T20 Policy Brief

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Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Blended Finance: A Capital-Catalyzing Tool for Financing SDGs in Latin America and the Caribbean (LAC)

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Abstract

The OECD estimates that even though the UN Sustainable Development Goals (SDGs) financing gap increased substantially after 2020, a 20% surge in funding happened due to multilateral efforts to raise capital from private sources globally (OECD 2023). It is estimated that USD19.7 billion is currently being allocated to Blended Finance (BF) initiatives in Latin America and the Caribbean (LAC), with 37% coming from Development Finance Institutions and Multilateral Development Banks (Apampa 2022) and 36% from commercial investors. The development of the domestic private and financial sectors is of equal importance to target capacity building and ensuring finance flows benefit targeted countries towards their Paris Alignment. In this sense, this policy brief will investigate how BF can be employed to overcome financing challenges, including the development of local capacities in LAC, delving deeper into the type of BF initiatives already operating in the region. Main challenges have been identified and classified into four dimensions of BF development constraints: (i) regulatory, (ii) operational (iii) technical, and (iv) market-based. Through reviews of the literature and the assessment of selected case studies, the brief will propose recommendations and practical solutions to tackle the above-cited challenges, which can be implemented by the G20 and its task forces.

Keywords: Blended Finance; Sustainable Development Goals; Sustainable Finance.

Diagnosis of the Issue

Despite a surge in global efforts to mobilize public and private resources, the annual financing gap for achieving the UN Sustainable Development Goals (SDGs) and Paris Agreement objectives remains substantial. Estimates of developing countries' needs to achieve these goals range in the trillions, though the financing sources available for these countries are insufficient. A promising solution to bridge this funding gap is blended finance (BF) mechanisms, which combine public and private resources to enhance the risk-return profile of projects, attracting more private investment towards high-impact SDG initiatives. Due to its scaling-up potential, Latin America and the Caribbean (LAC) offer a compelling case for applying BF; the region has allocated US$19.7 billion in BF initiatives (Apampa 2022). Even though a significant portion of these funds originate from international development finance institutions (DFIs) and multilateral development banks (MDBs), more commitment and action from those actors are needed to mobilize private capital through BF.

Thus, the G20's international outreach has the potential to leverage BF and mobilize private capital to unlock SDGs in LAC. Its members represent approximately 85% of the world's Gross Domestic Product (GDP) and two-thirds of the entire population (OECD 2024). Moreover, it represents a unique opportunity for developed countries to further acknowledge and address developing country needs, establishing a political agenda to open up space for scalable BF solutions in developing countries and, specifically, in LAC.

BF can contribute towards tackling key issues in the region, such as bridging the adaptation finance gap, addressing currency risks, strengthening country-level partnerships, supporting technical assistance, reducing financing costs for private investors, using guarantee instruments, coal decommissioning, and easing private flows towards accelerating the low carbon transition (Convergence Finance 2023; Kreibiehl 2022). BF is essential for industries and activities needing de-risking and "patient" capital, such as Nature-based Solutions (NbS) (Pegon 2023).

It is worth noting that BF is best applicable for projects that have not reached a minimum financial returns threshold but can demonstrate clear paths to social returns[1]. Hence, first-loss guarantees, outcome funding, concessional debt and equity, currency risk hedging, subordinated debt, impact-linked finance, impact bonds, grants, and technical assistance can be combined to reduce risk perception and enhance investment returns.

Despite BF's potential to contribute to emerging markets' development, it still presents some challenges - including cultural barriers (Gorini 2021; Gorini 2024; Laboratório de Inovação Financeira 2022):

- **Regulatory**: gaps that lead to inefficient blended structures, such as limitations on the practical use of financial instruments, mechanisms, and vehicles due to existing constraints in the mandate and fiduciary responsibility of managers, inadequacy of taxation, and ambiguous understanding of the regulator;
- **Technical:** asymmetry of information among different actors, financial knowledge, awareness concerning BF potential, governance with different actors and legal constraints within different institutions, and measurement, report, and verification (MRV) areas of impact[2] (Network for Greening the Financial System 2023);

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[1] The sweet spot concept is better illustrated at Pegon (2023).

[2] More technical issues are showcased at Jena & Saxena (2023).

- **Operational:** complexity regarding the financial model/approach derived by the presence of multiple stakeholders involved in a BF structure, driving lack of consensus, country ownership, and institutional constraints[3];
- **Market:** market, institutional, infrastructure, technological, logistics and supply chain low maturity. Bringing these markets into the mainstream requires additional incentives for managers' decision-making (UNEP-FI and PRI 2022).

Methodology

The methodology consists of the analysis of two case studies. Desk research (secondary data) and interviews (primary data) were conducted to collect data on general BF structures and on the selected case studies. The cases were chosen to represent the current deals in the region and complement each other: two funds with prominent contributions to the development of SDG projects that use or support BF in LAC (Fundo Vale and LA Green). We analyze challenges and lessons learned from both case studies and propose actionable recommendations for improvements across the region in G20.

Fundo Vale addresses the lack of investment in NbS businesses, specifically reforestation, but faces legal and regulatory challenges for upscaling. LA Green addresses the lack of local capacities and associated risks in accessing local capital markets. However, it struggles with the scale-up of private resources and impact measurement. By understanding the challenges identified in these two case studies, we identify general bottlenecks and formulate recommendations for the G20 to foster an enabling environment, ultimately bridging the climate finance gap in the region.

[3] Some of these limitations are explored at Global Partnership for Effective Development Co-operation (2019).

The overall objective is to showcase common challenges and address solutions, aiming for the development of BF initiatives in LAC.

Analysis of Cases

LAGreen[4] is an example of how BF can tackle the technical and market challenges through currency risk hedging and the provision of technical assistance for green bond structuring. **Fundo Vale** demonstrates how BF structures can support the development of NbS by providing catalytic capital and de-risking financial operations through philanthropic entities. For instance, each unit of Brazilian Real invested by Fundo Vale is multiplied by 8-fold with third-party investments[5].

Some key challenges for achieving a systemic change in the LAC region highlighted by LAGreen include substantial differences in efficiency levels across local stock exchanges. This is particularly harmful since engaging with local stock exchanges enables the fund to widen the range of green projects eligible for funding. Secondly, local institutional investors are reluctant to accept the high operational costs and risks associated with the strict regulatory requirements established by foreign public authorities and MDBs, constraining the fund from mobilizing existing private savings towards developing green domestic markets. Regarding NbS, LAGreen stresses that bond issuances targeting NbS are scarce, as private investors have not yet established or agreed upon concrete biodiversity indicators. Additionally, given the fund's short lifespan, LAGreen has not yet been able to measure and monitor nature-related impact beyond the

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[4] "LAGreen", accessed March 29, 2024, https://lagreen.lu/

[5] Fundo Vale, *Impact Report*, 2023.

level of conducted financial transactions. Lastly, LAGreen refers to the relatively low demand for funding from the Caribbean, which limits its engagement in the region.

In the case of Fundo Vale, philanthropic organizations face the challenge of working with limited options regarding BF mechanisms, given the potential risk of the loss of tax exemption. Precedents exist that address this issue outside of BF, including direct investment in commercial activities or direct credit provision. These could be considered eligible as tax-exempt philanthropic activities if aligned with a social purpose (Instituto Clima e Sociedade 2023).

A second challenge this particular type of capital faces is regulatory restrictions on donations to investment funds in blended mechanisms in Brazil. The current regulation (Resolution CVM 175) presents gaps in three main issues: (a) quota subordination structure is available only for credit receivables investment funds - FIDCs; (b) impossibility of funds receiving donations, non-refundable capital or non-repayable capital; (c) loans not available for a large spectrum of investment funds (available only for Private equity investment funds - FIPs) in blended mechanisms (Instituto Clima e Sociedade 2023).

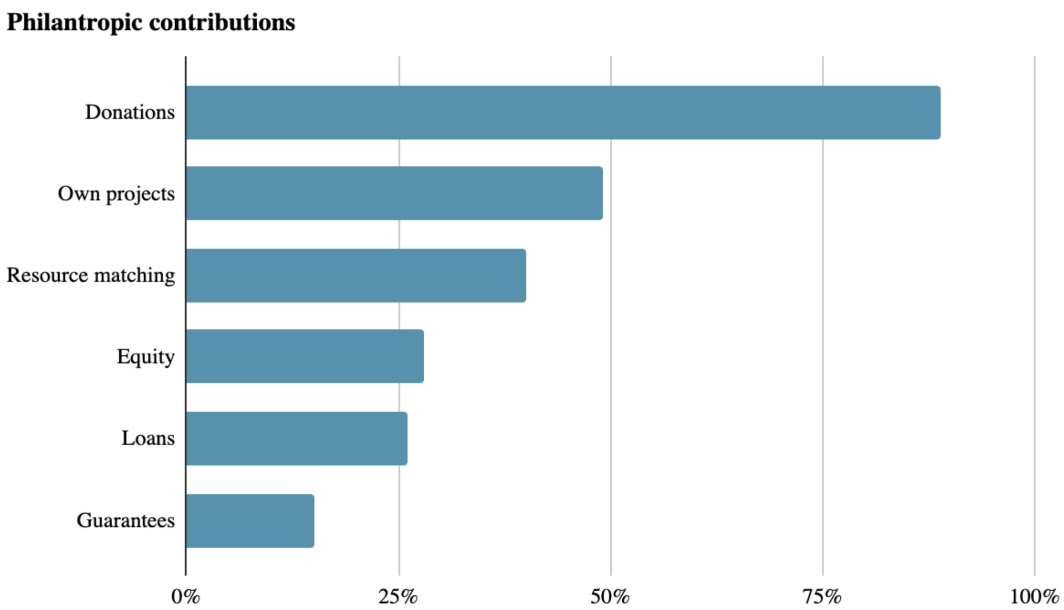
Thirdly, philanthropic organizations face difficulties aligning impact investment objectives with the holding company from which they receive financial support. For instance, Fundo Vale receives financial resources from its holding company, Vale S.A. Thus, impact investing from its holding company could avoid legal restrictions with philanthropic disbursement at Fundo Vale. Nonetheless, it uncovers another issue: Vale S.A.'s fiduciary obligations impose barriers to investments that do not maximize financial returns, such as social, climate, and environmental benefits. Therefore, social impact investing remains in limbo between Vale S.A and Fundo Vale.

Lastly, the diverse profile of participants in BF structures increases the complexity of the deals, affecting the technical and operational details and the reporting and impact management activities (Oxfam, Development Initiatives, and UK Aid Network 2019). Despite this, it is worth noting that Fundo Vale has successfully contributed to MRV (measure, report, verification) practices over the past years through its impact management project (IMP) tool, Gimpact. Developed internally in 2019 and aligned to international standards, the tool supports Fundo Vale in disseminating its goals and impact management culture across its partners. Even though Gimpact has some challenges to implement alongside its partners, it contributes to moving forward Fundo Vale's BF initiatives.

Recommendations

The G20 has the power to leverage capital from the private sector, mostly from developed to developing countries, which face constraints in public budgets and a lack of private capital.

Philanthropic institutions have a particular set of comparative advantages that can complement the role of Public Development Banks, including i) technical skills and expertise, ii) networks of entrepreneurship and partnerships, iii) innovative technologies, iv) agility and flexibility, and v) advocacy and influence (CEBRI 2023). According to the OECD, philanthropic organizations explore fewer opportunities for contributions through guarantees, equity, and loans than for donations, as presented in the chart below. There is potential for these institutions to mobilize private resources for both financial and social returns in projects that otherwise would not have private participation. NbS projects, for instance, usually require more than ten years to mature, but social and environmental upsides arise in the short term.



Source: OECD *apud* CEBRI (2023).

In addition, building on the example of LAGreen, it is crucial to reduce operational costs from BF platforms and increase the supply of related products. Therefore, this study urges relevant authorities to consider the introduction of feasibility assessments of public risk-sharing mechanisms, such as currency hedging and first loss guarantees, applicable to BF transactions conducted within the government's jurisdiction. Countries like Brazil have already started implementing such initiatives in collaboration with IDB. Other LAC countries could build on these mechanisms, considering their national context and financial needs. This initiative includes continuous internal capacity gap assessments regarding the identification and measurement of climate and nature-related (C&N) risks to ensure their proper integration into feasibility studies and the design of effective risk-mitigation instruments.

Lastly, an enabling environment for BF instruments and systemic change towards a sustainable economy in the LAC region requires a substantial increase in data availability and granularity on exposure levels to C&N risks among (non-) financial corporations. Governments should consider incorporating mandatory disclosure requirements in line with internationally recognized standards into national supervisory frameworks. This measure should be preceded by the issuance of appropriate risk management and C&N-related disclosure guidelines to enable an early business model adaptation and thereby mitigate underlying transition risks.

Mainstreaming BF in LAC will require combined efforts from multiple stakeholders. The G20 has the political and economic capital to encourage and address the challenges, policies, studies and use cases discussed in this paper, addressing the recommendations suggested below:

Dimension	Recommendations
Regulatory	• Ensure federal tax exemption for disbursements in social, environmental and climate impact businesses, opening space for concessional capital, as mentioned in the iCS Policy Brief • Facilitate regulatory frameworks that allow the combination of market capital and grants, both public and private, such as the review of resolution CVM 175 (Brazil) to adapt funds to blended structures • Include social, environmental and climate impact business in national taxonomy frameworks • Adopt a phased approach for introducing disclosure requirements in line with recognized standards in national supervisory frameworks to mitigate transition risks and create an enabling environment for BF deals
Technical	• Propagate standardization and scalable financial instruments to cover hedge on currency risks, such as IDB's exchange hedge funds • Disseminate BF use cases • Disseminate asset pricing models and risk management practices that include social, environmental and climate perspectives
Operational	• Implement market instruments to facilitate financial compensation mechanisms that can accelerate social,

	environmental, and climate business, such as carbon markets and Payments for Natural Services • Leverage public managers' knowledge of tools to apply BF, as promoted by GoBlended • Foster BF networking groups, such as GoBlended, LAB and Rede Anbima
Market	• Link national development plans and national macro regulatory frameworks and BF potential to develop emerging sectors for the transition economy, such as the Neoindustrialization Plan in Brazil • Embed BF potential into national and international markets and sectoral associations

Scenario of outcomes

Dimension	Short-term	Medium-term	Long-term
Regulatory	• Higher volume of private capital for impact investments through investment funds and other traditional vehicles • Market signals in the form of greater data collection, as a result of the introduction of disclosure requirements	• Reduction of mismatching of concepts regarding projects' impacts due to strong consolidation of a taxonomy • An initial issuance of data on exposure levels to C&N risks on a voluntary basis enables private market actors to identify disclosure gaps and adapt their reporting frameworks to ensure future compliance with mandatory C&N-	• Efficiency in capital allocation in BF structures • Mandatory disclosures would translate into a deeper and wider range of data to enable proper climate risk integration in investment decisions, facilitating deal-making

		related disclosure requirements	
Technical	• Facilitated flow of international capital through currency risk management	• Established knowledge pool in BF	• Elimination of information asymmetries in the BF ecosystem
Operational	• Integrated vision and knowledge in the BF ecosystem	• Different actors in the ecosystem are able to apply blended structures to enable Innovative solutions	• Established market instruments such as carbon markets and payments for environmental services
Market	• Public risk-sharing mechanisms introduced through pilot programs to kick-start momentum in how initiatives can be adapted to country contexts in the region	• Strengthened sectors for transition economy through integrated regulatory frameworks and incorporation of BF in sectoral and market	• Mainstreaming the use of public-sharing mechanisms would lower overall risk premium and costs, facilitating BF deal-making

		associations	

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