

Blended Finance Structures Without Unwarranted Fiduciary Drag

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- This is Article 3 of *The Great Development Finance Write-Off* series.
- Asset managers and institutional investors confront embedded concessionality in Blended Finance structures that distort portfolio valuations, undermine risk models, and mask true downside exposures.
- When grant-equivalents remain off-book, net asset values exaggerate performance, value-at-risk calibrations become problematic, and regulatory and client disclosures risk non-compliance—jeopardizing fiduciary duties and creating reputational risks.
- Read on to discover how integrating concessionality and donation metrics into portfolio governance—across performance reporting, risk controls, and investor communications—restores valuation integrity, strengthens compliance, and elevates capital allocation toward high-impact opportunities.

In emerging markets and developing economies (EMDEs), asset managers and institutional investors weigh multiple factors: the search for alpha, performance targets, market volatility, political risk and policy uncertainty, liability-matching needs, evolving environmental, social, and governance (ESG) standards, and jurisdiction-specific disclosure requirements. Within this environment, in the case of Blended Finance (BF) structures sponsored by development finance institutions (DFIs) or multilateral development banks (MDBs), face three imperatives: manage overhead costs associated with origination, monitoring, reporting, and evaluation; calibrate and negotiate the DFI/MDB and sovereign/philanthropy exposures that achieve the desired risk-return profiles; and, subject to DFI/MDB and sovereign/philanthropy protection, select the optimal exposure. While minimum concessionality is universally accepted in BF, opacity in concessional components—whether sub-market pricing or in-kind support—undermines accurate measurement of development impact, conflates bankability with viability, and distorts performance and risk metrics.

Nick Kolev's *"Pricing Development Assets in Non-Sovereign Guaranteed Operations"* draws a clear distinction between development agents and economic agents: the former maximize expected development impact as a function of donation, while the latter maximize expected utility as a function of consumption. Under this framing, proxies for development impact become unnecessary; in particular, investment volume is not a measure of development impact. Within each transaction, only the donation component generates, or contributes to, development impact.

In BF, concessionality leads to bankability, which is the ability of a structure to attract private-sector financiers. Derived from sovereign or philanthropic resources, concessionality achieves bankability by altering the relative values of a BF structure's tranches. Naturally, by the Modigliani-Miller theorem, the structure's total value remains

unchanged: expected cash inflows are unaffected, and their distribution among the various investors is irrelevant. Therefore, bankability differs from viability, which means positive net present value (NPV). In fact, through the redistribution of value among the investors, concessionality can render some non-viable structures bankable.

A non-viable structure can become bankable because concessionality redistributes value among investors, increasing NPV for the private sector—and, potentially for the DFIs/MDBs—and decreasing NPV for the sovereign or philanthropy. The increase stems from sub-market pricing—not merely from risk-return trade-offs. To see this, suppose that the private sector requires first-loss protection and that a sovereign provides the protection. If the protection is fairly priced, both the risk and the expected return of the private-sector exposure will fall, but the value of the private-sector exposure will remain unchanged. However, if the protection is concessionally priced, the value of the private-sector exposure will rise. In this way, concessionality not only reshapes the risk-return profile of the private-sector exposure but also transfers value to the private sector through its sub-market terms.

"Pricing Development Assets in Non-Sovereign Guaranteed Operations" goes a step further. In non-sovereign guaranteed operations (NSGOs), the principle of Additionality segments commercial markets and development markets, while the principle of Non-Distortion requires development agents—operating in development markets—to price in line with commercial markets. As a result, three prices emerge: the commercial market price, the development market price, and the traded price. Concessionality is generally defined as the difference between the commercial market price and the traded price. In Kolev's framework, for a development agent, donation is defined as the difference between the development market price and the traded price. The implication is that, because development agents must transact on commercial market terms, concessionality may be smaller than, equal to, or greater than donation.

Since concessionality reflects a price difference from the perspective of an economic agent, while donation reflects one from the perspective of a development agent, performance and risk metrics should be both augmented and aligned. For asset managers and institutional investors, such metrics have mixed implications. On the one hand, carving out concessionality may be perceived as detrimental; however, it protects fiduciary duties, ensures benchmark integrity, and promotes comparability across indices and mandates. Conversely, understanding donations is unambiguously beneficial: familiarity with the pricing methodologies of DFI/MDB partners helps establish pricing bounds, strengthens negotiation positions, and saves valuable time.

Whether intentionally or unintentionally, most institutional portfolios already carry concessional exposures, either directly (for example, via stakes in BF structures and thematic bonds) or indirectly (for example, via stakes in EMDE corporate and sovereign bonds). Yet, concessional terms are rarely unbundled. Because concessionality cannot

always be separated from the financial instrument itself, embedding it can reduce liquidity. For instance, if a well-meaning investor pays a premium for a thematic bond, they may have to recognize a loss upon sale. Unless concessionality is acknowledged and recorded separately, the investor is incentivized to hold the thematic bond to maturity. In the absence of mark-to-market discipline, the premium may never be recognized, thereby distorting valuations and undermining fiduciary duties.

Portfolio management systems in commercial institutions should automatically capture all concessional elements—price discount, technical assistance, or unpaid advisory services—and reconcile them against prevailing market prices. Practically, this means insisting on the recognition and disclosure of grant-equivalent amounts in term sheets, side letters, and reporting packs, as well as requiring managers to show both the market pricing and the concessional pricing. Such transparency serves the interest of commercial institutions: it safeguards fiduciary duties, sharpens pricing signals, and shields management and officers. The operational requirement is simple: identify every concessional component and disclose both market and concessional pricing separately.

Our subsequent analysis will show how monetary authorities can incorporate explicit concessional tagging into supervisory data templates, strengthen their stress-testing and prudential regulatory authority frameworks (including capital adequacy buffers), and adapt central bank lending facilities' valuation rules to enhance policy transmission and safeguard macro-financial stability.

Definitions:

1. *Non-sovereign guaranteed operation* (NSGO): An investment made by an MDB without a sovereign guarantee. By definition, all DFI operations are NSGOs.
2. *Concessionality*: The difference between the commercial market price and the actual traded price of an instrument, e.g., the subsidy embedded in loan terms.
3. *Donation*: The difference between the development market price and the actual traded price, i.e., the public-sector “grant equivalent” component.
4. *Additionality*: The principle that, in NSGOs, DFIs and MDBs do not undertake any financing for which sufficient private capital can be obtained on reasonable terms.
5. *Non-Distortion*: The principle that, in NSGOs, DFIs and MDBs undertake financing on terms and conditions usually obtained by private-sector investors for similar financing.