. Which role do I play in the transaction, and what can I bring to the table?



When structuring a blended finance transaction, it is important to consider and understand the various roles of stakeholders, the power dynamics, and what they each bring to the table.

| Role | Description |
|----------------------|--|
| Initiator | The initiator (or initiating consortium) is typically a mission-driven organization looking for a way to finance solutions to create impact. It is the initiator (or the consortium) who chooses the instrument and impact sector. |
| Donor | Donors commonly fund the design/structuring and development of the transaction in the initial phase. They provide the catalytic capital—for instance, as an outcome funder or a provider of de-risking capital—at a later stage. This role is usually played by a philanthropic organization or development actor. |
| Structurer | Structurers are knowledge partners that manage or assist in the implementation of the blended finance transaction. This role is usually played by financial intermediaries. |
| Beneficiaries | Beneficiaries are recipients of the investments. In most transactions, the beneficiaries are end beneficiaries and the public sector, but in some cases, they can also refer to social enterprises and the private sector, such as corporations. |

| Required contribution | Description |
|------------------------------|---|
| Capital | Development cost - grants and TA Catalytic capital - investment capital that is patient, risk-tolerant, concessionary, and flexible. |
| Structuring expertise | Usually provided by the initiator or initiating consortium, which includes an intermediary or an internal team with structuring background. |
| Sector knowledge | Provided by an intermediary or impact investing spinoff that has on the ground knowledge. |
| Creditworthiness | Typically provided by a larger institution with an established reputation. |

Q3. How much capital can I deploy?



- Initiators with limited funding may be unable to provide sufficient resources to mobilize a large scale blended transaction. Instead, they are likely to concentrate funding on supporting early development processes that may leverage funding downstream.
- Smaller initiatives face higher transaction costs on attempting more complex instruments.
- Facilities that mobilize large amounts can better justify more complex instruments relative to the degree of capital mobilized.

EXAMPLE

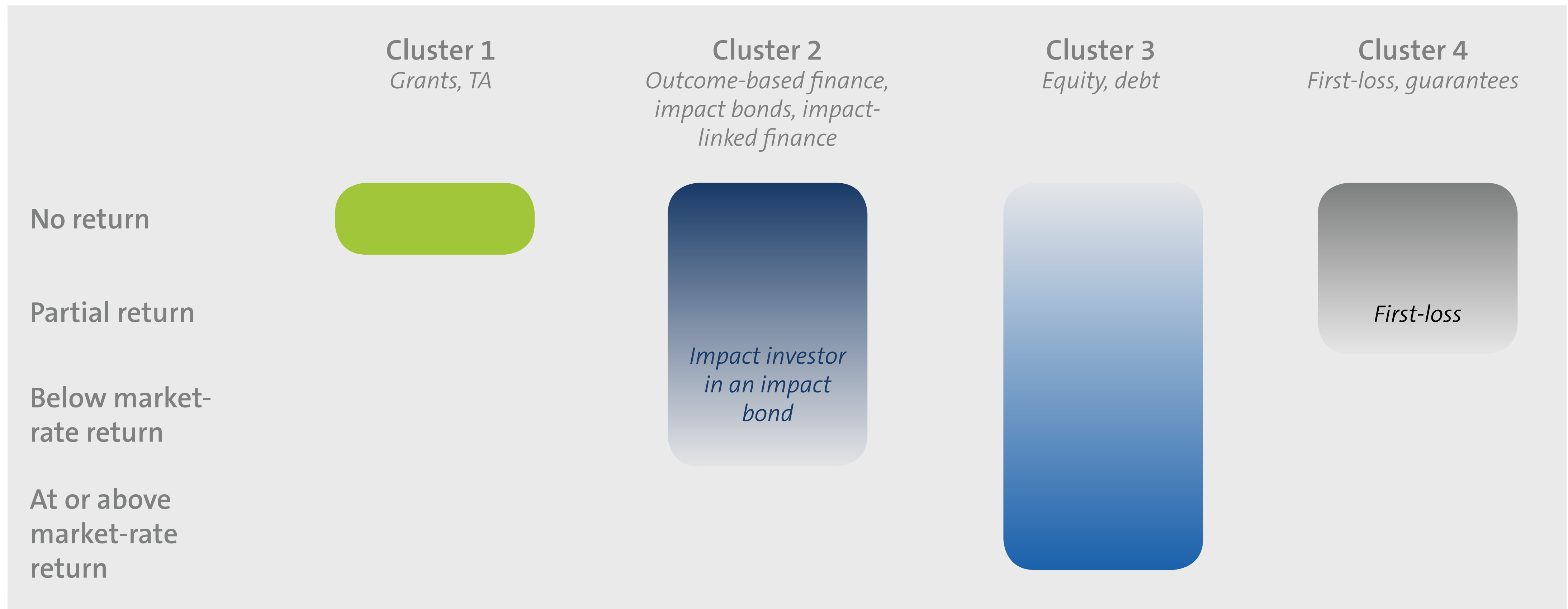
Guarantees are more apt for larger organizations, due to its credit enhancing nature. An interviewee mentioned, “A guarantee from a non-rated entity is a challenge for a bank. You can only do that with a strategic cooperation agreement, but you need to work with collateral.” In addition, being a guarantor requires having a large enough balance sheet, which makes it challenging for smaller organizations to utilize. As another expert interviewee stated, “If you don’t have as much on the balance sheet as someone like the Bill and Melinda Gates Foundation, you might ask yourself, can we pool some resources to create shared vehicles for those guarantees structures?”

Impact bonds, on the other hand, can be used by smaller organizations that have a greater capital preservation need. For instance, the Stone Family Foundation set up the Cambodia Rural Sanitation DIB by deploying capital as an impact investor, with USAID providing the \$10mil of outcomes funding to the foundation if the results of the programme were achieved.

Q4. What is my target financial return or requirements?



Organizations often have a target financial return or financial requirements set by the institutional mandate. The financial requirements can largely be divided into no return, partial return, below market rate return and at or above market rate return.

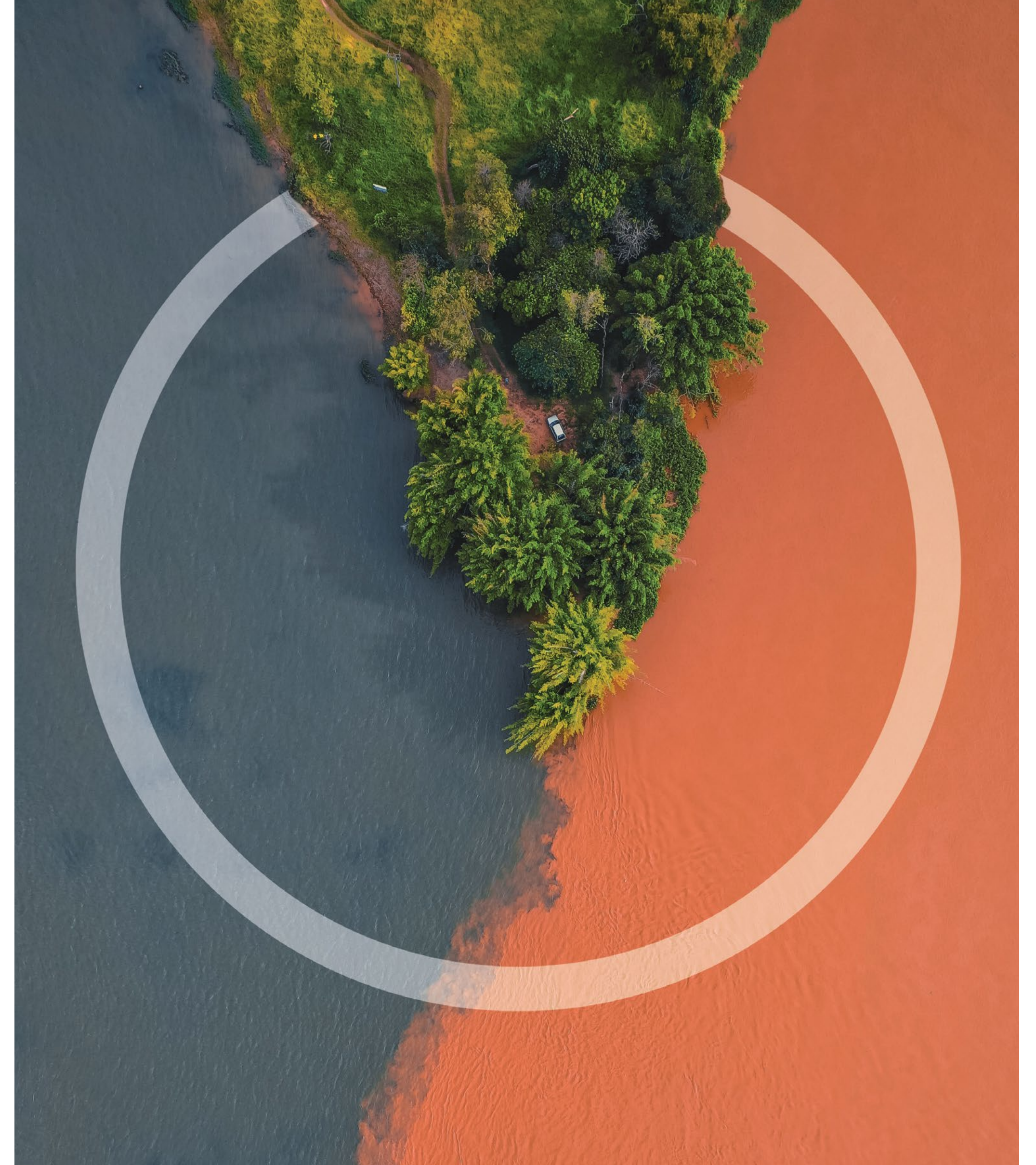


Key Questions for Instrument Selection

Purpose of the Transaction

The design of blended finance transactions needs to be anchored in the transaction-specific objective and context. Several context-specific factors influence the nature of additionality, concessionality, mobilization, and commercial sustainability in blended finance, which need to be taken into account when designing a blended finance structure. Purpose-built instruments, tailored to the context and intended stakeholders, may simplify the process of attracting and aligning stakeholders.

Blended Finance: When to use each tool?



Q5. What is my primary motivation?



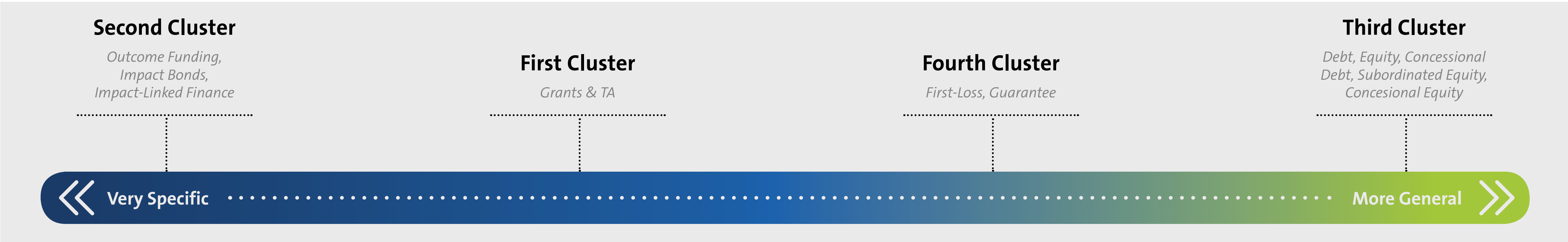
Depending on their motivation, investors' intentions range from broad commitments, such as a) to target impact, b) to mitigate risk, to more specific goals, such as c) demonstrate proof of concept for a nascent sector or instrument, or d) build a market for a sector or region.

- Directly targeting impact:** Some organizations are motivated to respond to impact needs because the creation of positive change for people and the planet is the reason that they exist. This is strongly associated with Cluster 2, which comprises financial instruments like outcome funding, impact-linked finance, and impact bonds.
- Crowding in and de-risking:** Their intention is to achieve impact through leverage and scale. The crowding-in motive is associated with a combination of instruments that cut across several of the clusters. Cluster 3 and Cluster 4 are especially strongly linked to the crowding-in motive. Within our research data, when de-risking was the primary motivation, it was used to attract commercial investors with higher return expectations.
- Demonstration:** there are a lot of innovative structures being developed with the potential to create impact more effectively and efficiently, and so some actors are engaging in blended finance transactions is the demonstration effect of such new structures.
- Market building:** linked closely to the “demonstration” motivation, market building aims to create a new market segment, support an underserved region and/or help markets that require scale to make the economies work.

Q6. What kind of impact problem am I addressing?



The specificity of the impact problem and the time horizon are key considerations for practitioners. Investment opportunities can be targeted at general or specific social and/or environmental impact needs, and different instruments have different limitations in terms of time horizon.



| Intervention | Benefits/outcomes | Timeframe | Example |
|--|--|----------------------|---|
| Healthcare services Surgeries | Quality healthcare to poor / underserved populations | Short to medium term | Cameroon Cataract Bond, which is helping the Magrabi ICO Cameroon Eye Institute (MICEI) to provide as many as 18,000 cataract surgeries over a five-year period. |
| Education Early childhood development | Quality education for vulnerable children | Medium term | The Utah High-quality Preschool Program SIB provided high-quality education for low-income children to prevent at-risk kids from entering expensive special education programs. |
| Conservation | Land conservation and restoration | Medium to long term | PT Royal Lestari Utuma Bond is a \$24million investment by &Green Fund, through 15-year notes, to finance a sustainable rubber plantation in Indonesia. |

Blended Finance: When to use each tool?

Q7. How do I want to ensure impact?



Some investors have formal requirements to ensure impact, such as DFIs and foundations, and others have more aspirational impact objectives but no formal requirements, such as institutional investors or impact funds. As an initiator, there are largely two approaches to ensuring impact: either through explicitly linking impact to financial reward, or through implicit agreement by aligning stakeholders.

Explicit impact assurance is strongly related to Cluster 2, comprising outcome funding, impact-linked finance, and impact bonds. These instruments link impact creation directly to financial rewards, making it an explicit goal of the transaction to achieve impact.

Ensuring implicit impact is more related to Cluster 3 and Cluster 4. These instruments do not have a formal link between impact and financial reward, so the impact is instead implied. This also invites the criticism of whether such transactions are truly effective in creating impact, especially since evaluation of the impact on end beneficiaries is done by only a limited number of funds—only 32% of funds surveyed by the OECD annual survey.

Whether such explicit structures truly motivate actors to achieve impact, and at which level the incentives should be aligned, seemed to be contested among our interviewees. Additionally, the cost of creating such an explicit structure, as well as measuring and evaluating impact, also needs to be weighed against the cost of stakeholder alignment and management.

Key Questions for Instrument Selection

Investee Context

Differences in sector maturity—including the macroeconomic conditions, legal and regulatory environment, and the general strength, maturity, and profitability prospects of enterprises within it—affects access to investable opportunities and the level and types of capital accessible.

Lower maturity and low profitability potential often signal greater demand for concessionality and route to scale.

Business models in the conservation, education and WASH sectors often times demand more patient capital than business models in other sectors such as renewable energy or financial inclusion.



Q8. What is the maturity level of the target market (sector/region)?



The maturity of the target market has an influence on the choice of instruments. Cluster 1 plays a crucial role in entering new markets. Cluster 2 requires interventions that have been proven to be effective. Cluster 3 can be deployed across various stages of maturity. Cluster 4 is more fit for markets that have a track record and are ready to be scaled but are seen as risky by private sector capital.

REGION

Blended finance investments into a region or country depend strongly on the macroeconomic state of the private sector and the regulatory environment

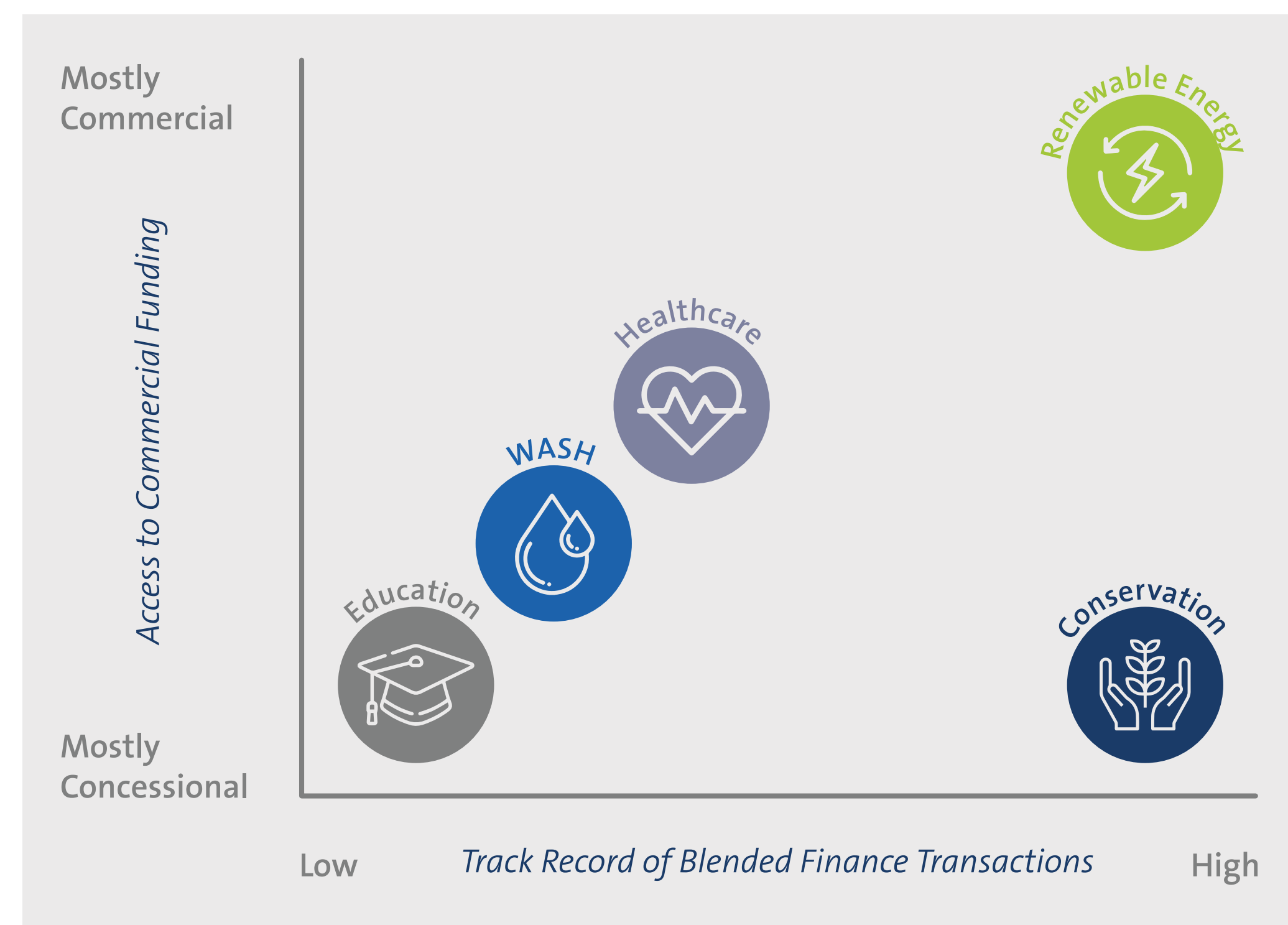
Fledging Private Market: usually an underdeveloped financial sector and little commercial interest, blended finance can play an important role in creating the foundation required for building a market

Developing Private Market: with precedent for commercial viability and evidence of opportunity, blended finance can be used to reinforce and strengthen a developing market.

Maturing Private Market In markets where there is a relatively established financial sector and private sector interest, blended finance can crowd in institutional capital to gradually allow the market to become self-sustaining

SECTOR

Blended finance investments in some sectors have a longer track record and maturity level than others in terms of commercial viability and business model development.



Q9. How does the investee want to scale? What is their growth trajectory?



Taking into consideration the scale and growth trajectory of the investee is important, with the main options for this being scaling through the public sector and scaling through the market.

Scaling through the public sector

There are some interventions in the social sector that are suited to scaling through the public sector. These interventions are generally difficult to make commercially viable, as they may target bottom of the pyramid populations, involve basic service delivery, or target very specific impact goals.

Cluster 2 impact bonds are typically used to experiment and incubate ideas for long-term scaling, usually through the public sector.

Scaling through the public sector is also a viable route to scale for some non-profits. There are few private sector credit models for nonprofits, and it is not possible to take an equity stake.

Public sector scaling example

An example of this is the Rahat Social Impact Bond, which is aimed at increasing the number of students matriculating with levels 4 and 5 mathematics in Rahat. The SIB additionally acts as a pilot for the Israeli Ministry of Education as part of a five-year socio-economic development plan for the Bedouin communities and will be replicated and scaled if successful.

Scaling through the market

For some interventions, large amounts of capital are required to make an impact at scale. These interventions cannot be supported through grants and concessional capital in perpetuity.

Here, it is important to match blended finance mechanisms with the risk profile, transitioning from concessional to commercial capital over time. Even for interventions that look to scale through the market, capital can be flexible or concessional at an early stage but needs to be reviewed and justified based on additional impact compared to grants.

The riskier nature of private capital also makes it suitable for interventions that aim to scale rapidly.

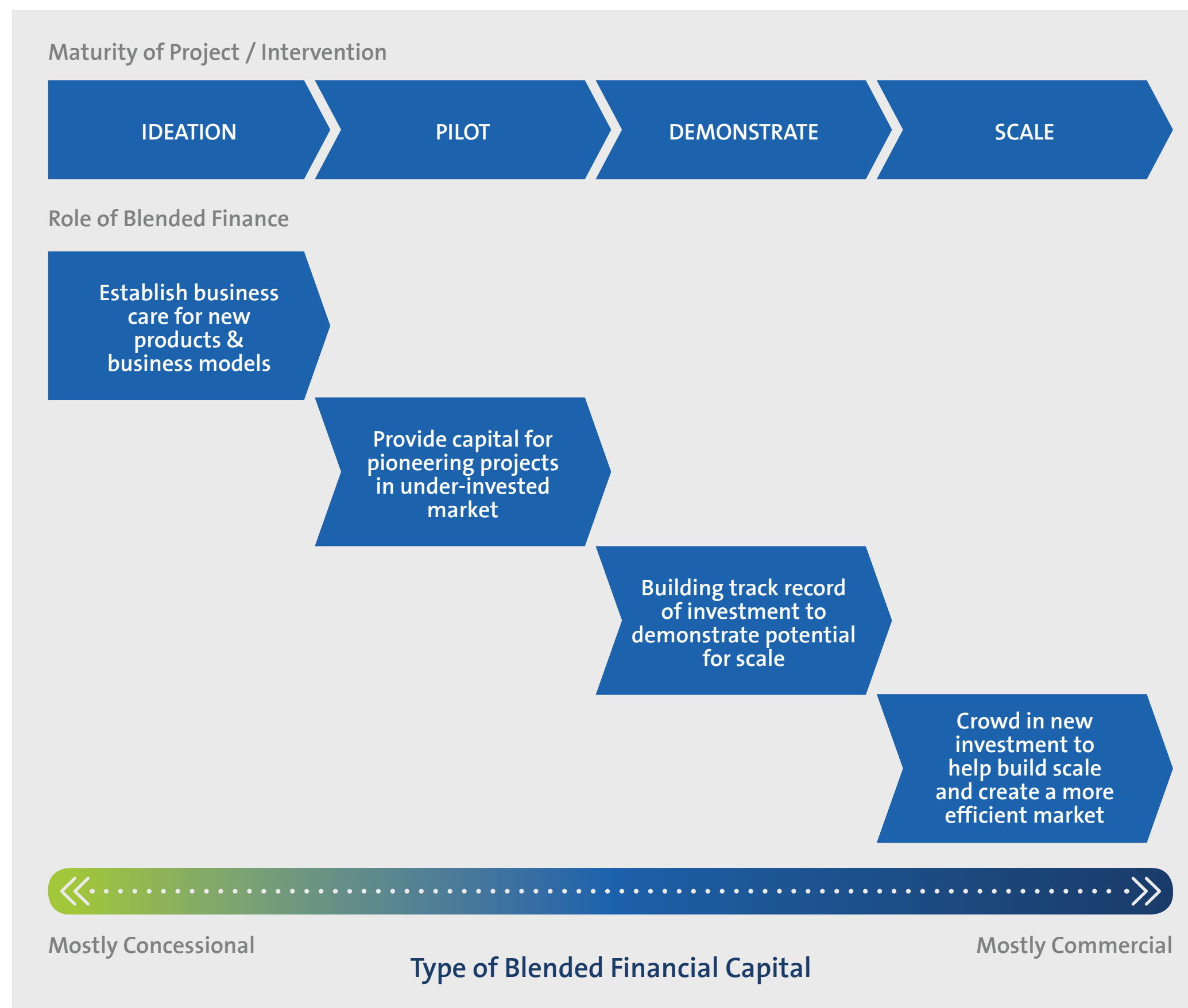
Market scaling example

M-KOPA, a Kenyan based solar home systems provider, has received various forms of concessional capital to aid in scaling. This includes a currency hedging product, issued by MFX, TCX, and responsAbility, which enabled M-KOPA to strengthen their credit score by matching their currency cash flows to their loans.

Q10. What is the maturity level of the intervention?



The level of maturity of the project or intervention will impact how blended finance is used and which instruments are selected.



Ideation example: “Technical assistance has been instrumental in overcoming capacity and knowledge constraints during the nascent phase of commercial finance developments for the water and sanitation sector in Kenya.” - Practitioner, outcome-based contract in WASH

Pilot example: “Five to six years ago, the clean energy sector required a significant amount of concessional capital to subsidize commercial capital. Since then, the costs of investors or batteries have dropped drastically, and commercial returns are achievable with no subsidy required whatsoever.” - Practitioner, intermediary in renewable energy

Demonstration example: “Demonstrating that a structure works is a market-building exercise. If you can demonstrate that it works, it removes some of the perceived complexity.” - Practitioner, impact bond in healthcare

Scale Example: Climate Investor One (CIO) mobilizes blended financing to invest in private sector renewable energy projects in low- and middle-income countries. To achieve this, the CIO bundles multiple funds under one facility to address different stages of the project cycle, with a range of instruments offered to achieve goals at each stage.

Key Questions for Instrument Selection

Cost & Resources

Instrument selection influences facility lifetime resource needs and costs. Practitioners can often anticipate project development and operational costs and determine which elements to avoid, assume, or secure third-party support for.

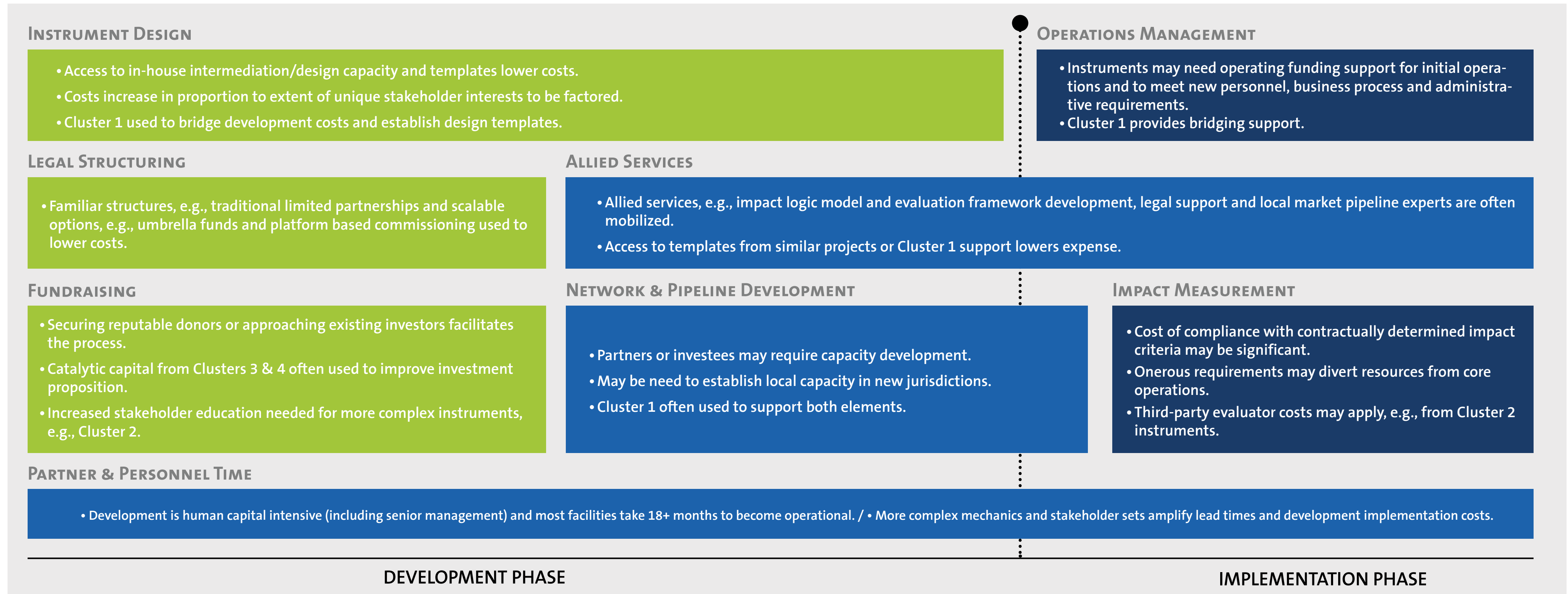


Q11. What are the costs associated and resources available?



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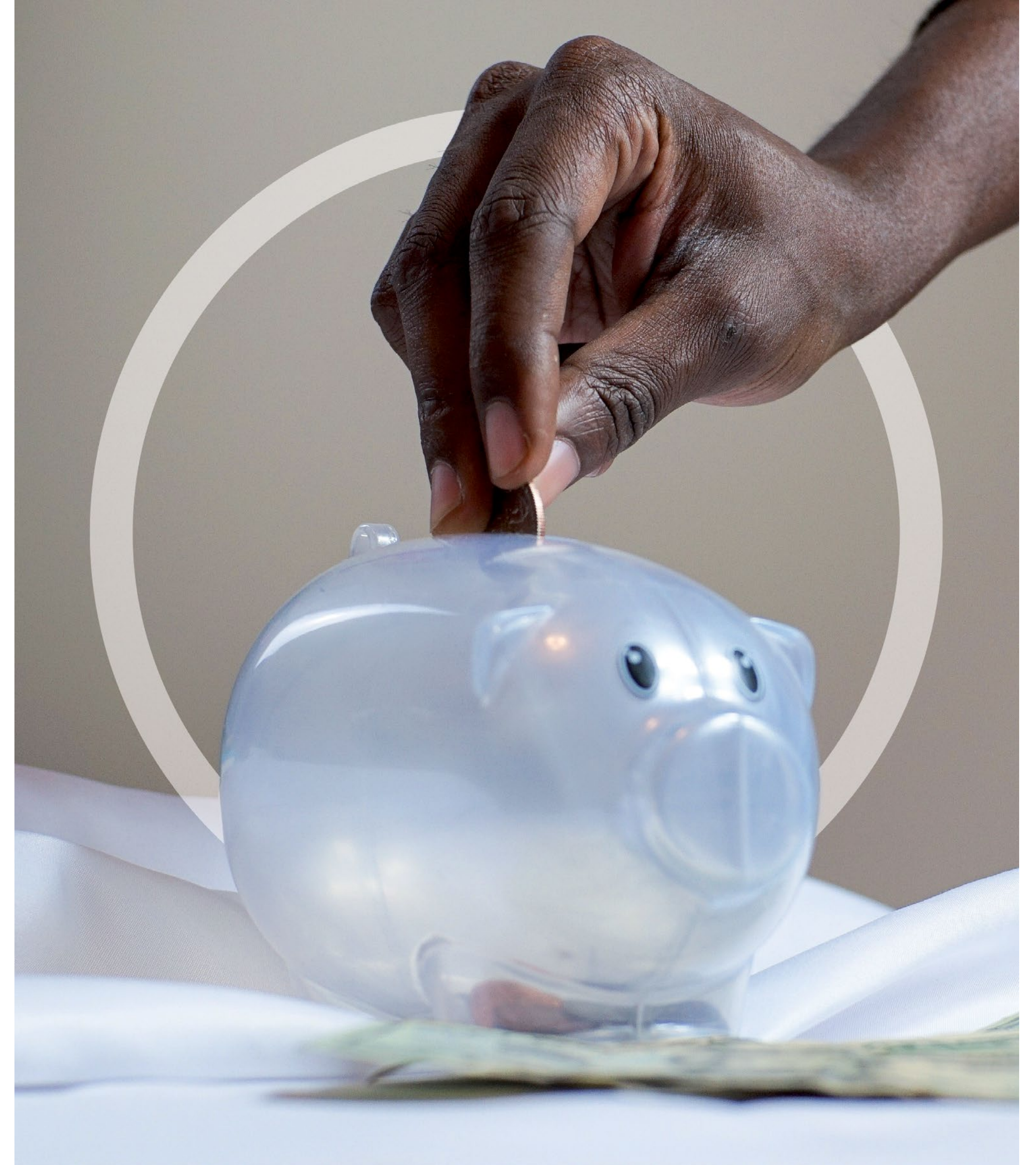
Blended Finance: When to use each tool?

Key Questions for Instrument Selection

Risk & Return

When solving for the risk-return profile of a transaction, decision-makers need to develop a product that solves both sides of the equation in an appropriate balance.

To achieve this, practitioners highlighted various considerations when selecting instruments or clusters.



Q12. What kinds of risks do I need to consider, and for what kind of return?



As seen across the transactions investigated and interviews, risk-return expectations and requirements will largely be dependent on the type of transaction structuring and investors involved in this process. Similarly, the motivations of the stakeholders could have a major influence on the risk-return profile.

| Input | Activity | Output | Outcome | Impact |
|---|----------|--------|---------|--------|
| Evidence risk: The probability that insufficient high-quality data exists to know what impact is occurring. | | | | |
| External risk: The probability that external factors disrupt the ability to deliver impact. | | | | |
| Stakeholder participation risk: The probability that the expectations and/or experience of stakeholders are misunderstood or not taken into account. | | | | |
| Drop-off risk: The probability that positive impact does not endure and /or that negative impact is no longer mitigated. | | | | |
| Efficiency risk: The probability that impact could have been achieved with fewer resources at a lower cost. | | | | |
| Execution risk: The probability that activities are not delivered as planned and do not result in the desired outcomes. | | | | |
| Alignment risk: The probability that impacted is not locked into the model. | | | | |
| Endurance risk: The probability that the required activities are not delivered for a long enough period. | | | | |
| Unexpected impact risk: The probability that significant unexpected positive and/or negative impact is experienced by people on the planet. | | | | |

External risk example:

External risk such as political and sovereign credit risk is an element that can influence the transaction, especially in fragile regions where financing is most needed. If the motivation of the capital provider is to create social impact in Sub-Saharan Africa, this is a risk that needs to be considered and a higher level of risk can be accepted in exchange for the potential of higher impact returns. One of our interviewees stated, “A period of delay can occur due to regulatory approvals, and in the meantime, high or volatile hedging costs may change the pricing of the transaction.”

Yet, if the main objective is to crowd in private capital by achieving high financial returns, the higher external risk might not be worth taking if the cost outweighs the potential financial return.

Thank You!