TC Podcast:
Blended Finance and Climate Adaptation Considerations for Financial Supervisors

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Opening automation: You're listening to a Toronto Centre podcast. Welcome. The goal of TC podcasts is to spread the knowledge and accumulated experience of global leaders, experts, and world-renowned specialists in financial supervision and regulation. In each episode, we'll delve into some of today's most pressing issues as it relates to financial supervision and regulation. The financial crisis, climate change, financial inclusion, fintech, and much more. Enjoy this episode.

Shelina Visram: Hello, everyone. Welcome to our Toronto Centre podcast. I'm Shelina Visram, program director at Toronto Centre. Today's podcast will address some key topics for leaders, including financial supervisors and regulators to consider blended finance as a vehicle to help support the fight against the worst effects of climate change.

We will cover topics such as, what is blended finance? Some examples of blended finance projects in developing and emerging economies, implications for regulators and supervisors, the role of blended finance in just climate financing, and finally, look at constraints and ways to increase blended finance.

I have the pleasure of speaking with Dr. Naresh Singh. Dr. Singh is professor and vice dean of the Jindal School of Government and Public Policy. He has served as special advisor on sustainability at the Toronto Centre, where he provided advice on climate and other environmental issues as they relate to financial regulatory and supervisory risk management and supported capacity development to manage such risks. He now serves regularly as a Toronto Centre program leader on climate risks to financial system. Welcome, Naresh.

Naresh Singh: Well, thank you very much, Shelina, it's great to be with you again, and to be looking at this very important subject. As the world seeks to do all they can to combat climate change, every little bit helps. And we are going to talk about how blended finance can increase financial flows to developing country and helping fight against this really serious problem. So where to begin?

Shelina Visram: Thank you, Naresh. So let's start with the introduction. What is blended finance, and why is it important to developing and emerging economies?

Naresh Singh: So first of all, what is blended finance? Blended finance, simply put, is use of public resources, public money, to de-risk private money where the risk might appear too high for private investors to invest. In other words, you have some kind of public financial guarantees, which is not exactly new, it has been used in the past, but not focused on sustainable development goals as SDG's for short.

So, these vehicles are so structured as to de-risk the finances coming from the private sector, and so encourage them. The importance of this is that the amount of public money available for developing countries as aid, for example, is just of the order of 150 billion US dollars a year.

But the need for the SDG's, the financial gap, is of the order of 2.5 trillion US dollars. So hence, we have to use all possible vehicles, financial vehicles at our disposal to begin to help bridge that gap. And that is why this vehicle of blended finance is so important. You see, the assets under management of the private sector are of the order of 200 trillion. So, we are talking of about 1%, if we can find some ways to get the private sector to invest just about 1% of that in this area of climate change, and broadly speaking, the sustainable development goals, we will be making a massive contribution. And that's why blended finance... That's what it is. And that is why it is so critically important for developing and emerging country economies.

Shelina Visram: Thank you for that. I think that was helpful in sort of setting the stage for our next question, which is, how can blended finance help in managing climate risks to the financial system? Perhaps you can provide us with one or two examples of blended finance projects in the context of climate risks.

Naresh Singh: So, like we just said, it is about getting private money into funding what was traditionally done by public money, by using the public finances as leverage in developing countries, so that private money will flow into these areas that don't typically see them. So let me provide one or two examples for you.

The first example I'll share with you is solar power company in Thailand. And this company in Thailand one day solar company group, they wanted to build solar farms in Thailand's sunny Northeast. The project was a first for the country in Thailand. And so commercial lenders obviously were reluctant to jump into this untested market because they figured nobody has done this before, this is too risky.

So, after a few years of persistence, and knocking at many doors, the IFC decided... The IFC is the International Finance Corporation of the World Bank, that provides loans to the private sector in developing countries at rather low interest rates. So, they decided that they will get an eight-million-dollar commercial loan. And this was then blended with another four million low interest loan from another fund called the Clean Technology Fund.

So, this gave confidence in the fact that IFC and the CTF, the Clean Technology Fund, was coming in with some money. Some local Thai banks then got confidence to invest as well. And they came in with a 14-million-dollar grant toward this solar power company group.

So, by 2015... amazing example. It's now well documented by the UN, and so on, it's on the UN finance special financial initiative, and so on. By 2015, this company had attracted of the order of 800 million dollars worth of investment. And all of that was coming from the private sector, excepting the small amount that we just discussed, which was initially invested by the public sector. SPCG, this local Thai company is now Thailand's largest, or one of them, largest solar farms reducing carbon dioxide emissions by almost 200,000 tons per year, which is equivalent to taking more than 40,000 cars off the road.

So, you can see the impact is tremendous. Now, this is one of the best stories you will find, and not all blended finance stories are this dramatically successful. But it demonstrates very clearly, the potential. Between 2013 and 2016, the company's revenues more than doubled, and its profits have quadrupled. So great example of how blended finance can be used to help fight climate change.

Naresh Singh: But that was an example in an emerging economy in a reasonably wealthy country. Maybe an example from a poorer part of the world, Africa, might be of value to our listeners as well.

Shelina Visram: Absolutely. Yes, thank you.

Naresh Singh: Yeah, so one example of a blended finance facility is what might be called a cascade approach in the Africa Agriculture, Trade, and Investment Fund. This was a 172 million US dollar fund public private structured, depth fund, which was administered by the Deutsche Bank, and it targeted sustainable agricultural investments in Africa.

You see, agriculture in Africa is sort of the backbone of the livelihoods of so many people. And at the same time, it is very sensitive to climate change, because of the soil, the weather, and all of that. The capital structure of the fund was made of several trenches of different size, with different risk/return profiles, and different maturity gates as well.

So, this is how it was structured. The German Federal Ministry for Economic Cooperation and Development, which is the acronym is well known to many people in Africa, and elsewhere in the world, BNZ, invests through their technical arm, which is KFW, they invest in the most, what might be called, junior trench, or seed shares.

See, the seed shares provide a public first loss capital, which serves then as a catalytic risk buffer to encourage the private investment to come in, and they get more senior shares. They also invest along with others, such as the Austrian Development Finance Institution, and their own technical arm in mezzanine or B trench shares. And finally, private investors come in and they invest in what might be called A shares. These are quite highly protected, the chance of loss is much less, the returns are structured in a way that they are quite attractive. And so, you attract the private investors to partner with this public fund.

And sometimes there is even an additional protected layer, which is made up of capital gains generated by the fund's equity investments. And so, they provide what might be called a super first loss gap. This fund has in fact been working for several years now, and it's ongoing in Africa, countries like Zambia, Malawi, and others, Senegal, are actively engaged in this fund with both energy, climate change, and related to climate, smart agriculture.

So, there we go, you know? Some examples of how this might work. There are other models, but these two give you a good feel about this.

Shelina Visram: Yeah, thank you for those examples. I think it will resonate with our audience. In terms of Africa, just your view on this, so there has been increased focus on blended finance relating to agriculture business, and climate smart agriculture. Do you think it would be fair to say that perhaps the growing focus now in blended finance is more around health, because of the economic fallout from the COVID-19 pandemic?

Naresh Singh: No, not at all. Most of blended finance, up to now, even post-pandemic, was to energy projects. There are some health projects. So, the investment in health projects would be greater than pre-COVID, but nowhere near the bulk of the funding going to health. It is still in energy projects, and some going to infrastructure projects.

Otherwise, we see for it to be attracted to health projects, the returns will have to be pretty significant, and the risk level and so on tend to be lower for longer term infrastructure type projects, or other parts of the economy. So, it is still in... The bulk of the funding is still in energy.

Shelina Visram: Thank you for that. So, in terms of central banks and financial regulators, and supervisory agencies, in your view, what is their role in the context of blended finance and climate risks to the financial system?

Naresh Singh: See, some regulation and supervision, as we all know, help in creating conditions for stronger financial systems, and a strong financial system critical to growth, job creation, the prevention and reduction of poverty, and so on, which are of critical importance to emerging and developing country economies. Inadequate regulation and supervision on the other hand, increases the risks of financial stability and financial crisis.

So, all financial regulatory and supervisory agencies have a mandate to preserve and main... Well, maintain and enhance the stability of financial systems for all of these reasons. Climate risks combined, for example, with the recent pandemic, which we were just talking about, these examples are shocks for the financial system, which, you know, is really of importance these days, to regulators and supervisors.

Now, they need a policy framework to support them. And sometimes that is not there. And it can be a challenge for financial regulators and supervisors to engage fully in managing climate risks, because they might see that it is sometimes beyond their mandate. But more and more, there is call for supervisory authorities to be more proactive on climate change, to be more engaged in financial inclusion, which they have been doing without climate change. But climate change might have also a different, or differential impact on women and more vulnerable groups. And so while they've been taking gender equality and so on into consideration, more and more they need to do so because of the differential impacts of climate change.

Now, both physical and transition risks of climate change can have adverse impacts on a range of aspects, components of the financial system. Credit, market risks, operational risks, legal and replicational risks are all likely to increase as a result of climate impacts on the financial system.

So, a bunch of risks need to be managed by financial regulators and supervisors. And if you don't have blended finance as a very important mechanism to help with this fight, we are going to end up now with new models of financing. New risks, because many of them, the regulatory agencies might not be familiar with these vehicles like we just discussed. And they would need capacity building, they would need to look at these additional risks of climate change, and work on all of this together.

So, this will be of critical importance to financial regulators and supervisors. On the other hand, as well, we must not forget that not only is climate change having a lot of negative impacts on the financial system, and indeed on the economies of all of these countries, but there are also opportunities. There are opportunities for growth, for development through low carbon solutions to the problem. In fact, the

Global Commission on the Economy and Climate estimates about 26 trillion dollars worth of growth, which will be job creating, creating as many as 65 million jobs around the world.

And so blended finance in developing countries would hopefully be growing in importance. It's been growing already at a low and slow rate of just about 3%. It needs to grow much more. And the importance of financial and regulatory agencies is therefore more than likely to increase.

Shelina Visram: Well, it's encouraging to know that it has opportunities. There are risks with everything. But it is good to know that, and very encouraging. It is a motivator that there are opportunities with this too. So, as we know, climate risks have and will probably continue to significantly affect more vulnerable members of society. Can blended finance help in supporting inclusive climate action? Meaning, the connection between the national inclusion strategies, the national literacy strategies, and now inclusive climate action.

Naresh Singh: Yes, I think so. We have to be more and more tailored to be able to have a greater impact on this problem. But the potential is there. I'll explain why. See, financial systems now, as we just mentioned, are facing these two extras concurrent, which I like to refer as exogenous shocks coming from climate change and the pandemic.

And the pandemic, of course, appeared to have bogged down in some places, surging again in others. It's this classic, what we call, complex adaptive systems that is highly uncertain and unpredictable. So, we need to continue to give it serious attention. Now, both of these are exacerbating existing social injustice, and indeed, economic inequality.

The pandemic, climate change is impacting and will have much greater impacts over time. The pandemic was a huge shock to the system. And we already have had clear examples of how it has differentially impacted more vulnerable members of society, people who are marginalized either by race, or ethnicity, or for some other social structure, social barriers. And women as well.

And so, in order not to have these vulnerable groups left behind, in fact, the sustainable development goals specifically mention that the main purpose of these goals is to ensure that no one is left behind. And blended finance is about bridging the SDG financial gap as we just discussed. It’s, therefore, right in the heart of helping to address the more vulnerable, the women, children, handicapped, and as we mentioned, other sectors of society that might be marginalized.

It is also important, we were talking a minute ago about all the elements for regulatory action, and supervisory actions. And we need to bring this together, because financial and regulatory agencies supervisors need to be looking at these together. So not only climate risks as a risk per se, but its differential aspects exacerbating these differential impacts on women's financial inclusion, on other aspects of being in this society. And therefore, we need to be looking at new products, new delivery systems, while identifying and mitigating risks to ensure consumer protection and others. So, this whole area has real potential to benefit from blended finance.

Shelina Visram: Thank you for that. I think it connects the dots nicely between inclusive climate action and as it relates to some of the other mandates of financial regulators and supervisors around financial inclusion, responsible market development, et cetera. So thank you for connecting the dots for us. From your perspective, what are some of the constraints to blended finance, and how can these be overcome?

Naresh Singh: Yeah, before I answer that question, I should also mention for our listeners who might be interested in the role of financial regulators and supervisors, and how their role in helping with this differential impact on the more vulnerable society, as well as the more general roles of climate change effects on the financial system. And I wanted to mention that a lot of very good detail is to be found in the Toronto Centre Note, what is typically called the TC Note. One that is dedicated to blended finance, the role of regulators and supervisors in relation to climate change and the sustainable development roles.

Naresh Singh: So those of our listeners who would like to see some more detail, do look up this Toronto Centre Note, which can easily be found at the Toronto Centre website.

Naresh Singh: But let me turn to the question you just posed, Shelina, and this one is on the challenges. And there are lots of challenges. We were just talking about in Africa, the challenges there. And unfortunately, the great irony here is that the countries that most need additional money, and hence, blended finance, are the ones that are in the least position to be able to attract them.

Naresh Singh: This depends on investment mandates, low risk capacity ratings. That's what investors look for, political stability, liquidity, foreign exchange risks, all of this, they look for. And these risks tend to be pretty high in the least developed countries. Several of these countries are not even rated, because they are considered below investment grade.

Naresh Singh: And this, therefore, provides a major challenge to attraction, attracting blended finance. So those are the framework constraints that we face. Now, development finance institutions might raise higher costs when using local partners. And so are sometimes decentivized to using local financial institutions. People, agencies, local investors, governments of developing countries are all looking to engage their local economy in these blended finance mechanisms.

Naresh Singh: But local currency risk is sometimes a barrier, either across border investment, or to more international investment. Then there might be financial regulations locally, which are seeking to have some kind of regulatory stabilization. But at the same time, they could be a kind of a barrier to international investments. And then you can have insurance regulations, which could limit blended finance engagements by the nature of the insurance frame, and which might require large capital buffers for longer term and higher risk assets.

Naresh Singh: So, a range of constraints, unfortunately, for those countries that really need more money. But that's how the reality of the situation is.

Shelina Visram: So, in terms of overcoming some of those, did you want to maybe discuss a little bit of those, share your ideas on that?

Naresh Singh: Yes, I would hate to leave our listeners, and to end our podcast on that note of challenge, difficulty, disadvantages of our least developed countries. There are ways, and many institutions are looking at these. And I'll just summarize these quickly. Multilateral development banks, and development finance institutions should set higher targets for how their money will mobilize private capital so that they their public money that they invest, that they use it to begin to attract more and more money.

And hopefully, because multilateral development banks and development finance institutions all the OECD countries are actively engaged in these countries, we have this advantage of hopefully attracting some degree of blended finance to these countries. Institutional investors and asset managers can commit more to investing in sustainable infrastructure. We need to tackle regulatory disincentives that we just mentioned. Where these exist, governments and regulatory and supervisory agencies need to address these, to look at them, and to address them.

Data. You know, investors coming in to invest, data can be a big challenge. And so improving the access to data will help in getting more and more blended finance to these countries. Again, we need to look at how we can develop and scale blended finance vehicles and instruments to increase the investment in key areas, including sustainable land use, resilient cities, and so on.

In order to make all of this happen, something that is centrally important, both for regulatory and supervisory agencies, but for developing countries as a whole, is to build the capacity to create and manage blended finance deals. And that kind of money is available and should be accessed more by these countries.

So, I hope this has been you know, we have been able to put this on much more of a positive note that countries might continue to seek more and more blended finance is appropriate too their countries, and taking steps that I've just outlined, so that they might be better able to deal with the challenges of climate change with the financial system.

Shelina Visram: Thank you, Naresh. And just building on some of the ideas you shared, as you know, a lot of countries that Toronto Centre works with, and agencies, and central banks, they are in the process, particularly in the developing countries, in the process of transitioning from a compliance based supervisory regime, to a risk based supervisory regime that offers more proportional way of doing things. And I feel that this can also further help with integration of blended finance as an element into their effective supervisory toolbox. And in terms of the data, I think even sort of slicing and collecting data that is more sex desegregated can probably provide a more focused investment opportunities in blended finance that incorporate a gender lens.

Naresh Singh: Mm-hmm (affirmative).

Shelina Visram: So, does that resonate with you?

Naresh Singh: Absolutely. If we did not have risk based supervisory structures, we would need to introduce them now in order to make this work, because it's all about risk management. And you know, like we mentioned at the very beginning, blended finance is about using public money to de-risk private money, in order to address the central risk of climate change. So that way, it's all about risk management. And the capacity for risk-based supervision, indeed, is an asset in order to be able to attract blended finance. So very much on point.

Shelina Visram: Thank you very much, Naresh. This session has been very insightful, as you have highlighted, with examples, some key topics for leaders, including financial supervisors and regulators to consider, when engaging in blending finance discussions. Thank you so much for your time.

Naresh Singh: It was a great pleasure to be with you again, Shelina, to be able to share with our listeners this really important subject of how to be able to help developing countries and emerging economies attract more money to fight this really difficult and looming challenge of climate change. Thanks very much for having me.

Shelina Visram: Naresh, as always, a pleasure to work with you. Thank you very much. To our audience, you've been listening to a Toronto Centre podcast. Thank you so much for joining us.