Keynote address by Fundi Tshazibana,
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Blended Finance: Barriers, Opportunities and Implications
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Scaling up blended finance: the role of financial regulators

Good morning from London, where I am participating in the annual plenary meetings of the Network for Greening the Financial System (NGFS). I thank the Toronto Centre for inviting me to add the voice of the NGFS to the conversation that you are having on the barriers and opportunities presented by blended finance, and by implication for financial stability and supervision.

The most recent analysis from the Climate Policy Initiative (2023)[1] indicates an annual average climate finance gap of between US$8.1 and US$9 trillion. Of this amount, US$2 trillion is the estimated amount required for global investment in energy alone – this amount is projected to increase, with estimates suggesting that global investment needs to accelerate from current levels to well over US$4.5 trillion per year to transition energy systems.

At the same time, we are faced with major obstacles to scaling up the financing of climate action. In the aftermath of the COVID-19 crisis, fiscal space has diminished in most countries. Deglobalisation and increased geopolitical fragmentation are likely to slow economic activity, making future funding more difficult. Ageing populations require additional fiscal support, even as the working-age populations in many economies fall. These pose significant risks to economic and financial stability.

[1] https://www.climatepolicyinitiative.org/publication/global-landscape-of-climate-finance-2023/

In this context, it is clear that unblocking constraints and scaling up the funding of climate mitigation and adaption requires more integrated approaches and instruments that take the present risk context into account.

Blended finance has emerged as an important tool to reduce project risks and increase private sector financing, particularly in emerging and developing economies. Blended instruments aim to reduce the cost of borrowing, increase funding and extend the maturity of loans. The risk, however, does not disappear. It simply shifts from one balance sheet to another that is better positioned to absorb possible losses. Effectively supporting the development of blended instruments requires that we understand their risk-sharing mechanisms.

As central banks, we are faced with three main questions:

1. How do we support the scaling up of blended finance?
2. How do we identify the risks embedded in different blended instruments?
3. How do we mitigate against them?

Today I hope to provide some preliminary responses to these questions. I hope that you will spend time unpacking them in the remaining sessions of the conference.

First: How do we support the scaling up of blended finance?

The NGFS recently published several recommendations on how financial regulators and central banks can support the scaling up of blended instruments. These recommendations were based on several case studies which discussed recent experiences with blended finance instruments.

Our assessment is that financial regulators and central banks can help with increasing blended finance only as part of a broader country approach to addressing obstacles to climate finance.

Some of the obstacles to blended finance include the absence of project pipelines or macroeconomic instability due to fiscal crisis. These two obstacles require intervention from fiscal authorities and other parts of government.

For some developing countries that are in debt destress, debt restructuring is required, indicating that the success of blended finance instruments in these countries is directly linked to the work of the Global Sovereign Debt Roundtable and mechanisms such as the G20 Common Framework for Debt Treatments.

Examples of focus areas for central banks and regulators include addressing data gaps so that financial institutions can price risk appropriately, embedding climate considerations in governance and risk management practices, and understanding the

risk profile of different instruments so that these can be treated appropriately in the microprudential framework.

Data gaps remain a major obstacle to increasing climate financing. Financial regulators have an important role to play in addressing these gaps. Using appropriate taxonomy and disclosure rules in their regulatory and supervisory approaches can improve information flows and enhance the operations of financial markets.

Embedding climate considerations in the governance and risk management practices of financial firms helps manage climate-related risks more effectively and improves the allocation of capital across the economy. The NGFS's work on transition planning provides important guidelines on how financial institutions can incorporate climate considerations in all aspects of their operations and manage climate-related risks during the transition.

Another important area to support the scaling up of blended instruments is around their risk treatment in the regulatory and supervisory frameworks. Financial regulators face increasing pressure to reduce the risk weights associated with blended financial instruments. Lower weights can decrease capital costs and support the expansion of blended finance.

This brings us to our second question. How do we identify the risks embedded in different blended instruments?

In many cases, reducing the risk weights of blended instruments is justified. But is it justified in all cases? We face several challenges in our regulatory treatment of blended instrument. For example:

1. It is easy to understand the risk profile of some blended instruments such as guaranteed loans. But other blended instruments have more complex structures. It is difficult to create a universal framework for all blended instruments.

2. As I mentioned earlier, the risk does not disappear. It is shifted from one balance sheet to another. This other balance sheet sometimes sits in the domestic financial system and sometimes sits in another jurisdiction. For financial sector supervisors, this creates a significant level of complexity around how we think about the risk profile of blended finance. We need to understand the balance sheets of the institutions that we supervise but also of those institutions that provide risk insurance.

Many of our tools such as risk ratings and internal capacity adequacy are based on historical data. Climate-related risks and those associated with new financial instruments require forward-looking analysis, which is often characterised by high levels of uncertainty. This often leads to a higher pricing of risk.

Global standard-setting bodies recognise this challenge and have prioritised climate-related risks in their work plans.

Now to the last question. How do we mitigate against risks related to blended finance instruments?

Many efforts to improve climate-related information flows in financial markets and enhance reporting by financial institutions can help with scaling up blended finance by helping central banks to better understand the risks associated with these instruments and mitigate them more effectively.

This, however, is impossible without greater international cooperation as risks shift from one jurisdiction to another. Blended instruments will increase financial linkages and require a greater exchange of information across different jurisdictions.

Financial sector regulators need to develop new skills and research capabilities to understand the various implications of the climate transition on the financial system. More importantly, we need to understand how the combination of different structural changes is likely to impact financial stability. For example, the rapid deployment of artificial intelligence (AI), in addition to the climate transition, is likely to have profound effects on the financial system and generate significant financial innovation.

Scenario analysis and transition planning can help financial regulators in understanding future pathways and the associated risks. There have been advances and improvements but data quality and consistency need to be enhanced, particularly in emerging market and developing economies.

In conclusion, we need a massive increase in financing for the climate transition but also to adjust to other structural challenges.

Central banks and financial regulators have an important role in ensuring that the financial system is resilient to shocks and scales up fundings. However, our efforts to increase blended finance or the use of other financing tools depends critically on how our actions are coordinated within the broader policy environment. We not only need to unblock unnecessary regulatory obstacles to new finance instruments but also need to recognise that some of these instruments can pose risks to the financial system.

I thank you again for the invitation and encourage you to reflect on these issues in the remaining sessions of the conference. All NGFS material is available on its website, including the paper on blended finance and recently released papers on climate disclosure for central banks, transition plans and recommendations on how central banks' portfolio managers should develop sustainable and responsible investment strategies.