

Legal Challenges of Blended Finance

8th Inclusive & Sustainable Finance Conference – University of Luxembourg
Thursday 23 November 2023, Prof. Dr. Dirk A. Zetsche & Pedro Vilanculo



UNIVERSITÉ DU
LUXEMBOURG

Start date:
September

Collective Investment Schemes
Law & Regulation



Banking & Financial Law



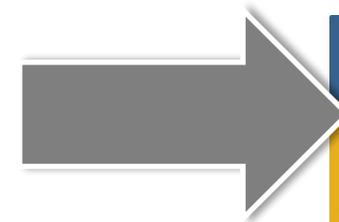
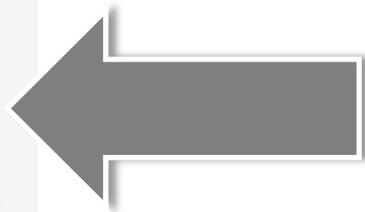
Agenda

- A. Introduction
- B. Examples of Blended Finance
- C. Blended Finance Missions as Key Features
 - I. Blended Finance Definition
 - II. Legal Characteristics
- D. Regulatory Challenges of Blended Finance
- E. Policy Considerations
- F. Conclusion

A. I. Introduction

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“Blended Finance as Instrument to Finance Transition”



A.II. Introduction

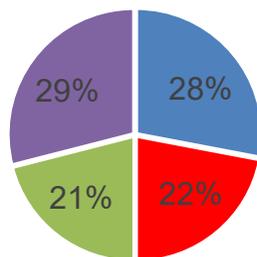
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“Market Size & Regional Focus”



Sectors



- Energy
- Financial Services
- Agriculture
- Other 6 Sectors



“Lake Turkana Wind Power Project (Kenya)”:

→ Capex €625M- 17% of Kenya’s electricity

→ **Official institutions:**

→ EU-DEVCO and AITF (EU-AITF)

→ **Blending partners:**

→ EIB; KP&P Africa B.V. and Aldwych International; Investment Fund for Developing Countries (IFU); Vestas Eastern Africa Limited; FinFund for Industrial Cooperation Ltd; KLP Nortfund Investments AS; and Sandpiper

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→ **BF mechanics for LTWP:**

- EU-AITF provided concessional loans plus equity and EIB provided commercial loans
- Dividends to finance rural electrification and social projects
- EIB structured and manages the financial instrument

→ **LTWP Impacts**

- 6000+ gigawatts of clean and affordable energy (SDG7)
- €281M less fuel imports + 85% locals employed
- Delivered industrial project an infrastructure (SDG9)

“The Philippine Water Revolving Fund (PWRF)”:

→ Capex \$50+M

→ **Official institutions:**

→ JICA

→ **Blended Finance mechanics:**

→ DBP established PWRF to induce private sector into water supply services

→ JICA provided \$50.8M concessional loan to DBP

→ **BF mechanics for PWRF:**

- PWRF loaned fund to water services suppliers
- PFI applied for credit risk guarantee covering 85% of risk.
- Guarantee issued locally by a Philippino private entity.
- USAID provided co-guarantee facility to back the guarantee

→ PWRF impacts

→ 216.872 households connected to water services.

→ Market access to private financial institutions

→ Improved financing terms (lower + fixed interest rates)

→ More access to water and sanitation plus employment (SDG6 and SDG 8)

C. Blended Finance Missions as Key Features

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I. Blended Finance Definitions

II. Legal Characteristics

- **OECD, WEF, IMF**- “Blended finance is the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries ”
- **EU**- “Blended finance is the combination of EU grants with or equity loans from public and private financiers.”
- **GIIN**- “Blended Finance as a strategy that combines capital with different levels of risk in order to catalyse risk-adjusted, market-rate-seeking financing into impact investments.”

! Lack of Consensus but each definition provides key elements

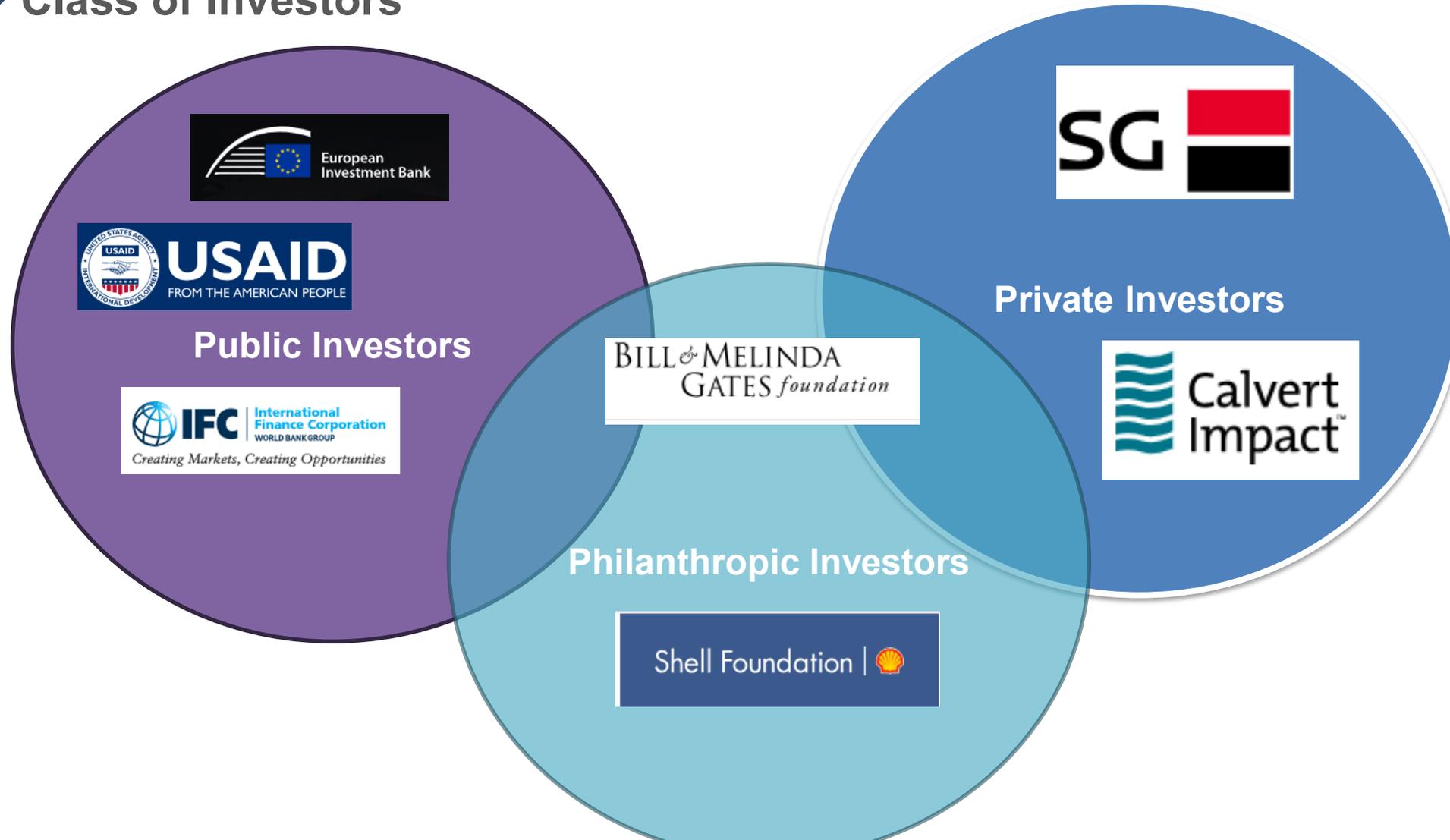
- **Mix of Diverging interests with a view to furthering Environmental and Social Sustainability**

- **Private returns vs Risk tolerant catalytic capital**
 - Public investor provide concessional loan to mobilize private funds
 - Public investor pursue public returns and private investor pursue profit
 - Dual class capital structure: Class **A** return seeking capital paired with class **B** risk tolerant capital

C.II. Legal Characteristics

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→ Class of Investors



C.II. Legal Characteristics

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→ Class of Investors (Class A & B)

Archetype investor	Role	Driver	Risk exposure
Public investor (B, A)	<ul style="list-style-type: none">-Promote sustainability-Originator + concessional and non-concessional loans-Mobilize additional funds-Assume risk + assume regulatory reform-Manage BF structure	<ul style="list-style-type: none">-Pursue public policy to promote sustainable develop-Provide access to affordable capital-Address market failure-Local market knowledge and transfer	High
Philanthropic investors (B)	<ul style="list-style-type: none">-Promote sustainability-Originators (sometimes)-Concessional loans	<ul style="list-style-type: none">-Pursuit of philanthropic goals aligned with public policy-Provide access to affordable capital	High
Private investors (A)	<ul style="list-style-type: none">-Provide commercial loans-Mobilize additional funds	<ul style="list-style-type: none">-Access to emerging markets- Make profit	Low

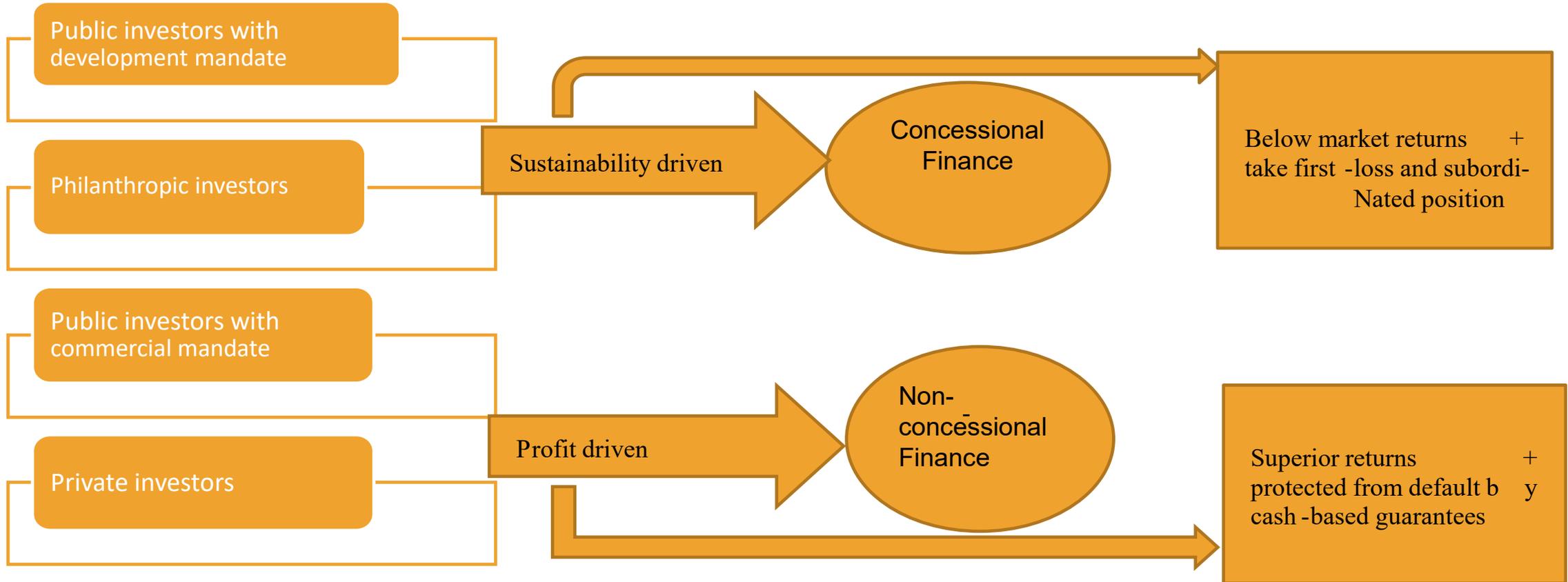
D. Regulatory Challenges of Blended Finance

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- I. Diverging Interest of Contributors (the blending in BF)
- II. Contractual Complexity
- III. Weak Institutional Environment
- IV. Lack of Transparency
- V. Public Actors Define Success and Guarantor vis-avis Geopolitical Risks

D.I. Diverging Interest

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D.II. Contractual Complexity

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- Residual claimants (Class B) do not have the last word.
- Class B cannot realize the project w/t Class A (preferred claimants.)
- Class B investors have incentive to usurp the project.
- Diverging interests require internal & external governance (e.g.. board/management of SPV)
- Board/management represent interest of all constituencies

→ **Cross-border set-up**

→ Enhances legal costs & reduces enforcement.

→ **Project location (GS)**

→ GS are the most dynamic regions for BF (e.g. 48% in SSA)

→ High transaction costs & complex processes (e.g. multiple authorities + permits, tech imports)

→ Dependence on HG threaten contractual order (customer etc)

→ Project location (GS)

- Class B investor seek additional capital from Class A to diversify risk.
- Class B investors use grants to offset costs.
- Class B investor provide political guarantees.
- Governance is permanent challenge in BF.

D.IV. Lack of Transparency

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- SPV legal form does not mandate disclosure.
- Project is small to warrant separate disclosures in the books of FI
- Public bodies involved in BF not mandated to disclose details
- So, monitoring compliance & performance management is challenging

- Vis-a-vis uncertainties public actor ensures success.
- Success seen on sustainability impacts and private returns.
- Sustainability may lose relevance when local beneficiaries participate in private returns (directly or indirectly)
- Private returns may become less relevant where local elites capitalize on sustainability

- Class B investors assume below market rates + first-loss piece.
- The above may prompt HG to claim exclusive ownership.
- The above may undermine contractual compliance to commitments.
- For both Class A+B investors credibility over commitments on returns and sustainability is key challenge.

E. Policy Considerations

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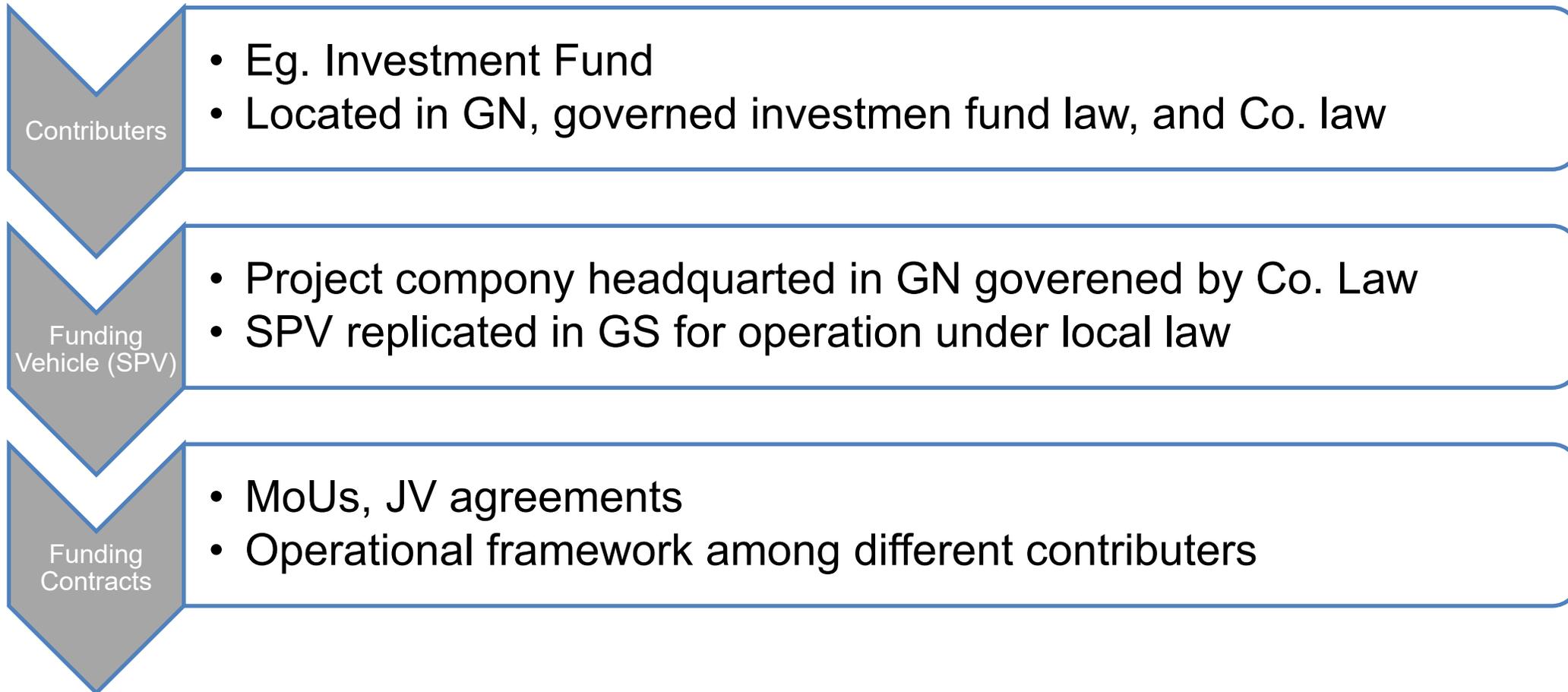


- I. Regulatory Levels of BF
- II. Governance Arrangements
- III. Disclosures
- IV. Soft Law Instruments

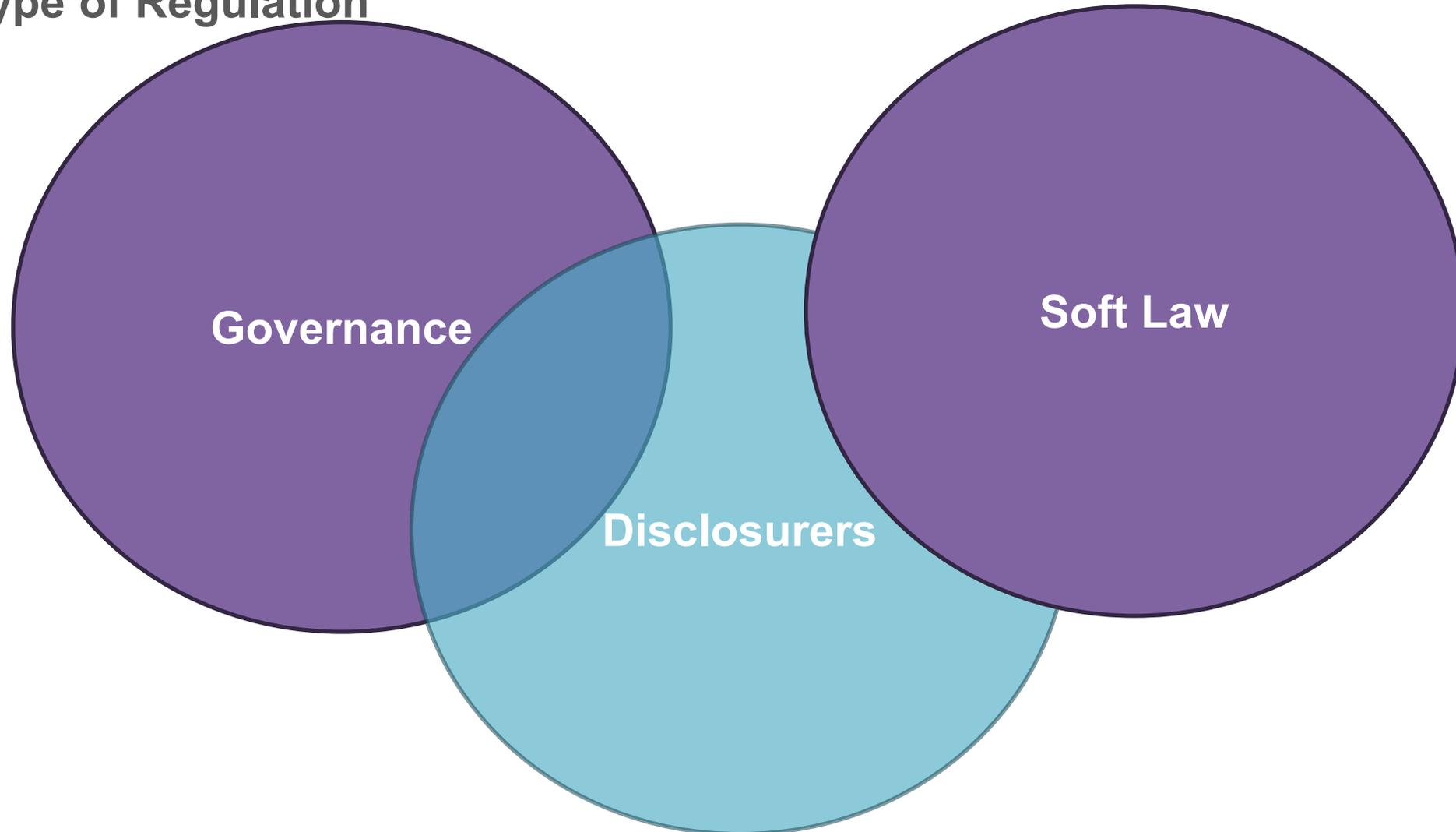
→ Geographical Scope

- Choice of local law may benefit HG before local court and arbitration panels.
- Third country law may be seen as undue influence
- When an award is granted in North there is no guarantee of enforcement in HG.

→ Object of Regulation



→ Type of Regulation



E.II. Governance Arrangements

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→ Governance arrangements



Corporate law prerequisites



Profit distribution &
Reinvestment



Conduct



Risk management
(consider double materiality)



Audits (financial and
sustainability)

→ Disclosures



Risks (internalities e.g. reputation)



Sustainability impacts (externalities)



Voluntary & mandatory disclosure



Free disclosure Vs disclosure standards (e.g. reporting standardization)



Audits (financial and sustainability)

E.IV. Soft Law Instruments

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→ **Soft law instruments**



Non-binding best practices
(IFC standards, UN GC etc)



Self-Labeling (ESG , impact
labels etc)



External Rating (IRIS Carbon,
Nasdaq ESG solutions etc.)

→ Adopting the proposed regulatory and policy considerations will:

- Reduce risk & prompt more private capital to be blended
- Scale up BF investments + deliver SI
- Over-regulation shall be avoided
- Practitioners list SFDR + Securitization as key regulatory challenges faced while structuring BF vehicles.

Thank you!

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**More Research on Blended
Finance to Follow**

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Thank you!