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Daring to do more blended finance

Book chapter by Oliver Bäte, Chief Executive Officer of Allianz SE

The newly published book "The Decade of Decision - Germany 2030" features many present-day pioneers of progress from a wide range of social sectors including Oliver Bäte as they provide forward-looking and solution-oriented answers on **how we can accelerate a sustainable transformation,** without sacrificing Germany and Europe's competitive advantage.

Oliver Bäte's chapter, titled "Daring to Do More Blended Finance", focuses on how the combination of public development financing and private capital could make a definitive contribution towards a brave, rapid transformation of our economy. Blended Finance hasn't yet appeared on the posters of environmental activists, but a look at how it is impacting Africa shows its true power.

Read his full book chapter:

Blended finance hasn't shown up on environmental activists' posters up to now. And yet the combination of public development financing and private capital might make a definitive contribution toward a brave, rapid transformation of our economy. A look at Africa shows what's possible.

When Soga Oni decided to build medical diagnostic centers in clinically underserved regions of Africa, by his own account he had three kinds of investors – "families, friends, and fools." Today, the Nigerian entrepreneur heads a firm named MDaaS Global, and is advancing the expansion of Africa's largest network of healthcare services. To date, the outfit's 200 employees have treated more than 140,000 patients.

Oni's success was supported by AfricaGrow, an umbrella fund capitalised at EUR 200 million and intended to support 150 small and medium-sized enterprises (SMEs) and startups on the African continent. Funding comes from the German Federal Ministry for Economic Cooperation and Development (EUR 100 million), the KfW development bank's subsidiary DEG (EUR 30 million), and the Allianz Group (EUR 70 million).

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AfricaGrow is an impressive example of the power of "blended finance" – a model in which projects are financed out of both public development funding and capital from the private sector. Any losses are first absorbed by public funds. Private funding has to cover only when this "concessionary capital" no longer suffices. This approach also enables institutional investors to invest, because up to now, regulatory requirements have usually kept them from investing to more than a small extent in countries with sub-investment grade debt – meaning with a low credit rating. The consequence: 97% of European insurance companies' bond portfolios are invested in the developed world; only 3% of total investment volume goes to developing countries.

AfricaGrow is intended to help fill financing gaps in heavily populated, reform-oriented African countries. The fund is intended to create more than 25,000 new, urgently needed jobs by 2030. Which in turn is expected to encourage **sustainable economic growth** on the African continent – and Soga Oni's company is an impressive example of how well this can work.

Financing the green transformation in Europe

Blended finance has proved its effectiveness over and over in the past 10 years, for instance in developmental aid. But that's not all. The provided funds have often advanced projects to achieve the United Nations' sustainability goals. For instance, in 2017, under the Managed Co-Lending Portfolio Program, the Allianz Group and the International Finance Corporation set up a program that focuses entirely on implementing the goals of the 2015 Paris Agreement on climate protection.

Which leads me to the following suggestion:

> "Why don't we also apply blended finance in the European Union? It could be a major lever in mobilising much more capital for public-private partnerships, and thus help achieve our ambitious climate goals faster and more easily."

The United Nations has called climate change the most urgent existential threat to humanity. If we still want to avert the worst scenarios in the latest reports from the Intergovernmental Panel on Climate Change, the world has to become climate-neutral by mid-century.

To achieve that goal, the Member States of the European Union (EU) and the largest national economies worldwide must reduce their greenhouse gas emissions substantially. The EU has already set itself the goal of cutting its Member States' emissions 55% from the 1990 level by 2030. That's an ambitious interim target, though only a first step.

The European Commission now estimates that achieving even this goal will **call for investments of more than EUR 1 trillion a year**. For comparison, in recent years we've invested only around EUR 700 billion.

European governments know they can't possibly finance such amounts on their own, and are openly appealing to private investors for support. Since investors have become increasingly aware over the past few years of the threats from advancing climate change, interest in green investments has grown vigorously. Yet we can't rely on rising demand alone. **We need to get active and combine the power of public and private financing**. That's the only way we can strengthen the funding for European projects to mitigate climate change, and accelerate those projects' execution.

Obstacles to blended finance

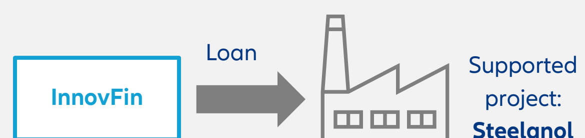
Europe already has mixed-financing instruments for investment, of course. But the problem is that we haven't worked out yet how to scale them up fast and effectively.

Through its InvestEU fund, the European Commission is making some EUR 26 billion in credit guarantees available to encourage innovative technologies relating to environmental projection, climate resilience, or social sustainability. These guarantees are intended to cushion the credit risk for private investors, and to mobilise up to EUR 370 billion in private investment.

As a supplement to this funding, the European Commission and European Investment Bank have launched the InnovFin initiative, intended to selectively encourage innovative, significantly riskier company models that would often get no financing from private investors alone. InnovFin is furnishing up to EUR 75 million per project to attract further investment.

Decarbonisation of the steel industry

One example of a supported project is Steelanol, an unprecedented plant in Belgium that will convert waste from steelmaking into ethanol. The plant is expected to compensate for the CO_2 emissions of up to 250,000 passenger cars at a single stroke.



So blended finance funds can make a major contribution toward mitigating risk for investments in climate technologies. But they're not yet available on a sufficient scale to cover the urgent need to decarbonise the industrial sector. So we need to concentrate on making these instruments available across the board.

Regulatory impediments

The problem is that this development is impeded by numerous regulatory requirements. European Union rules on state aid are a particularly significant obstacle. These rules are actually intended to ensure a fair internal market. And they're meant to prevent the European Union's 27 governments from tilting the playing field in favor of domestic companies or economic sectors.

This approach has done good service for the EU up to now, but it poses almost insurmountable obstacles for the financing of projects relating to the climate. One such obstacle comes from the fact that state support is not allowed to distort competition. Proving the absence of such distortion is a complex, heavily bureaucratised undertaking – and often scarcely possible in the case of climate-related projects in particular.

Take clean hydrogen as an example. If governments hold firm to their commitments, hydrogen is going to become an important energy source. By 2050 it may account for up to 24% of the world's energy demand. It could drive trucks, ships and aircraft – in a word, it might become the key to climate-neutral mobility. Last but not least, hydrogen might stabilise our electric grids, enabling us to store surplus renewable energy during the day and feed it back into the grid at night.

That's a courageous, encouraging vision. But getting there will be no easy task – because generating clean hydrogen will need extensive investment, for instance in catalysts and a storage infrastructure. On top of that, the existing gas infrastructure will need to be retrofitted for this new energy source. Still more, we'll have to continue expanding the network to carry hydrogen from future production sites to Europe's economic centers.

Another matter we'll have to address is the regulatory and solvency treatment of blended finance vehicles. As is well known, insurance companies like the Allianz Group are covered by "Solvency II," a European Union Directive that governs insurers' capitalisation, organisation and disclosure obligations.

Following the global financial crisis of 2008 and 2009, risk capital regulations were tightened substantially. Ever since, companies regulated by Solvency II must maintain significantly more risk capital for investments associated with a securitisation structure than for an investment in a vehicle not classified as a securitisation.

The same also goes for the structures typical of a blended finance fund, and if the rule were to be applied, it would make such funds unattractive for many investors. To avert that today, very complicated, non-transparent fund structures often come into play. We urgently need to simplify that.

We invest mainly in familiar models

It might be argued that Europe is already flooded with funding for the green transformation, especially in the aftermath of the European Union's financial injection of some EUR 800 billion in the form of NextGenerationEU. This is an ambitious program for making Europe's economy more resilient, more innovative, more digital, and more sustainable.

However, a large share of that funding is likely to go into familiar business models – meaning business models with whose underlying technologies we have many years of good experience, like solar farms and wind farms. **Yet much of what we need in order to avert a climate crisis falls in the category of little-tested models.**

Investors, especially institutional investors like insurance companies and pension funds, are willing to do their share to assist the green transformation – including for a very obvious reason: our long-term pension obligations have an investment horizon that often extends far beyond 2050, and we need to safeguard our portfolios.

Numerous alliances and initiatives have been founded in recent years, many of them under UN patronage, to rechannel capital flows in favor of sustainable investments.

Yet as I've already outlined, these investments' current risk-return profiles are often unsuitable for large-scale investment. All the same, private capital is around that is willing to invest. **Here blended finance can help right now to overcome the impediments for the private sector**, and thus speed up the growth of innovative climate solutions and low-carbon energy sources.

Getting important climate projects under way

Fortunately, the dynamics for blended finance in Europe are positive. Germany itself has already gained initial experiences that can be applied in structuring blended finance vehicles.

One good example is the "Fund for the Future" set up by the Federal Ministry for Economic Affairs and Climate Action in 2021 to facilitate funding for startups in the capital-intensive growth phase.

Part of the available financing is to be provided by way of a EUR 1 billion umbrella fund, the KfW Capital Growth Fund, which has two modules: (1) an aid-free product with an asymmetric distribution of risk and return, intended to mobilise investment from institutional investors; and (2) a parallel structure in which public funding and private investors both invest on the same terms. As part of the structuring, KfW has dealt successfully with matters like state-aid law and questions of securitisation. So the expertise is on hand.

We face a gigantic task in averting the impending climate catastrophe. For that reason, I believe government and regulators must take **three specific steps to ensure even greater scalability** and replicability for blended finance models:

First: National and European laws on state aid must be revised to facilitate focused state support by way of blended finance structures.

Second: We need to revise the rules for how the solvency of blended finance vehicles is assessed, so as to avert complex, non-transparent fund structures.

And **third**: We must acquire investors, especially for concessionary capital in the economy.

I'm certain that blended finance can make an important contribution here. And I'm confident we'll be able to do that. All we have to do is dare to make the effort – and now.

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