



Nick K. Kolev
Independent Consultant

Blended Finance: The case for realism and reform¹



Amil Aneja
Independent Consultant

Summary

Blended Finance is a structuring approach in which concessional resources—from sovereigns or philanthropies—are used to crowd private-sector investors into financial vehicles with significant development impact.²

According to some, the performance of Blended Finance has been disappointing.³ As performance cannot be judged accurately in the absence of a suitable benchmark, this paper examines briefly four elements of Blended Finance: the generation of development impact, the use of concessional resources, the tension between bankability and viability, and the availability of proper legal forms. The analysis leads to the conclusion that Blended Finance faces fundamental hurdles that inhibit its growth.⁴ Therefore, the expectations of Blended Finance, on the basis of which its performance has been deemed lackluster, appear unrealistic.

Upon identifying fixable hurdles, practical recommendations—consistent with prevailing laws and norms—are made.

Development impact

Development Finance Institutions (DFIs) and Multilateral Development Banks (MDBs) with non-sovereign guaranteed operations (NSGOs) strive to maximize development impact through investments in private-sector institutions and projects. However, development impact is not well-defined: institutions rely on heterogeneous proxies with inconsistent units—for example, number of jobs created, percentage of emissions reduced, and volume of transactions approved—that rarely differentiate DFIs and MDBs from private-sector financial institutions. To address this, NSGOs are constrained by the principle of Additionality: DFIs and MDBs must not undertake any financing for which sufficient private capital can be obtained on reasonable terms. Unsurprisingly, being a constraint, Additionality cannot ensure optimality. Moreover, a focus

on volumes approved and mobilized, often justified by “financing gaps,” puts the principle of Additionality (viewed narrowly as preventing the crowding-out of the private sector) and the objective of mobilization (viewed narrowly as promoting the crowding-in of the private sector) in conflict.⁵

Alongside Additionality, NSGOs are governed by the principle of Non-Distortion: DFIs and MDBs must transact on commercial market—or fair, according to commercial markets—prices, with minimum concessionality permissible only in Blended Finance.⁶ Thus, Additionality and Non-Distortion are not aligned: Additionality segments markets, while Non-Distortion requires DFIs and MDBs to price on commercial market terms.⁷

Acknowledging the segmentation between commercial markets and development markets is crucial.⁸ In practice, mobilization is the intricate activity—by DFIs and MDBs operating in development markets but pricing on commercial market terms—of incentivizing the private sector to invest in commercial markets. Furthermore, DFIs and MDBs use Blended Finance to engage in appropriate mobilization by structuring vehicles, offering different types of investors different exposures, and consigning sovereigns, philanthropies, and themselves to junior positions in the capital stack relative to the private sector. By contrast, when a DFI or an MDB co-finance on identical terms with an asset manager, it is impossible to know who mobilized whom—or even tell the institutions apart. In and of themselves, anchoring, originating, sponsoring, or syndicating are not equivalent to mobilizing.

Concessional resources

DFIs and MDBs are well placed to mobilize through Blended Finance.⁹ While private-sector financial institutions maximize shareholder value, DFIs and MDBs maximize development impact.¹⁰ Despite the fact that development impact is not well-defined, the different objectives of these entities exist for good reasons, and

it is unhelpful to conflate them.

When used loosely, terms such as “public funds” and “public resources” obfuscate the reality that both the private sector and the public sector ultimately serve the interests of individuals: individuals elect managements and governments, and individuals finance firms and countries. In other words, “public funds” and “public resources” are allocations that individuals have chosen to make towards public goods and services. Public goods and services must meet the requirements of Non-Excludability and Non-Rivalry; otherwise, resources belonging to all individuals may be used to advance the interests of only some individuals. For instance, a government may offer electric vehicle (EV) credits to all of its citizens, but it may not create either a fund that subsidizes the EV cost for only some of its citizens or a fund that subsidizes the EV production of only some domestic EV manufacturers. Similarly, a government may use concessionality to launch a Public-Private Partnership that benefits all of its citizens with a select group of foreign private-sector institutions, but it may not do so with a select group of domestic private-sector institutions.¹¹ In the same vein, when government aid is deployed abroad as assistance to the private sector, processes must be open and transparent to avoid even perceptions of favoritism.¹² For instance, if donor country X wishes to create a fund that subsidizes the EV cost for the citizens of recipient country Y, all interested financial institutions from countries X and Y should be allowed to participate as investors in the fund, and every country X citizen demanding an EV should be able to benefit.

Official Development Assistance (ODA) is based on the concept of government aid. Taxes, from which ODA is derived, represent the cost of public goods and services that individuals have elected to shoulder collectively. Because a government’s aid provision cannot possibly reflect the optimal aid provisions of individuals and because individuals can only add onto—and not subtract from—a government’s aid provision, philan-

thropy arises as an aid add-on. Either directly or indirectly, individuals finance philanthropic initiatives.¹³

Hence, it is illogical for public-sector institutions—national or supranational—to call on the private sector to do more. It is up to individuals—through public-sector institutions, private-sector institutions, and philanthropic initiatives—to determine their collective and personal choices. What public-sector institutions, such as DFIs and MDBs, should do is facilitate the role of philanthropy as an add-on by producing transparent donation paths.

Bankability vs Viability

The terms “aid,” “concessionality,” “donation,” and “grant” are closely related. In Blended Finance, concessionality results in bankability, which is the ability of a vehicle to attract private-sector financing. Concessionality, which emanates from sovereign or philanthropic resources, achieves bankability by altering the values, as well as the risk-return profiles, of a vehicle’s tranches.¹⁴ Naturally, by the Modigliani-Miller theorem, the vehicle’s value does not change: expected cash inflows are not affected, and the distribution of cash inflows among the various investors is irrelevant.¹⁵ Therefore, bankability is different from viability, which means that the vehicle has positive net present value (NPV).

Unfortunately, Blended Finance vehicles are almost never viable because what motivates Blended Finance most of the time is the creation of sub-market financing sources.¹⁶ For example, a decision is made that creating a vehicle that lends at 15% can promote “affordable” climate finance.¹⁷ So, instead of lending at the market rate of, say, 20%, through concessional sovereign or philanthropic resources that lower both risk and return while redistributing value among the investors (with the sovereign or philanthropic exposure losing value and the private-sector exposure gaining value), the vehicle has to be structured in such a way that it can “break even” by lending at 15%. Of course, the matching of expected returns does not control for risk¹⁸; specifically, the aggregate riskiness of the vehicle’s borrowers—who borrow at 15% instead of at 20%—does not change¹⁹. So, to lend USD 100 million, a Blended Finance vehicle has to raise USD 100 million, but the value of the vehicle’s assets falls below USD 100 million the moment the cash is converted into climate finance loans.

Some non-viable vehicles achieve bankability because, as value is redistributed among investors using concessionality, the NPV for the private-sector investors becomes attractive. In the above example, if private-sector investors are offered debt that pays 13% but an

equity position taken by a sovereign or a philanthropy is such that the debt should pay 11% instead of 13%, some private-sector investors will participate. Suppose that the participating private-sector investors pay USD 75 million for debt exposure worth USD 78 million and that the sovereign or philanthropy pays USD 25 million for equity exposure worth USD 12 million; then, USD 13 million has been transferred from the sovereign or philanthropy to the Blended Finance vehicle’s borrowers (USD 10 million) and the private-sector investors (USD 3 million).

Proper legal forms

The example above raises questions that jeopardize the credibility—and, therefore, the scale—of Blended Finance vehicles:

1. Social Norms: May concessional public resources be used for the benefit of only some private-sector persons, such as Blended Finance vehicle investors and Blended Finance vehicle clients?
2. Governance Mandate: Which legal forms permit the management to be guided by a public purpose mandate, or a development impact mandate, rather than by the mandate to maximize shareholder value?
3. Sovereign Participation: Under which conditions may a sovereign be a shareholder in a Blended Finance vehicle, and what are the established best practices associated with sovereign ownership?
4. Philanthropic Participation: When a philanthropy is a shareholder in a Blended Finance vehicle, are there limits on philanthropy ownership?
5. Exit Arrangements: Which special rules, if any, govern the exit of a sovereign or a philanthropy from its equity position in a Blended Finance vehicle, the distribution of residual value, and the continuation or winding-up of related obligations, and how is the equity exit managed to protect both development impact and capital integrity?
6. Tax Treatment: How does the tax-exempt status of MDBs interact with the structure and operation of Blended Finance vehicles?

These six questions, which do not represent an exhaustive list, imply that Blended Finance has been limited to functioning in a grey area.

Recommendations

Expectations of Blended Finance have often exceeded what legal frameworks and social norms can bear. Four hurdles recur: reliance on poor proxies for development impact; deployment of concessional sovereign resources to initiatives that do not meet the requirements of Non Excludability and Non Rivalry, and that create perceptions of favoritism; structuring of Blended Finance vehicles with negative NPVs; and use of precarious legal forms.

For Blended Finance to achieve substantial scale, the following practical fixes are proposed:

1. Mandates: While philanthropies may support initiatives with varying coverage, sovereigns may support only initiatives open to all relevant private-sector institutions and benefiting all interested citizens;
2. Viability: Separate bankability and viability, disclosing value transfers and retiring transactional volume as a proxy;
3. Transparency: Tag and report concessional elements, publish both contractual and market pricing, and align ODA accounting; and
4. Form: Deploy grants whenever Blended Finance vehicles face legal or tax challenges.

Respecting the boundaries between private goods and services and public goods and services, minimizing perceptions of favoritism, and empowering philanthropy will move Blended Finance from promise to practice.

Footnotes

1. Version of August 18, 2025
2. For two slightly different definitions, see <https://www.convergence.finance/blended-finance> and <https://www.ifc.org/en/what-we-do/sector-expertise/blended-finance/how-blended-finance-works#dfiworkinggroup>.
3. For instance, see <https://www.hoganlovells.com/en/publications/blended-finance-funding-sustainable-development-with-public-and-private-funding> and <https://www.ngfs.net/system/files/import/ngfs/medias/documents/scaling-up-blended-finance-for-climate-mitigation-and-adaptation-in-emdes.pdf>.
4. Two popular explanations for the supposedly unsatisfactory performance of Blended Finance

- are that vehicles have complex and diverse structures, and that insufficient concessional resources are being committed.
5. When Additionality and mobilization are defined clearly, catalyzation will be identified as a performance metric, and replicability and scalability will be adequately appreciated.
 6. See <https://www.adb.org/sites/default/files/institutional-document/876671/dfi-bcf-joint-report-2023-update.pdf>. Concessionality is defined as the difference between the commercial market price and the traded price.
 7. The model proposed in Kolev's "Pricing Development Assets in Non-Sovereign Guaranteed Operations," recognizing the market segmentation mentioned, defines the concept of "donation" as the difference between the development market price and the traded price: https://www.linkedin.com/posts/activity-7347279872794255361-92p_/.
 8. According to Kolev's model, just as an economic agent maximizes utility as a function of consumption, a development agent maximizes development impact as a function of donation. Investments, both in commercial markets and in development markets, are merely means of intertemporal transfer: on their own, they generate neither utility nor development impact, and their soundness hinges on their payoffs.
 9. The establishment of a global Blended Finance platform is almost certain to be helpful. See "A Global Blended Concessional Finance Hub": https://journals.co.za/doi/abs/10.10520/ejc-defa_v9_n2_a2.
 10. Sometimes, the objective may be described as maximizing the value of the firm. The fiduciary duties of directors are usually interpreted as advancing the interests of shareholders.
 11. A government can procure private-sector goods and services through standard competitive and transparent processes.
 12. The decision to send aid is, at least partially, based on national interests. Good processes further foreign policy objectives.
 13. For instance, individuals engage in philanthropy through firms.
 14. Investors are not concerned with rates of return: they are concerned with NPVs. A rational investor would prefer an investment that makes \$100 and offers a return of 5% to an investment that makes \$50 and offers a return of 10%: this is why NPV takes into account risk and return.
 15. Blended Finance vehicles may be assumed to pay no taxes (funds are pass-through entities) and face immaterial costs of financial distress (sovereigns, philanthropies, DFIs, and MDBs are extremely averse to reputational risk). There is a common misconception that concessional equity offered to a vehicle—by a sovereign or a philanthropy—as protection for private-sector debtholders decreases the vehicle's overall cost of capital by helping price debt more favorably. For example, see page 16 in *Scaling Blended Finance: Practical tools for Blended Finance Fund design*: <https://assets.bii.co.uk/wp-content/uploads/2025/04/23104557/Scaling-blended-finance.pdf>. The cost of capital associated with an investment depends mainly on the riskiness of the investment: it is the use of the money, not its sources, that matters. The weighted average cost of capital can be interpreted as the required return on the vehicle's assets. This required return, which can also be called the appropriate discount rate, depends on the riskiness of the assets, and it does not change due to changes in the vehicle's capital structure. See Chapter 14 and Chapter 16 in Ross, S., Westerfield, R., and Jordan, B. (2010). *Fundamentals of Corporate Finance* (9th ed.). McGraw-Hill/Irwin.
 16. Blended Finance allows for minimum concessionality for a reason.
 17. The term "affordable" is nebulous. It is akin to "need" or "want," and, unlike "demand," has no economic meaning.
 18. The way to ignore risk is to concentrate exclusively on notional amounts, as in the cases of holding debt to maturity or relying on historical cost accounting. This is why mark-to-market is not customary practice.
 19. One way to think about this is as paying par for a bond with a coupon rate of 15% and a discount rate of 20%. To become 15% borrowers, the Blended Finance vehicle's 20% borrowers would have to purchase adequate guarantees. In effect, through the Blended Finance vehicle, grants are passed from the sovereign or philanthropy onto the Blended Finance vehicle's borrowers and the Blended Finance vehicle's private-sector investors.