Blended Finance: Unlocking capital for impact and competitive returns

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FAITHINVEST

CONTENTS

EXECUTIVE
SUMMARY

Blended finance represents an innovative financing approach that addresses the critical gap between impact-first and return-prioritised investment objectives. This whitepaper explores the mechanics, applications, and real-world examples of blended finance structures that have successfully mobilised capital toward environmental and social challenges while delivering competitive returns.

Key findings of this whitepaper include:

- Blended finance provides a solution to the persistent challenge where socially and environmentally valuable projects struggle to attract sufficient capital due to misalignment with conventional investor risk-return expectations.
- By creating tiered investment structures with varying risk-return profiles, blended finance enables diverse investors to participate in the same projects while meeting their individual financial and impact objectives.
- Catalytic capital from development finance institutions and philanthropic sources can provide risk mitigation that makes projects more attractive to market-rate investors.
- Case studies across affordable housing, sustainable forestry, and renewable energy showcase how blended finance has unlocked significant capital while delivering both social/environmental impact and financial returns.
- Faith-based organisations are uniquely positioned to benefit from blended finance structures that can participate across multiple tranches that offer varying degrees of risk and return, aligning investments with values while meeting fiduciary responsibilities.

Despite mobilising approximately $249 billion in capital towards sustainable development to date[1], blended finance remains underutilised as an investment strategy considering the much larger size of the overall impact investment universe, which the Global Impact Investing Network (GIIN) estimates at $1.571 trillion[2]. This whitepaper aims to inform investors, particularly faith-based asset owners, about this effective approach to achieving dual objectives of positive impact and competitive returns.

[1] Source: https://www.convergence.finance/blended-finance
[2] Source: Sizing the Impact Investing Market 2024 https://thegiin.org/publication/research/sizing-the-impact-investing-market-2024/

INTRODUCTION
A Problem and a Solution

The Problem: The Financing Gap

When undertaking impactful projects, notably in developing countries or sectors addressing critical societal challenges, project sponsors frequently encounter a fundamental financing gap.

This financing gap – funding shortfalls – occurs because the expected financial returns of many available impact projects simply don't align with the risk profile or return expectations of conventional market-rate investors. This misalignment creates a persistent obstacle: despite the project's potential social, environmental, or developmental significance, it struggles to attract sufficient capital when relying solely on market-rate investment sources. Project sponsors find themselves in a challenging position, unable to proceed with initiatives that could deliver meaningful impact.

The Solution: Blended Finance

The challenge of this financing conundrum has led project sponsors to pursue alternative funding approaches—specifically, strategically incorporating the use of grants and catalytic capital that can help mitigate risks for market-rate investors, thereby unlocking the full spectrum of capital needed to bring these valuable projects to fruition. This approach is often referred to as blended finance, and it has long been considered a viable strategy for organizations, including faith-based entities, to address some of the world's most pressing environmental and social challenges, while also generating attractive financial returns.

OVERVIEW OF BLENDED FINANCE

A core characteristic of blended finance structures is that they allow organisations with different risk/return objectives to invest alongside each other and simultaneously achieve their own goals. Collectively, this makes the project viable and allows project sponsors to attract additional capital. For example, investors primarily focused on generating social/environmental impact (such as development finance institutions or philanthropic investors) will provide risk-tolerant, catalytic capital (i.e., concessionary / below market rate) in a way that allows institutional investors, including those that are faith-based, to receive the market rate return they are seeking, which more closely aligns with their long-term return targets.

In effect, this structuring approach can significantly scale the amount of public and private capital flowing to solutions such as renewable energy, affordable housing, healthcare, education, and agricultural projects, where traditional market mechanisms often fall short.

How Blended Finance Works

Blended finance is built on the notion that investors in a given fund will be repaid in a specific order (i.e., a tiered capital structure) and at varying rates of return based on the amount of risk they are willing to take. Each tier in the capital structure is often referred to as a "tranche".

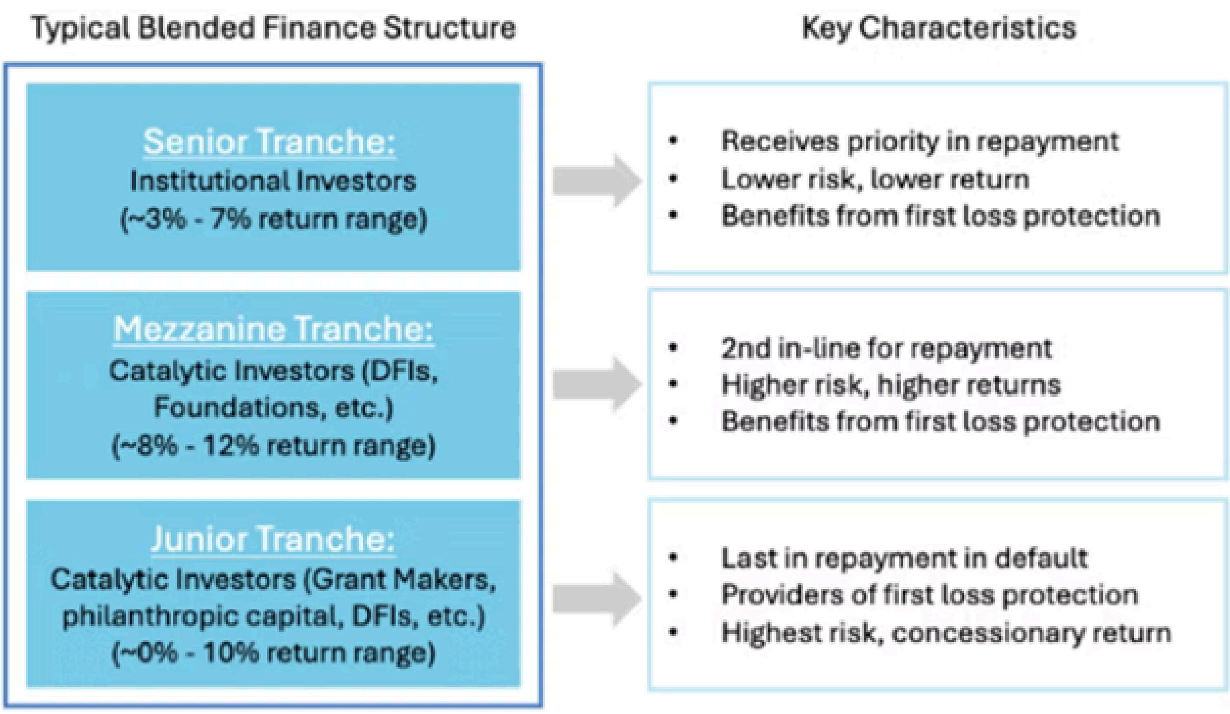
The Multi-Layered Capital Structure

Think of a blended finance project like a multi-layered cake, where each layer serves a different purpose while contributing to the whole:

Just as you might choose a slice with more frosting or fruit based on your preference, investors select tranches that align with their risk tolerance and return expectations. When it's time to serve the cake (repayment), some layers are consumed first (like senior tranches getting repaid first), while others wait their turn (like junior tranches).

Each tranche serves specific types of investors with different objectives:

1. **Senior Tranche (3-7% returns)**: Attracts institutional investors and pension funds seeking stable, predictable returns with investment-grade risk profiles. These investors receive priority in repayment, making this the safest position in the structure.
2. **Mezzanine Tranche (8-12% returns)**: Appeals to banks and more diversified investors willing to accept moderate risk for enhanced returns. These investors receive payment after the senior tranche but before junior investors.
3. **Junior Tranche (0-10% returns)**: Filled by development finance institutions (DFIs), foundations, and impact investors primarily focused on social and environmental returns. These investors accept higher risk and lower (sometimes zero) financial returns to generate impact.
4. **Equity/First-Loss Layer**: Often provided by philanthropic capital or grants, this layer absorbs initial losses from underperforming loans, creating a protective buffer for other investors. This critical element makes the entire structure viable by significantly reducing risk for market-rate investors.



In certain cases, additional "first-loss protection" may be needed through an explicit equity tranche. This becomes the riskiest layer as it's first to absorb losses and last in repayment, but it enhances the risk-return profile for all other investors.

First-Loss Protection Mechanism

First-loss protection is particularly beneficial for institutional investors because it allows them to engage in investments with a lower risk profile, knowing they have a cushion against potential losses. This mechanism works by:

1. Creating a designated pool of capital (often from foundations or DFIs) that absorbs initial losses.
2. Establishing a contractual arrangement where this capital takes first losses before affecting other tranches.
3. Providing transparency to senior investors about the size and terms of this protection.
4. Enhancing the creditworthiness of the overall investment vehicle.

This protection ultimately makes projects more palatable to traditional and values-based investors who might otherwise avoid riskier ventures, effectively bridging the gap between impact goals and market-rate return requirements.

Common Blended Finance Implementation Approaches

After understanding the basic structure of blended finance vehicles, it's important to consider practical implementations. Blended finance can take various forms depending on the specific needs of the project, sector, and region. Below are some common approaches:

Structured Funds and Facilities

Many blended finance vehicles are structured as funds or facilities that pool capital from multiple investors with different risk-return appetites. These structures often include:

- **Dedicated Guarantees**: Partial or full guarantees provided by development finance institutions or foundations to cover specific risks (e.g., political risk, currency risk, or credit risk)
- **Technical Assistance Facilities**: Complementary funding used to strengthen the capacity of investees, improve project design, or address specific operational challenges
- **Design-Stage Grants**: Early-stage funding that supports the development of investment-ready projects, particularly in frontier markets where project development costs can be prohibitive

Common Blended Finance Implementation Approaches (cont.)

Sector-Specific Applications

Blended finance has proven particularly effective in certain sectors where traditional financing struggles, but impact potential is high:

- **Renewable Energy**: Supporting early-stage renewable energy projects in emerging markets by mitigating technology and policy risks.
- **Sustainable Agriculture**: Providing working capital to smallholder farmers and agricultural SMEs through value chain financing.
- **Affordable Housing**: Creating financing mechanisms that support development of housing for low-income populations.
- **Healthcare**: Enabling the expansion of healthcare facilities and services in underserved regions.

Geographic Targeting

Blended finance is often tailored to specific geographic contexts:

- **Emerging Markets**: Addressing higher perceived country risk through first-loss capital and guarantees.
- **Frontier Markets**: Providing deeper concessional funding to overcome severe market failures and information asymmetries.
- **Local Currency Solutions**: Incorporating currency hedging mechanisms to protect international investors from exchange rate volatility.

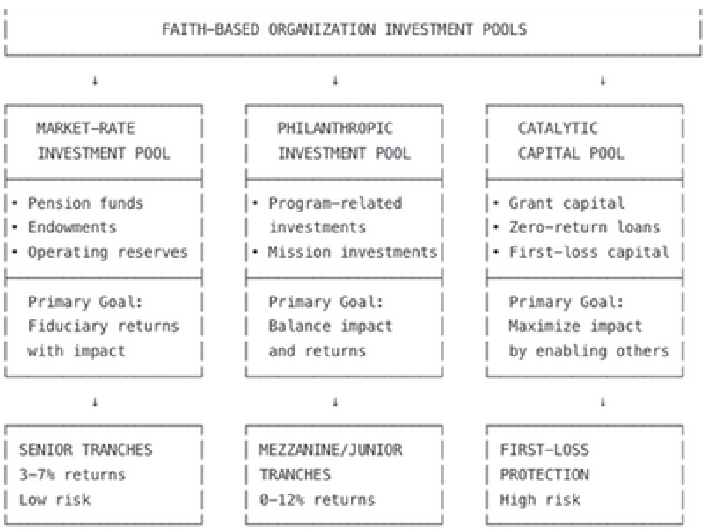
WAYS TO INVEST IN BLENDED FINANCE OPPORTUNITIES

Blended finance may be particularly attractive for investors with dual investment objectives – such as faith-based asset owners (FBAOs) – who have developed (or are developing) a portfolio-wide approach to investing alongside their values. In addition to negative/positive screening, or a heightened focus on engagement, blended finance offers an additional option to a FBAO's sustainable investment program that enhances its pursuit of solution-oriented impact investments.

Leveraging Diverse Capital Pools

Faith-based organisations often manage multiple pools of capital with different objectives, making them ideally positioned to participate across the blended finance spectrum:

1. **An Investment Portfolio Seeking Market-Rate Returns**: This capital can be used to participate in senior tranches of blended finance projects, which often have return targets comparable to traditional investment grade corporate bond portfolios. Senior tranches of blended finance vehicles often benefit from enhanced risk mitigation through first loss protection, often improving the risk-adjusted return profile of the investment.
2. **A Portfolio of Philanthropic Investments**: This pool might engage directly in mezzanine or junior tranches where the FBAO is willing to accept a higher level of risk and return for generating significant social or environmental impact.
3. **A Portfolio Focused on Providing Catalytic Capital**: Funds set aside for grants and/or below market-rate loans help create the first-loss cushion in blended finance structuring. By accepting higher risk from providing this type of capital, the FBAO improves the risk profile of the overall investment fund, facilitating capital flow from more risk-averse, institutional investors.



Case Studies: Successful Implementation of Blended Finance

To demonstrate how blended finance structures allow organisations with different objectives to invest in a project alongside each other and simultaneously achieve each of their unique goals, we highlight three investments made in distinct regions of the world comprised of a wide range of investors.

Case Study #1: Wespath Benefits and Investment's Positive Social Purpose (PSP) Lending Program

Wespath Benefits and Investments (Wespath) maintains one of the largest faith-based pension funds in the world, serving more than 100,000 active and retired clergy and lay employees of the United Methodist Church. With its subsidiaries, Wespath manages nearly $26 billion in assets (as of December 31, 2024) and is committed to making a positive impact on the environment and society while generating competitive returns that allow it to fulfil its fiduciary obligations.

One of Wespath's unique and long-standing investment programs is its Positive Social Purpose (PSP) Lending Program, founded in 1990, it has invested over $2.1 billion in affordable housing and community development projects in the United States and in global microfinance opportunities.

Fund Background

The Broadview Senior Apartments project located in Broadview, Illinois demonstrates how Wespath's PSP Lending Program utilises blended finance principles to create positive social impact while generating market-rate returns.

As a senior debt investor, Wespath holds the primary claim on assets in the event of default, which helps minimise risk while ensuring competitive returns for its beneficiaries.

This affordable housing development, like many in the PSP portfolio, relies on what is often referred to as "lasagna financing" or multiple layers of funding sources that work together to make projects financially viable while addressing critical community needs.

Capital Structure

The financing structure for the Broadview transaction included several layers of funding, each with different risk-return profiles:

- First mortgage loan participation with Wespath holding the senior debt position.
- Financing provided by the Cook County HOME funds, which are part of the U.S. Department of Housing and Urban Development's (HUD) HOME Investment Partnerships Program and finance a variety of housing activities assisting low-income households.
- U.S. Government Low-Income Housing Tax Credit (LIHTC) program funding the equity investment.
- Illinois Affordable Housing Tax Credits, which encourages private investment in affordable housing by providing a one-time tax credit equal to 50% of the value of qualified donations.
- ComEd Energy Efficiency grant, which incentivised the integration of high-efficiency heating and cooling systems and advanced air-sealing techniques throughout the building envelope to minimise air leakage and reduce heating and cooling costs.

This layered financing approach enables Wespath to occupy a risk position that meets its fiduciary requirements while allowing other investors and funding sources with different risk-return expectations to participate in the same project. The result is a successful investment that provides stable housing for low-income populations including seniors, veterans, disabled persons, and individuals experiencing homelessness.

The PSP Lending Program has demonstrated remarkable resilience over time, even during economic downturns, due to several factors:

- High demand for affordable housing -- With a nationwide shortage of approximately 7.3 million affordable rental units for extremely low-income households, these properties can maintain high occupancy rates as well as waitlists.
- Government subsidies: Support from federal, state, and local agencies helps ensure steady rent inflows over the financing term.
- Professional oversight: Wespath collaborates with Community Development Financial Institutions (CDFIs) that conduct thorough due diligence, underwriting, and loan servicing on these transactions.

By positioning itself as a first-position debt investor within this blended finance structure, Wespath successfully balanced its fiduciary duty to generate competitive returns with its commitment to making a positive social impact in underserved communities.

Case Study #2: Forestry and Climate Change Fund

Convergence Blended Finance is a global network for blended finance that works collaboratively with all types of stakeholders to help make the UN Sustainable Development Goals (SDGs) investable through blended finance. As a non-profit organisation designed to address the core challenges that hinder private investment in emerging markets and developing economies (EMDEs), Convergence provides guidance, education, and networking opportunities to advance the field of blended finance. Additionally, and importantly, they help mobilise private capital toward EMDEs by providing access to blended finance deals and by providing grants for the design of – and sharing learnings from – early stage blended finance structures.

One of the shared learnings we highlight here is a case study provided by Convergence on the Forestry and Climate Change Fund (FCCF) managed by the Investing for Development (IfD) SICAV.

Fund Background

IfD launched FCCF in October 2017 to directly address a major environmental challenge in Central America: the ongoing conversion of forest to pastureland. The fund was established as a $20 million, 15-year fund to create a viable and sustainable business model for timber production within secondary and degraded forests (SDFs). Secondary forests are those that have naturally regenerated after significant human and/or natural disturbance, while degraded forests are those in which most or all of the commercial timber has previously been removed. SDFs represent a significant portion of global forest area (up to 58% according to the Forest Resources Assessment Report 2015) and are at particular risk of conversion to other land uses despite being an important source of a range of goods and economic services.

By investing in entities which provide management solutions to owners of SDFs, the fund was able to further demonstrate the economic value and commercial feasibility of sustainable timber production within SDFs, thereby contributing to climate mitigation and heightened local economic development.

Capital Structure

After identifying local challenges and solutions to forestry and conservation, IfD adopted a blended finance approach through the use of first-loss capital to mitigate for uncertainty and perceived risks held by institutional investors unfamiliar with investing in secondary forest restorations.

The fund is a multi-tiered closed-end private equity fund that is built off two share classes (i.e. tranches or "layers" in the cake example provided earlier). The Class I Shares provide first loss protection in the event of credit losses or defaults. This tranche appealed to public investors that were primarily seeking development impact and were willing to take additional risk to achieve their goals.

Class J shares are the senior ranking investment class in the fund, benefiting from downside risk protection provided by the other subordinate tier of shares (i.e. Class I shares).

By dividing the fund into tranches, IfD was able to reduce the perceived risk of the fund to market rate levels that aligned with risk-return expectations from Development Finance Institutions (DFIs) and institutional investors.

The fund also allowed for senior notes, targeting High Net Worth Individuals (HNWIs) and institutional investors seeking the most risk protection. Noteholders ranked senior to all shareholders of the fund and were thus the most protected from any potential losses.

Lastly, the fund was complemented by a technical assistance program (TAP) that helped ensure the investment readiness of the fund's pipeline borrowers by improving the technical, organisational, and entrepreneurial skills of local forest management entities that were potentially eligible for investment by the fund.

Overall, the fund attracted numerous investors representing a wide range of investment expectations. For example, Luxembourg's Ministry of the Environment, Climate and Sustainable Development provided the first-loss capital commitment (Class I shares), while the Luxembourg Ministry of Finance invested in Class J shares.

By leveraging a tiered capital structure, FCCF was able to provide each investor with the return expectations that met their individual risk appetite, while successfully delivering critical climate mitigation, adaptation, and local economic development benefits.

Case Study #3: Green for Growth Fund

Another successful example of blended finance in action is the Green for Growth Fund (GGF).

Fund Background

Founded in 2009 as an initiative of the European Investment Bank and Germany's KfW Development Bank, the GGF is a unique public-private partnership with a layered risk-return structure.

It blends funding from public sources and international financial institutions to attract private capital to substantially increase investment volumes to regions and sectors that do not normally attract such flows.

The fund centers on mitigating climate change and promoting economic growth by investing in measures that reduce energy consumption, resource use and CO2 emissions. The GGF operates in 19 markets across Southeast Europe, Turkey, the European Eastern Neighborhood Region, and the Middle East and North Africa.

Capital Structure

The GCF is a closed-end, Luxembourg registered investment company that was set up in 2009 for an unlimited duration. It is open to institutional investors only and utilises a tiered risk-sharing structure to attract commercial capital from multilateral and private institutional investors.

As a public-private partnership, the GGF leverages funds from public investors, in the form of first-loss C shares, and international financial institutions' funds in the form of mezzanine shares, and allows private capital in the senior shares and notes.
The fund offers five types of shares (i.e. tranches), each with a distinct risk/return profile to suite varying investor expectations.

Investors in the GGF primarily include multinational development banks (including the European Investment Bank, Germany's KfW Development Bank and the European Bank for Reconstruction and Development, among many others) and private institutional investors (including Finance in Motion, and ASN Bank (the largest sustainable bank in the Netherlands.

Since its inception, GGF's blended finance structure has successfully attracted a range of public and private investors, allowing it to invest EURO 1.7 billion in partner institutions cumulatively.

The fund currently manages EURO 962 million and is invested in 65 active partner institutions, which are contributing to significant emissions reductions and savings in water, waste, and energy. For example, GGF provided a EURO 28 million loan for the construction and operation of a 50MW solar plant in Topoje, Albania, which is estimated to generate 108,000 MW of clean energy annually and eliminate ~1,900 tonnes of CO_2 emissions per year. This plant – known as the Blue 1 solar plant – is the largest unsubsidised project of its kind in the Western Balkans and increases the stability and resilience of the Albanian energy system by diversifying its energy mix and reducing its reliance on hydropower, which has not been able to provide sufficient electricity to meet local demand during the country's dry years.

Conclusion: The Strategic Value of Blended Finance

Blended finance represents a strategic mechanism for mobilising resources toward projects that create lasting, positive impact around the world, while also generating returns that meet a range of investor expectations. By creating a tiered return structure, based on varying levels of expected risk and return, and offering risk mitigation mechanisms like first loss protection, blended finance structures provide a viable solution to helping fund the financing gap that arises from high impact projects/loans in high risk or emerging/frontier markets.

Strategic Advantages for Faith-Based Investors

Faith-based organisations – particularly those with diverse pools of capital – are in a unique position where they can catalyse impactful projects that align with both their values and their investment objectives by investing in the tranche that best meets their goals. Those that provide first-loss protection play a pivotal role facilitating other institutional investors to participate in senior tranches, creating a compelling case for the scaling of blended finance opportunities that yield both financial gains and social good.

Key Benefits of Blended Finance

1. **Dual Objectives Achievement**: Blended finance structures offer the unique ability to meet varying investor risk/return expectations while meaningfully scaling environmental and social impact.
2. **Portfolio Alignment**: Integrating these investments into an asset-owner's investment portfolio can assist in better aligning the organisation's investments with their values, while demonstrating industry leadership.
3. **Economic Transition**: Well-structured blended finance vehicles help facilitate the transition to a more sustainable and inclusive economy by directing capital to underserved but impactful sectors.
4. **Practical Implementation**: With numerous investment opportunities currently in the market, and no shortage of qualified asset managers, faith-based asset owners looking to help scale impactful investments that generate risk-commensurate returns should not hesitate to further explore the feasibility of blended finance solutions for their portfolios.

As demonstrated through the case studies presented in this whitepaper, blended finance has proven effective across multiple sectors—from affordable housing in the United States to sustainable forestry in Central America to renewable energy in Eastern Europe and beyond. By understanding the mechanics and opportunities of blended finance, faith-based investors can expand their toolbox for achieving both impact and returns in service of their mission and fiduciary responsibilities.

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