MOBILIZING CLIMATE FINANCE AND MITIGATING MACRO RISKS IN DEVELOPING COUNTRIES – PRIVATE EQUITY INVESTOR PERSPECTIVES

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ABSTRACT

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Recently, the lack of action in addressing climate change and its adverse effects has been at the centre of attention worldwide. Raising to the challenge requires massive investments and the current levels of finance are far from adequate. This is a particularly pressing issue for developing countries, because they are at the highest risk of danger. However, these countries have not yet succeeded to attract enough private capital due to various macro risks associated with investments in these countries. Blended finance seeks to raise to these challenges as it seeks to leverage private finance for sustainable development investments in developing countries through various instruments offered by development financiers. The new Paris Agreement on climate change embodies a similar idea as blended finance but uses a different name for it – climate finance mobilization. However, the Paris Agreement does not define how climate finance, including private equity, should be mobilized into low-emission and climate-resilient investments and the Agreement does not include explicit references to the use of blended finance. Thus, I explore how well the substance of the Paris Agreement's climate finance mobilization aligns with that of blended finance. To this end, I explore legal instruments concerning blended finance, blended finance principles. These principles are explored because they bring up notions that are critical for the fulfilment of the objectives of private equity investors and for the success of blended finance. However, because these principles are non-binding, it must be established whether they can be expected to be applied in blended finance investments. After examining blended finance principles, I proceed to examine risks associated with private equity investments in developing countries and low-income countries in particular. Building on this, I examine how well blended finance instruments available for private equity investors accommodate different macro risks such as regulatory risks, financial/macroeconomic risks and political/institutional risks. Lastly, I determine gaps in protection left by blended finance instruments by paying attention to particularly regulatory risks. My study combines different research methods including legal dogmatics. With regard to macro risks, my research builds on Yescombe's classification of risks and uses other economic literature. The conclusion of my thesis is that whereas blended finance accommodates some macro risks in developing countries, macroeconomic conditions specifically must be strengthened in the poorest countries to make blended finance a promising alternative for private equity investors.

Key words: blended finance, climate change, Paris Agreement, private equity, risk mitigation

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Viime aikoina ilmastonmuutoksen torjuntaan tarvittavien toimien riittämättömyys on saanut runsaasti huomiota maailmanlaajuisesti. Ilmastonmuutoksen torjunta tarkoittaa massiivisia investointeja ja nykyisten investointien riittämättömyys on ilmeistä. Köyhimpien maiden on arvioitu olevan erityisen haavoittuvaisia ilmastonmuutoksen vaikutuksille, mutta nämä maat eivät ole saaneet osakseen tarpeeksi yksityistä pääomaa runsaiden makrotason riskien olemassaolon vuoksi. Yksi mahdollinen keino vastata näihin haasteisiin on nk. sekarahoitus (eng. *blended finance*). Sekarahoitusinstrumentein pyritään mobilisoimaan yksityistä rahoitusta ml. yksityistä pääomaa kehittyvien maiden kestäviin sijoitusmahdollisuuksiin. Pariisin ilmastosopimus tähtää samankaltaisiin tavoitteisiin kuin sekarahoituskin, mutta käyttää tästä eri nimeä, nimittäin ilmastorahoituksen mobilisointi. Kuitenkaan Pariisin sopimus ei määrittele tapoja, joilla ilmastorahoitusta ml. yksityistä pääomaa tulisi mobilisoida kestäviin investointeihin eikä se myöskään viittaa sekarahoitus-käsitteeseen. Tämän vuoksi tutkin, kuinka hyvin nämä kaksi eri käsitettä sopivat yhteen tutkien myös, koskevatko ne kokonaan tai osittain samaa substanssia. Tätä varten tutkin sekarahoitusta koskevia oikeudellisia instrumentteja, sekarahoitusperiaatteita. Nämä periaatteet ovat tärkeitä sen vuoksi, että ne pitävät sisällään useita seikkoja, joiden huomiointi on tärkeää pääomasijoittajien tavoitteiden täyttämisen ja sekarahoituksen onnistumisen kannalta. Koska nämä suositukset ovat kuitenkin ei-sitovia, tutkin, voidaanko niitä olettaa sovellettavan sekarahoitusinvestoinneissa. Tämän jälkeen jatkan tutkimusta avaamalla, mitä riskejä kehittyviin maihin tehtyihin pääomasijoituksiin on tavanomaisesti liitetty. Analysoin, kuinka erilaiset sekarahoitusinstrumentit, joita pääomasijoittajien on mahdollista käyttää, pienentävät makroriskejä kuten sääntelyriskejä, makroekonomisia riskejä sekä poliittis-institutionaalisia riskejä kiinnittäen huomiota siihen, mitä makroriskejä sekarahoitusinstrumentit jättävät auki. Näistä riskeistä keskityn erityisesti sääntelyriskiin. Tutkimukseni hyödyntää erilaisia tutkimusmetodeja, ml. lainoppia, mutta makroriskien osalta se rakentuu Yescomben riskiluokittelulle ja hyödyntää muuta taloudellista kirjallisuutta. Tutkimukseni johtopäätelmä on se, että vaikka sekarahoitus pienentää erilaisia makroriskejä, erityisesti makroekonomisen ympäristön vahvistamista tarvitaan köyhimmissä maissa pääomasijoituksen mobilisoimiseksi kehitysmaihin.

Asiasanat: ilmastonmuutos, Pariisin ilmastosopimus, pääomasijoittaminen, riskien hallinta, sekarahoitus

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ABBREVIATIONS

AGF High-Level Advisory Group on Climate Change Financing
COP Conference of the Parties
DFI Development finance institution
EDFI European Development Finance Institutions
ESG Environmental, social and governance
EU European Union
FDI Foreign direct investment
FX Foreign exchange
GHG Greenhouse gases
GP General partner
IFI International finance institution
IPCC Intergovernmental Panel on Climate Change
IPO Initial public offering
ISDS Investor-state dispute settlement
LDC Least Developed Country
LP Limited partner
MDB Multilateral development bank
MIGA Multilateral Investment Guarantee Agency
NDC Nationally Determined Contributions
OECD Organization for Economic Cooperation and Development
PE Private equity
PRI Political risk insurance
SDG Sustainable Development Goals
UN United Nations
UNEP United Nations Environmental Programme
UNPRI United Nations Principles of Responsible Investment
UNFCCC United Nations Convention on Climate Change
VC Venture capital
VCLT Vienna Convention on the Law of Treaties

1. INTRODUCTION

1.1 Climate change and investment

Climate change has recently become a hot topic not only on an international plane but also in finance peers, and for a good reason. We know that climate change has catastrophic consequences for people's livelihoods, human life, and biodiversity.[1] Whereas climate change threatens both developed and developing countries, developing countries are the most vulnerable for the adverse effects of climate change. Climate change is dangerous already now, and it is getting far more dangerous in the decades to come taking forms of, *inter alia*, extreme weather conditions, droughts, prolonged periods of heat, heavy downpour and the rise of sea levels.[2] These phenomena cannot be avoided without drastic changes in global financial flows. Nevertheless, data indicates that the current volumes of finance are really far away from keeping the global warming within safe limits.[3] There is a consensus that the current level of action is not enough to keep climate change under control,[4] and the latest tracking data available suggests that with the current pace of climate action the global temperature will rise approximately 3.2 degrees of Celsius by year 2100.[5] But how drastic changes are needed in the financial sector to keep climate change manageable? The recent reports from the OECD and New Climate Economy (NCE) estimate that the global infrastructure investment needed from 2016 to 2030 to limit the global temperature rise under 2 degrees Celsius is approximately US$ 6 trillion a year.[6] These amounts wildly exceed the capacity of public funding.[7]

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[1] *IPCC* 2018, p. 10 estimates that even limiting the rise of global temperature from 2 degrees Celsius to 1.5 degrees Celsius will reduce the impacts of climate change on biodiversity and ecosystems. The IPCC also projects climate-related risks to health, livelihoods, food security, water supply, human security, and economic growth to increase when the global temperature raises from 1.5 degrees Celsius to 2 degrees Celsius (p. 11).

[2] *Wuebbles* 2018, p. 15–16.

[3] *Climate Policy Initiative* 2015, p. 10.

[4] *Bodle et al.* 2016 p. 9 refers to the probability of keeping the rise of global temperature under 2 degrees Celsius, let alone in 1.5 degrees Celsius. These estimates were based on the assessments of Intended Nationally Determined Contributions (INDCs) handed in before the Paris conference.

[5] See, for example, *UNEP* 2019, p. XIII.

[6] *OECD* 2017, p. 92–93. The OECD estimates that annual investments of US$ 6.3 trillion are needed in energy, transport, water and telecommunications sectors between 2016 and 2030 to sustain economic growth, even if governments take no further action on climate change. *The New Climate Economy* 2016, p. 24 also states that annual infrastructure investment needs to be approximately US$ 6 trillion. The assessment includes investments in built infrastructure such as urban, transport, water, waster, telecommunications, and energy systems, but not natural infrastructure (p. 120). See also *McKinsey & Company* 2016b estimation that annual infrastructure investment of US$ 3.3 trillion is needed until year 2030 if the world wants to keep up with projected GDP growth stating that this investment need could increase by up to US$ 1 trillion annually to meet the UN Sustainable Development Goals (p. in brief).

[7] Governments alone cannot address climate change because neither the actions nor the wealth of governments alone are enough to keep the climate change under control.

Climate change does not pose a threat only to life in its various forms, but it also threatens investments as a regulatory risk posing danger also to physical assets and revenue streams. Despite the effects of climate change vary by region, the Intergovernmental Panel on Climate Change (IPCC) estimates that in total the net damage costs of climate change are likely to be significant and increase over time.[8] Although estimates differ, one thing is certain: climate change concerns leave no investor intact either. Climate change may affect the bottom line through increasing energy and carbon costs and make previously viable businesses unviable.[9] The risk posed by climate change for investors is widely acknowledged and increasing regulation is expected among investors as countries are incorporating their climate pledges made under the new Paris Agreement on climate change into their national regulations and policies. For this reason, climate change and the regulatory framework surrounding it are not something investors should ignore.

In spite of dystopian outlooks, and uncertainty surrounding future climate and environmental regulations, climate change also brings opportunities, which are not only compatible with the Paris Agreement but also encouraged by its treaty text. The Paris Agreement has interesting implications for private sector investors in the form of climate finance mobilization which seeks to leverage private investment into low-emission and climate-resilient development in developing countries by using public development finance as a catalysator. This type of finance combining public/development finance and private finance has been called as *blended finance*. It covers different types of finance (debt, mezzanine, equity) and uses a number of instruments (e.g. guarantees, grants) that seek to rebalance risk-return ratio for private sector investors. Private investments are primarily, if not entirely, driven by profit so investments where risks are out of line compared to possible profits often fail to attract enough investments. In essence, blended finance seeks to leverage private finance to new markets by making investments in these countries more attractive for private sector investors.

Among private sector investors are private equity (PE) investors, who buy (usually a part of) a company (portfolio company), make improvements to it to increase its value, and then exit the portfolio company. Bringing private equity and venture capital (VC), which is one form of private equity, into the blended finance scene is not only needed from the point of view of the Paris Agreement: it also paves the way for PE/VC investors to access

[8] *IPCC* 2007, Summary for Policy Makers, p. 17.
[9] *IIGCC*, p. 6.

new markets with the world's fastest growth rates being among the first to profit from enormous growth potential[10]. Blended finance also enables private investors to benefit from the experience of development financiers in emerging markets. The Paris Agreement is significant from the viewpoint of financing low-emission and climate-resilient development and implies a critical role for providers of development finance. Development financiers such as development banks and development finance institutions (DFIs) function as catalysators of private finance into investments in the poorest developing countries, which without development finance would be too risky for most private investors to consider. Now also institutional investors, private equity funds and venture capital are engaging in blending.[11]

Blending development finance with private equity nevertheless raises several questions. Do blended finance instruments actually address those risks that in the past have made it hard to attract private finance into developing countries? How effective these instruments are in addressing risks generally associated with foreign investments in poorer developing countries such as low-income countries? What engaging in blended finance means from the viewpoint of PE/VC investors: what are the pros and cons of engaging in blended finance and which risks are left unaddressed by blended finance instruments? What are the most prominent blended finance instruments for PE/VC investors keen on impact investing? What this all has to do with the Paris Agreement? To these questions I will provide answers in my research. Although blended finance is not a panacea, it addresses some concerns[12] of private equity investors in developing countries.

1.2 Research questions and their relevance

The new Paris Agreement on climate change puts heavy weight on the role of finance in tackling climate change. However, the Paris Agreement leaves the sources, channels and

[10] See, for example, *Dickinson* p. 1 referring to an African experience of Celtel telecommunications company. Out of the Least Developed Countries, many of which are also low-income countries, a great majority are located in the sub-Saharan Africa. Various economic analyses indicate that the economic growth is the strongest in the sub-Saharan African countries. *Nasdaq* lists Guyana, Ethiopia, Rwanda, Bangladesh and India as the world's five fastest growing economies. Out of these countries Guyana's economy is projected to grow by 33.5% in 2020 and during four-year period of 2018–2021 impressive 16.3%. (Information from 24 August 2019).

[11] *OECD* 2018, p. 62.

[12] Barriers for leveraging private equity/venture capital investments in developing countries have been well-studied. *International Finance Corporation* 2018, p. 42 provides a brief list of overcoming these barriers referring to contract enforcement and investor protection, financial markets offering exit options for PE investors and different sources of capital, compliance with international business standards, appropriately enforced and transparent legal regime relevant for PE industry and intellectual property, as well as capacity for innovation.

instruments from which this finance should be mobilized undefined and does not even detail how this should be done. This is problematic given that climate finance, i.e. finance for the purposes of combating climate change and its adverse effects, should be mobilized at an unprecedent scale and speed. Moreover, it is clear that private finance is desperately needed as public finance will not be adequate to achieve the objectives of the Paris Agreement and academic research indicates that the actions under the Paris Agreement are clearly not in par with its key objectives. Mobilization of private finance, too, is lagging behind from what is needed to make the Agreement's key objectives a reality. Indeed, obtaining the objectives of sustainable development goals (SDGs) generally requires cumulative investments of approximately US$ 2.5 trillion per annum for developing countries alone.[13] However, investments in developing countries have often been perceived very risky while risk-return ratios have been unattractive for private investors. This is a problem blended finance seeks to address and to this problem I take a private equity investor perspective in this research.

The need for leveraging private finance into low-emission and climate-resilient development and the inadequacy of public finance make blended finance a concept worth examining. The Paris Agreement does not explicitly mention the term 'blended finance' but rather uses the term 'climate finance mobilization'. This warrants further attention and examining whether 'climate finance mobilization' and 'blended finance' govern the same substance matter. This might have implications for PE/VC investors and how these investors' perspective is considered in the cases of climate finance mobilization. Considering PE/VC investors' perspective in blended finance investments concerns particularly commercial viability, an issue that is highlighted in legal instruments regulating blended finance, *blended finance soft law*. This brings us to my research questions.

As my first research question I will examine *whether the Paris Agreement's term 'climate finance mobilization' implicitly refers to blended finance*. If the terms 'climate finance mobilization' and 'blended finance' govern the same substance matter, this could have consequences for the consideration of blended finance soft law when private finance is mobilized for climate-friendly investments by development financiers (DFIs, MDBs).

[13] *UNCTAD* 2014, p. xi.

Because legal instruments on blended finance have yet taken only softer norms, I will consider blended finance soft law. My second research question examines blended finance soft law's application in the area where the terms 'climate finance mobilization' and 'blended finance' govern the same substance matter. As my second research question I will examine *whether the soft law on blended finance can be expected to be actually applied by development financiers in the area where blended finance and climate finance mobilization govern the same substance matter*. My second research question differs from the first question in that it seeks to provide an answer to the question when will the relevant non-binding blended finance soft law *actually* be applied. It examines the practical challenges that stem from the 'soft' nature of blended finance soft law. These challenges are considered from the perspective of development financiers, development finance institutions and multilateral development banks, due to the scope of my research.

The reason why I wanted to research blended finance soft law is because taking blended finance soft law ('blended finance principles') into account in blended finance operations is vital from the viewpoint of attracting private capital to developing countries, and thus critical for the success of blended finance. This view regarding the importance of blended finance soft law is supported by the *Convergence's* study on the characteristics of successful blended finance operations.[14] Failures to accommodate the perspective of PE/VC investors would likely lead to not attracting private capital at an adequate scale. This is because private equity is primarily driven by profitability, and investments that do not consider this will likely fall short from attracting private equity. The notions contained in blended finance soft law are critical for PE/VC investors because they highlight the need to consider private investors' objectives, among which are issues which have traditionally been among make-or-break factors for private equity investors.[15] Because this soft law addresses some concerns of PE/VC investors not addressed by other legal instruments binding upon development financiers, I will examine whether this soft law

[14] *Convergence* 2018, p. 17. Whereas Convergence's study did not concern the importance of blended finance soft law, it nevertheless concerned factors common to successful blended finance operations. As later shown in my study, Convergence's study acknowledges that certain notions highlighted in blended finance soft law have been often common for successful blended finance operations. Among these notions is, for example, agreeing upon common performance indicators.

[15] As later shown in my study, blended finance soft law includes several notions which have traditionally been vital for private equity and venture capital investors. Among these are, for example, considerations related to e.g. scalability. The reason why these issues are critical for PE investors stems from the fact that private equity as a form of capital is heavily geared towards profitability, although it now accommodates environmental and society related issues, too.

needs to be disregarded in any situations. I will also consider lack of legitimacy, which might hinder the application of blended finance soft law.

Traditionally, in developing countries risks have been out of line compared to possible profits, i.e. the risk-return ratio has been unattractive for private investors. This is what blended finance seeks to address. Thus, as my third research question, I will carefully examine blended finance instruments at disposal of private equity investors and *establish how these risk management alternatives accommodate macro risks typically associated with investments in developing countries*. Macro risks are risks that are not at a project level, and encompass risks such as political/institutional, regulatory and financial (macroeconomic) risks. My research considers those blended finance instruments that are available for private equity investors. Blended finance instruments nevertheless cannot fix all risks associated with investments in developing countries and one of the most prominent risks is regulatory risk i.e. a chance of a portfolio company's host state adopting regulations that negatively affect the value of the investment. While answering my third research question, I will bring up gaps blended finance instruments leave in terms of addressing macro risks such as regulatory risks. I will also briefly bring up considerations related to climate policies from the viewpoint of PE/VC investors engaging in blended finance seeking to establish which kind of regulatory risks exist for PE/VC investors engaging in blended finance.

Of different forms of finance, I have chosen to focus on private equity and venture capital, as the role of equity investment in blended finance has gone much of the time under radar in publications covering climate finance. Of different forms of private equity, venture capital is particularly intriguing due to its nature in financing technological innovations, which are undoubtedly needed in solving the climate crisis. Moreover, whereas there has been research conducted on blended finance and its feasibility in general, the ability of blended finance to mitigate or transfer risks has not yet caught academic attention, at least not from a PE/VC investors' point of view. This might be due to the fact that new climate funds[16] have recently gained more attention, thus putting the emphasis on mobilizing climate finance from institutional investors and not from private equity investors. I consider my research questions to be relevant for PE/VC investors because blended

[16] An example of a multilateral climate fund is the Green Climate Fund which seeks to mobilize climate finance from institutional investors such as pension funds which hoard massive amounts of wealth.

finance operations offer alternatives for risk governance which differ from those employed in operations where development financiers are not present.

From a risk governance side, I wanted to reflect particularly *macro* risks such as political/institutional, financial (macroeconomic) and regulatory risks. Whereas engaging in blended finance operations might have other benefits for private equity investors in terms of addressing also risks tied to project level, I have excluded project risks from the scope of my study. I have chosen to focus particularly on macro risks because the relevance of macroeconomic conditions, a component of macro risks, has been considered a determinant factor in profitability in earlier research.[17] I have chosen macro risks also because equity investments are considered risky already in developed countries, let alone in countries with weak institutional strengths and financial markets, coupled with concerns of political risks. These are risks commonly associated with investments in low-income countries, such as the Least Developed Countries (LDCs). Since my research is focused on macro risks generally associated with investing in developing countries, its findings are not limited to a specific group of countries such as low-income countries. Thus, the findings of my study may be relevant also for other developing countries, such as lower-middle-income economies.[18] Whereas the risks detailed in my research have been commonly associated with developing countries, I am bringing up considerations relevant particularly for low-income countries where macroeconomic conditions are weaker than in other developing countries.

I have chosen to focus on private equity investments particularly in the poorest developing countries, low-income countries such as the Least Developed Countries because: i) many bilateral and multilateral development financiers are focusing on these countries paving the way for private equity investors; because ii) low-income countries such as the LDCs have gained the least attention in private investor peers; and because iii) the LDCs have mobilized ten times less private finance than upper-middle income countries[19]. As many low-income countries are sub-Saharan African countries with the world's fastest growing economies with high population growth rates and increasing energy needs, they offer

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[17] *Office of Evaluation and Oversight* 2017, p. 18 notes that the International Finance Corporation has highlighted the importance of macroeconomic conditions stating that 60% of the institution's returns could be attributed to macroeconomic conditions.

[18] *World Bank* 2019 divides countries into different classes based on their income. These groups are low-income countries, lower-middle income countries, upper-middle income countries, and high-income countries.

[19] *OECD – UNCDF* 2019, p. 13. Average amount mobilized for the LDCs has been US$ 6.1 million per transaction compared to US$ 61 million per transaction in upper-middle income countries.

interesting growth opportunities for foreign investors if macro risks are tackled and risk-return ratios rebalanced.

1.3 Methods and the organization of the text

My research utilizes different methods for each one of my research questions. Whereas this choice might appear unorthodox, such an approach best reflects varying natures of my research questions and also best answers them. My first research question on the alignment of terms 'blended finance' and 'climate finance mobilization' employs legal dogmatics as its primary method. My second research question takes into account practical challenges to the application of soft law. Thus, my first two research questions combine *de jure* and *de facto* approaches. In my third research question I use a method combining both economic and legal literature, using economic literature to understand different types of risks faced by private equity investors in developing countries. My third research question is explorative in nature and seeks to provide an overview of blended finance instruments available for private equity investors. My third research question also seeks to establish how these instruments accommodate macro risks commonly associated with investments in developing countries, examined from the perspective of low-income countries in particular.

In the beginning of my research I explain blended finance as a concept in further detail. This choice reflects the notion that blended finance as a term is a novelty in private equity peers. After this, I proceed to provide the reader with the key features of development financiers and PE/VC investors in chapter two. After this, I will assess what is the climate law's position regarding blended finance and which are the Paris Agreement's most critical provisions in this regard. Because blended finance is not a term mentioned in the Paris Agreement, the soft law I consider is adopted outside the United Nations (UN) climate regime. In this regard, I have chosen soft law on blended finance from the Organization for Economic Cooperation and Development (OECD) and the International Finance Corporation (IFC). I then proceed to illustrate how 'climate finance mobilization' of the Paris Agreement and 'blended finance' relate to one and another. I will then continue to establish whether blended finance soft law can be expected to be applied by development financiers in the aligned substance matter area of climate finance mobilization and blended finance while considering challenges to the application of this soft law.

In chapter four, I proceed to examine risks typically associated with investing in developing countries examining these risks from the perspective of low-income countries. For the sake of systematic approach, I have grouped risks into macro and project (or commercial) risks, dividing the former into three sub-groups: regulatory, political/institutional, and financial (or macroeconomic) risks. I have categorized those risks which have been considered the most critical in the literature and reflected in the opinions of private equity investors. After examining how blended finance instruments address macro risks generally associated with investing in developing countries such as low-income countries, I summarize which types of risks persist, i.e. what are the risks against which blended finance instruments offer inadequate protection. With regard to the gaps in protection against macro risks, I pay particular attention to regulatory risks which pertain when PE/VC investors engage in blended finance and invest in projects that support combating climate change and its adverse effects.

Because my research has a heavy emphasis on risk, not exploring economic literature is no option. Of this literature, I am using economic literature regarding macroeconomic conditions in developing countries, development financiers (development finance institutions and development banks), and private equity.

Challenges for my research stem from the fact that the Paris Agreement is primarily a procedural treaty which entails no sanctions. Thus, assessment regarding the Agreement needs to take into account *de facto* effectiveness considerations. Another challenge for my research stems from risk classifications and aspirations to provide a complete picture of macro risks associated with equity investments in developing countries. For this reason, I have sought to rely on a number of sources regarding risks generally associated with investing in developing countries. I have also considered opinions of private equity investors to gain a better understanding of risks which are the most determinant risks when investing in developing countries such as low-income countries.

2. TERMS AND FRAMEWORKS

2.1 Blended finance

As private equity firms are seeking for new growth opportunities in developing countries and as development finance institutions and banks are trying to help developing countries to cope with climate change and limit its adverse effects, blended finance seems to provide for a win-win situation. Nevertheless, this must be confirmed through further examination. Currently, there is ambiguity and variety with regard to the definition of blended finance,[20] but the term can be understood as the "*strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries*", additional finance referring to commercial finance that does not have an explicit development purpose.[21] For the purpose of my research, I have chosen the OECD definition of blended finance because I will also address soft law from the OECD and because the definition encompasses the key elements present in other definitions of blended finance. Other definitions embody similar notions as the OECD's definition but differ in approach and emphasis.[22] Thus, it cannot be said that blended finance has one clear and definite definition albeit the content of different terms is in essence very similar. Nevertheless, the component of financing sustainable development is in the heart of blended finance, and the blended finance instruments available for private equity investors require these investors to adhere to sustainability standards.

The reason why blended finance is relevant for my research is because achieving the key objectives of the Paris Agreement practically requires it, although the Agreement does not explicitly refer to it. Blended finance as a term is a novelty and it has taken off the ground especially after Addis Ababa Financing for Development conference in 2015. Combining instruments and institutions in creative ways have been estimated to be among the most fruitful approaches.[23] However, as *Klein* notes, blended finance transactions should not be attempted lightly and it must be carefully assessed, whether the fundamentals for financeable transactions are in place.[24] I understand this to mean that whereas blended finance can be used to attract private finance into transactions, it cannot

[20] *OECD* 2018, p. 13.
[21] *OECD* 2018, p. 13.
[22] *OECD* 2018, p. 49–50 makes a list of different definitions of blended finance as developed by institutions, development actors and researchers.
[23] *Thompson* 2016, p. 155.
[24] *Klein* 2015, p. 1. Klein acknowledges that blended finance is not a panacea and it will not make financially unsustainable transactions sustainable nor render unaffordable infrastructures affordable.

solve fundamental problems in the financing structure. Blended finance investments where risks are out of line compared to possible returns, are not likely to succeed. Thus, considering the perspective of private equity investors is vital for successful blended finance operations.

The role of blended finance is to attract *additional* finance, i.e. finance, that would not have been committed if the development finance component of blended finance was not present. By development finance I refer to finance provided by development financial institutions (DFIs) and multilateral development banks (MDBs). These institutions have a capability to attract commercial finance as they have experience in riskier transactions in developing countries and they could participate in the riskier phases of different projects e.g. by means of junior shares and cushions. By *commercial finance* I refer to different forms of private finance not primarily aiming for development objectives, such as venture capital. Blended finance is important for achieving the objectives of the Paris Agreement as public streams of finance alone are not enough to fill the remaining investment gap. As the Paris Agreement sets US$ 100 billion as a floor for climate finance mobilization objective and as required infrastructure investments are around US$ 7 trillion a year, US$ 100 billion should be understood as the development finance component of blended finance. This US$ 100 billion should then mobilize further commercial finance to fill the investment gap.

Blended finance can take different forms and structures. For example, public funding can cover first losses in forms of grants, and junior equity can attract private sector investors. Later in my research I will use the term *blended finance instruments* to describe instruments offered by development financiers that mitigate/transfer risks, i.e. make them less prominent in the first place or transfer them away from private investors. It must be noted that whereas in some cases blended finance means that development financiers and PE/VC investors invest in the same portfolio companies, the situation is not always this and blended finance instruments can also involve political risk insurances from development finance actors. Thus, blended finance does not in all cases mean that development financiers and PE/VC investors hold equity positions in portfolio companies. This is only one option, and it will be covered in further detail in chapter four.

Whereas clearly identified development impact outcomes, objectives and outputs have been common for successful blended finance projects, it should be acknowledged that blended finance is better to employ only into such activities that provide cash flows

enabling financial returns for private sector investors.[25] Also, the feasibility of blended finance highly depends on the type of finance that has been employed. Using equity funding does not seem like an attractive option in cases where projects involve little technological or operational risks, and when cheaper debt financing can be used. Thus, not all promising conclusions about the mobilization of private *finance* should be generalized to apply to mobilization of private *equity*. There are, for example, plenty of climate-resilient energy projects that have been financed by market-rate loans. It is the involvement of risk that should determine the appropriateness of private equity in blended finance investments.

Private equity investors' expertise in growing companies combined with DFIs' and MDBs' willingness to assume risks of initial costs seems to be a match made in heaven. Combining capital from these two very different types of investors, however, represents several questions. Although blended finance can attract commercial finance into otherwise too risky transactions, it cannot alter the fundamental economics of different industries.[26] Rather, it makes changes to risk-return ratio attracting private investors to invest in developing countries. Among these investors are also private equity investors.

2.2 Private equity investments

2.2.1 Private equity

Private equity (PE) refers to private capital that is not listed on a public exchange. Private equity can take different forms such as venture capital (VC), angel investments, distressed investments, growth capital and leveraged buyouts. In my research I am examining blended finance particularly from the viewpoint of VC investors with regard to mitigating/transferring macro risks associated with investments in developing countries. Nevertheless, my conclusions can be generalized to cover also other types of PE investments although macro risks are examined from the viewpoint of VC investors. The risk mitigation/transfer instruments specified in this study are not limited with regard to the types of private equity. Because in the heart of blended finance is attracting additional finance, it is questionable how relevant blended finance investments are at this stage for, say, leveraged buyouts. Private equity is not only used by PE firms and funds, but it also

[25] *Convergence* 2018, p. 17.
[26] *Klein* 2015, p. 1.

used by development financiers which also seek to influence the conduct of portfolio company through board management.

Venture capital is often used to finance new innovations e.g. in the field of technology by new companies when cheaper finance such as debt is not available. Through VC financing venture capitalists often acquire a minority shareholder position in a portfolio company seeking to grow its value and then exit the portfolio company through initial public offering (IPO) or other means such as strategic sales.

Venture capital firms are highly driven by growth and revenue.[27] As I will later in my research illustrate, growth aspirations of PE/VC investors might well be in par with those of development financiers.[28] Aligned objectives of PE/VC firms and development financiers matter because with very diverging objectives it would be hard to attract private capital to developing countries such as low-income countries. However, not all private equity/venture capital firms have similar objectives, and some are more focused on financial returns whereas some take into account a broader range of issues, such as environmental and social impact of the investments. In my research my emphasis is on PE/VC investors seeking to create an impact and deliver financial returns. For this reason, I will briefly explain impact investing and how it relates to PE/VC investing.

2.2.2 Impact investing

Impact investing refers to investments that seek to provide financial returns for investors and also create positive impacts on states where portfolio companies are operating. One way to frame impact investing is investing in multidimensional companies with a double or even triple purpose, financial and social.[29] However, despite interested in making an impact, also impact investors are primarily driven by profit,[30] and impact investments should not be mistaken as philanthropic in nature. The reason why impact investing has relevance for blended finance is because both PE/VC impact investors and development financiers target impact factors, although there is variance regarding desired impacts. However, investing that has positive impacts as outcomes does not *per se* qualify as

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[27] See, for example, *Block et al.* 2019, p. 344.
[28] An example of this is job creation which is often a result of growth, and which thus contributes to the objectives of both private equity/venture capital investors and development finance institutions.
[29] *Viviani – Maurel* 2019, p. 38.
[30] *GIIN* 2017, p. 10 establishes that 48 per cent of investors surveyed primarily target risk-adjusted, market-rate returns whereas 31 per cent of investors surveyed targeted primarily below-market rate returns.

impact investing, as impact investing is about being explicit about managing to achieve the desired, previously articulated impact outcomes.[31] Impact investing as a term has gained popularity during recent years but not all investors agree upon what impact investing is. Moreover, not all impact investors give exactly similar weight to financial returns and desired impacts, and this translates into different weight of incentives given regarding financial and impact outcomes.[32] Whereas almost all investors are either interested or have already incorporated impact into their investment strategies, not all investors are willing to compromise financial returns at the expense of making an impact. This should be borne in mind also when understanding the feasibility of blended finance operations involving private capital.

Whereas the point of this research is not to draw conclusions regarding profitability of blended finance investments, previously conducted research suggests that environmental, social and corporate governance issues *do* affect firm value.[33] Since these concerns get heavy weight in blended finance operations, it can be carefully suggested that from this perspective, blended finance involving PE/VC could indeed be a feasible option for PE/VC investors. Furthermore, in the past countries open to foreign investment are now putting more weight e.g. on the impact of the investment on environmental and social issues.[34] Assertations like this underline the importance of sustainability, which is what blended finance ultimately is all about.

Impact investing as a term comes close to sustainable investing which also seeks to address environmental factors in addition to generating financial returns. There are no single, globally adopted sustainability standards but indeed there are many, among which the UN Principles on Responsible Investment (UNPRI) and Global Reporting Initiative.[35] Measurement methods private equity investors use include UNPRI, IRIS Metrics, and Sustainable Development Goals (SDGs).[36] The reasons investors want to measure their

[31] *Clark – Emerson – Thornley* 2014, p. 5.

[32] *GIIN* 2017 notes that financial performance and impact both are in the heart of impact investing. However, according to GIIN, traditionally impact investors have offered more commonly incentives related to financial performance leaving impact-related issues without external incentives.

[33] *Fatemi et al.* 2018, p. 58. A research by Fatemi et al. suggests that environmental strengths increase the firm valuation while environmental concerns decrease it. Weaknesses in social and governance issues decrease the firm valuation but strengths in these areas do not increase it. Based on this research, it is thus environmental factors that seem to have the biggest impact on firm valuation, and climate issues can certainly be counted among these factors.

[34] *International Chamber of Commerce* 2016, p. 5.

[35] For more standards, see e.g. *Leblanc – Fraser* 2016, p. 623.

[36] *GIIN* 2017, p. 15 concludes that IRIS Metrics are the most commonly used impact metric system, as 62 per cent of GIIN survey respondents use IRIS Metrics and 42 per cent UN Sustainable Development Goals.

impact covers various reasons of which the want to measure the impact, reporting impact to key stakeholders (such as Limited Partners, LPs), managing and improving impact, and the possible business value of impact data were the most popular answers.[37] Some of these issues are also covered in blended finance soft law, which will be discussed in chapter three.

Impact investing relates to previously defined blended finance in that they both attempt to achieve similar objectives.[38] As blended finance includes a public/development finance component, considerations regarding how well commercial PE/VC finance fits together with non-commercial development finance becomes an intriguing issue to examine. Among impact investors certain areas have attracted more attention than others: the most desired area for impact has been decent work and economic growth.[39] This might not be surprising, and this feature is not common only to private investors and many DFIs and MDBs also include economic growth and job creation among factors they consider when estimating the impacts of their investments. Whereas development finance actors seek to maximize impact and create financial returns, the dominant criteria for a majority of PE/VC firms is maximizing financial returns and having an additional element of creating positive impacts. This raises interesting question from the viewpoint of PE/VC investors such as how combatable PE/VC financiers' and development finance actors' interests are, and what kind of benefits blended finance represents for PE/VC investors from the viewpoint of impact investing.

2.3 Providers of development finance

2.3.1 Development banks

In my research I am focusing on institutions providing development finance, MDBs and DFIs, leaving out philanthropic actors, which have sometimes been mentioned as providers of blended finance.[40] Of multilateral development banks, I am taking a closer look at the World Bank Group which also encompasses the International Finance Corporation and the Multilateral Investment Guarantee Agency (MIGA). Multilateral development banks have development mandates and previously, they have been active in

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However, it must be noted that the GIIN survey covered various types of investors such as institutional investors and not only private equity investors (GIIN 2017, p. 12).

[37] *GIIN* 2017, p. 14.

[38] *World Economic Forum – OECD* 2015, p. 8.

[39] *GIIN* 2017, p. 25.

[40] *OECD* 2018, p. 49–50 provides examples of different definitions of blended finance. Of these definitions, some make a reference to philanthropic finance.

riskier parts of transactions in developing countries. MDBs have been notably attractive actors in mobilizing private finance and some funds are seeing mobilization rates as high as 800 per cent.[41] Reflecting the fragmentation of global climate governance, international organizations outside the United Nations climate regime such as the World Bank have sought to integrate climate change concerns in their operations.[42] Engaging in blended finance in the form of providing principles on blended finance and providing blended finance instruments well reflects this notion. These principles and instruments will be examined in chapters three and four.

Because blended finance seeks to rebalance risk-return ratio of investments in developing countries such as low-income countries, it is appropriate to inquire what multilateral development banks can do in this regard. Development banks can bring value for PE/VC investors engaging in blended finance investments, as they often have local expertise that is needed to advance in developing markets. These providers of development finance could e.g. finance specialized financial and technical advisory services.[43] Development financiers such as MDBs can also undertake activities that lead to the improvement of markets in emerging and frontier markets, such as engage with governments on investment plans and procurement processes.[44] Public finance lenders have the ability to provide stability also during times of high volatility and halts at capital markets such as financial crises.[45] Multilateral development banks can further be beneficial in blended finance operations already due to their presence alone, as host countries can be deterred from acting against foreign investors' interests fearing that such conduct can lead to repercussions from multilateral development financiers, such as the World Bank.

2.3.2 Development finance institutions

Besides MDBs, also development finance institutions can catalyse private finance to developing countries. DFIs are government-backed institutions investing in private sector projects in both low and middle-income countries, and often together with private sector investors.[46] Sometimes development finance institutions prefer to invest in private equity

[41] *Thompson* 2016, p. 155 refers to the World Bank's Clean Technology Fund as an example. For more information, see *World Bank* 2011, p. 14. For each US$ contributed to the Fund, US$ 8 in additional finance is attracted from both public and private sources.
[42] *Van Asselt* 2014, p. 23.
[43] *World Economic Forum – OECD* 2015, p. 11.
[44] *World Economic Forum – OECD* 2015, p. 11.
[45] *International Monetary Fund* 2011, p. 38.
[46] See, for example, *Savoy – Carter – Lemma* 2016, p. v.

directly and sometimes through specialized funds.[47] DFIs invest in commercially sustainable projects and have a dual mandate of positively influencing development in developing countries besides delivering financial returns. It seems that DFIs can achieve both development impact and financial results. Indeed, empirical results have confirmed that a majority of investments made by European DFIs have earned both high development and high financial outcomes: only 4 per cent of considered projects have delivered high financial returns while ranking low in development.[48] *Lemma* argues that the theoretical links between growth and DFIs are strong meaning that DFI investments into private sector help to reduce hurdles for growth, although the empirical studies in this field have been scarce.[49]

As DFIs are government-controlled, they receive their instructions from their respective governments but in addition, DFIs have also joined different initiatives[50] with the objective of mobilizing climate finance into developing countries. DFIs often follow policies set not only by their home governments but also those set by international agencies such as the World Bank Group. DFIs, as other investors, need to consider their environmental, social and governance (ESG) policies and other policies such as the IFC's standards as appropriate. Standards which DFIs need to adhere to limit the scope of possible DFI investments. As DFIs may be required to heed high environmental and social standards, PE/VC investors who want to engage in the same companies in the form of blended finance can also be expected to follow high standards. Indeed, different blended finance instruments require private equity investors to comply with a high degree of sustainability requirements. These instruments will be addressed in chapter four.

Development finance institutions can be bilateral or multilateral. The former seek to implement one country's foreign development cooperation policies while the latter are institutions established by more than one country and act as the private sector parts of the International Finance Corporation.[51] Such structures might also influence the policies followed by DFIs in their investments, including blended finance investments. In

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[47] See, for example, *Office of Evaluation* 2017, p. 23 on returns delivered by fund investments in private equity.
[48] *Dalberg* 2010, p. 26–27 shows that depending on the measurement strategy, these numbers vary slightly but the overall results remain consistent: projects ranking high in development tend to rank high also in financial returns and high financial returns can be rarely achieved when the development impact is low.
[49] *Lemma* 2015, p. 18.
[50] An example of such initiative is a partnership formed between the Climate Finance Leadership Initiative and the Association of European Development Finance Institutions.
[51] EDFI.

development financing bilateral DFIs have become increasingly important players in terms of private capital mobilized.[52] Majority of bilateral finance is now focused primarily on climate change mitigation projects, whereas some projects are cross-cutting and some focus only on climate change adaptation.[53] The focus areas naturally depend on e.g. geographical location and country priorities. This is naturally an issue worth acknowledging also for PE/VC investors: from the profitability point of view it makes little sense to engage in blended finance investments that do not provide adequate growth opportunities.

Multilateral development financial institutions often have a greater financing capacity than bilateral DFIs and they allow for cooperation opportunities between governments.[54] Examples of multilateral DFIs include, for instance, the International Finance Corporation. Multilateral development financial institutions can provide their resources to be used as risk management tools such as political risk insurances.[55]

Development finance institutions can contribute to the catalysation aims of blended finance e.g. by taking riskier equity positions in portfolio companies. I will address these ways to leverage private capital to developing countries more in chapter four. DFIs have different reasons for equity investing, among which seeking to serve important but overlooked investees, helping to build local equity markets, maximizing impact while generating returns and influencing the private sector inside companies.[56] European DFIs can help to improve standards in relation to, for instance, environmental compliance and good practices related not only to workers but also to the larger community.[57] Nevertheless, DFIs have not always maintained a clean track of record in the past.[58] DFIs in their equity investments, similarly to PE firms, seek to influence decision-making through boards and they are not often majority shareholders[59] in their companies.

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[52] *OECD – UNCDF* 2019, p. 33 notes how bilateral DFIs have become more important players in mobilizing private finance into the Least Developed Countries. As per amounts, multilateral institutions were the biggest players.

[53] *UNFCCC* 2018, p. 8 notes that of US$ 31.7 billion of bilateral climate finance 50 per cent was committed to mitigation, 29 per cent to adaptation, and 21 per cent to cross-cutting projects focusing both on mitigation and adaptation. This data is from years 2015–2016.

[54] *Dickinson*.

[55] See, for example, *Climate Policy Initiative* 2015, p. 8.

[56] *Office of Evaluation and Oversight* 2017, p. 13–14.

[57] *Dalberg* 2010, p. 18.

[58] An example is the International Finance Corporation’s conduct in Honduras. See, *Juana Doe et al. v. IFC*.

[59] Similarly, private equity firms often hold minority shareholder positions in companies and seek to the influence the management of companies through boards. Venture capital firms predominantly take minority

Even though development finance aims to become irrelevant one day in the future, for a period of time, development finance and commercial private finance will co-exist.[60] Co-existing of commercial and development finance simply does not imply that they will co-exist the exactly same period of time, although the exit times of private equity firms and development finance institutions might align. Similarities of development financiers and PE/VC investors and their co-existing are issues worth consideration for PE/VC investors as similar objectives and the presence of development financiers in blended finance operations can help to mitigate risks associated with investing in developing countries such as low-income countries. Because both development financiers and PE/VC investors seek to influence the performance of portfolio companies predominantly through board management, having very diverging would make it hard, if not possible, to manage the business. This remark is relevant in situations where both development financiers and PE/VC investors own equity in the same portfolio companies. Next, I will assess how development financiers measure the impact of their investments.

2.3.3 Development financiers and impact measurement

Traditionally, an important measure of development has been job creation[61]. DFIs have traditionally used job creation as a measure of assessing the development impact of their investments.[62] Mostly this has concerned direct jobs created, as indirect[63] employment creation measurement can be hard and inaccurate. However, not all jobs created imply development impact: this is the case e.g. in situations where the jobs created do not benefit the poor.[64] An example of such situation is when high-technology innovations are brought to areas where the workforce lacks necessary education.

However, poverty and poverty reduction goals are not measured by DFIs, as DFI investments as a rule do not directly affect the poor.[65] *Dalberg* asserts that besides jobs,

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shareholder positions, but this is not a rule without exceptions for private equity. Large leveraged buyouts can, for example, involve PE firms taking majority shareholder positions.

[60] See, for example, OECD DAC Principles of Blended Finance, p. 9 on investments where development finance and commercial finance co-exist.

[61] *Massa* 2013, p. 2 notes that job creation has been one of the top priorities for development finance institutions such as the International Finance Corporation, African Development Bank and European Investment Bank.

[62] *Massa* 2013, p. 2.

[63] Indirect job creation refers to jobs created in supplier or distribution firms linked to development finance institutions' portfolio companies. For more, see *Lemma* 2015, p. 17.

[64] *Massa* 2013, p. 5.

[65] *Lemma* 2015, p. 22–23.

DFIs measure their impact through also taxes and net currency effect.[66] Development impact considerations for DFIs include also innovation and technology development.[67] These are certainly critical factors also for venture capital investors, and the fact that DFIs and PE/VC investors share investment-wise at least partly similar objectives implies that blended finance *prima facie* seems an alternative with the ability to mobilize capital from private equity investors. Nevertheless, it must be carefully examined whether development financiers can accommodate risk concerns of private equity investors in blended finance operations. This stems from the fact that PE/VC investors are primarily driven by profit, and without accommodating risks in developing countries, blended finance will likely fall short.

Now that I have briefly introduced blended finance, development financiers and private equity/venture capital investors, it is time to look at the fundamentals of the United Nations climate change law regime, which is also relevant from the viewpoint of blended finance. It is relevant because a treaty of the regime, the Paris Agreement, contains one term that is examined in my research, namely climate finance mobilization. A brief examination of the regime is also relevant because climate finance mobilization is not an issue which can be considered without knowing the key objectives that lay underneath it.

In the next section, I will briefly cover the most central features of the UN climate change treaties to understand which principles guide the interpretation of the provisions of the Paris Agreement – among these also the climate finance mobilization article. Later in my research I will examine this article to establish how climate finance mobilization relates to blended finance. This examination of climate law treaties and their most central features is warranted because climate change regime is a complex and continuously evolving system, and rules pertaining to climate change are multi-layered, involve different actors at different levels, and span on different policy areas. Although the climate law regime is known for its complexity, it has evolved around different principles which even today form the backbone of international climate change law. Examining 'climate finance mobilization' without examining the most central features of the UN climate regime would fail to give a sufficiently detailed picture of the issue.

[66] *Dalberg* 2010, p. 29. According to Dalberg, net currency effect measures the contribution of the company to the national balance of payment.
[67] *Massa* 2013, p. 8.

2.4 The climate law framework

2.4.1 The UNFCCC

The United Nations Framework Convention on Climate Change (UNFCCC) was the first international treaty on climate change and a rich and diverse regime has developed around it. The cornerstone of current climate regime, the UNFCCC was adopted in 1992 and due to its high ratification rate, it has become universal in scope.[68] The UNFCCC was then followed, but not replaced by the Paris Agreement which I will assess next and which is more relevant for my research. Around the UNFCCC various forms of cooperation, legal instruments, funding instruments, and initiatives have been developed and neither adaptation nor mitigation finance has remained intact from international regulation. In many ways, the Paris Agreement builds on the rules laid down in the UNFCCC and climate finance is no exception to the rule.

The main objective of the UNFCCC is to "*stabilize greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system*". As the UNFCCC is a framework convention supplemented by other binding legal instruments,[69] it does not itself specify in detail country obligations regarding greenhouse gas (GHG) emission reductions but these are for example detailed in the Kyoto Protocol, which is the second treaty adopted under the UN climate law regime. Because the Kyoto Protocol does not entail obligations regarding climate finance mobilization,[70] and because it rather just adds flesh to the bones of the UNFCCC, I have left it outside this presentation.

Another key feature of the Convention is the "*common but differentiated responsibilities*" which refers to rather bifurcated responsibilities between developed and developing countries. The UNFCCC classifies countries into different groups, and in this sense it differs from the Paris Agreement although the latter agreement keeps up the bifurcated

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[68] *Kulovesi* 2013, p. 35.

[69] Among these is the Kyoto Protocol which sets binding emission reduction targets for countries which have ratified the Protocol. Despite the Kyoto Protocol has been described as "dead", it is still in force for countries that have ratified its second replenishment round.

[70] The Kyoto Protocol mentions the importance of finance in its treaty text but does not focus on climate finance mobilization. Article 13(4)(g) of the Kyoto Protocol spells out the obligation to mobilize additional financial resources in accordance with Article 11(2) of the Protocol, which in turn makes a reference to the articles of the UNFCCC. The Protocol is left out of this presentation because it does not have any independent obligations related to climate finance mobilization and because the Protocol builds upon the UNFCCC while not detailing obligations relevant for my research.

obligations regarding also climate finance.[71] *Rajamani* acknowledges that certain commitments regarding climate finance, despite being binding, are essentially old and continuing ones which did not create new substantive obligations.[72] Climate finance brings us to the Paris Agreement, which is in the core of my first research question regarding the alignment of the terms climate finance mobilization and blended finance.

2.4.2 The Paris Agreement

The Paris Agreement is the third treaty[73] adopted under the UN climate change regime and it builds on a complex body of rules, procedures and institutions established earlier.[74] It is a milestone in efforts to limit the scope of climate change and a watershed due to its climate finance provision, which seeks to leverage finance for the purposes of combating climate change and its adverse effects. The first and the main objective of the Paris Agreement is to keep the global rise of temperature "*well under 2 degrees Celsius*", making also a reference to 1.5 degrees Celsius.[75] However, this goal cannot not be achieved without drastic shifts in global financial flows. According to *Bohne et al.,* there was a broad consensus that climate finance enables climate action, and that both climate change mitigation and adaption require significant shifts in financial flows as well as private investment.[76] Thus, it is logical that the Paris Agreement also aims to make global financial flows consistent "*with a pathway towards low GHG emissions and climate resilient development*".[77]

Other goals noted in Article 2 of the Agreement include eradicating poverty and ensuring that food security is not threated by fostering climate resilient and low-emission development. The Paris Agreement preamble raises a broader set of concerns in its preamble than the previous climate treaties and particularly its focus on human rights is something unpreceded in international climate change agreements.[78] Whereas preambular language has a more limited importance in practice than treaty obligations, these human

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[71] The UNFCCC in its Articles 4(3)–4(7) spelled out ways how developed countries shall assist developing countries by means of finance. The Paris Agreement in its Article 9 leaves developed countries with the primary responsibility in providing climate finance while encouraging other parties to the Agreement to participate in providing climate finance.
[72] *Rajamani* 2016, p. 353.
[73] *Bodle – Overthür* 2017, p. 92. Bodle and Overthür consider the Paris Agreement to be clearly a treaty due to fulfilling several criteria, among which the entry into force of the Agreement and several formal procedures common for treaties.
[74] *Depledge* 2017, p. 27.
[75] Article 2(1) of the Paris Agreement.
[76] *Bodle et al.* 2016, p. 11.
[77] Article 2(1) of the Paris Agreement.
[78] *Nishimura* 2018, p. 48.

rights concerns reflect notions that are worth acknowledging also when mobilizing private finance into developing countries for the purposes of combating climate change and its adverse effects.

The Paris Agreement on climate change is legally binding upon states who have ratified it but not all provisions of the Agreement have normative content. As such, the level of binding degree of the Agreement's obligations varies between provisions. The Paris Agreement combines both harder and softer provisions.[79] It must be recalled that binding international treaties, such as the Paris Agreement, do not necessarily fall into 'hard law' or 'soft law' category, but can embody features of both classes.[80] The Paris Agreement has a number of provisions which, according to *Rajamani,* seem to have weak normative content, if any.[81] Provisions of the Paris Agreement that do impose clear obligations for the parties to the Agreement are procedural and process-related, which require further, political decisions by the parties.[82] In this sense, the Paris Agreement is similar to the UNFCCC. In spite of the procedural nature of the Agreement, it should not be concluded that the 'hard law' obligations of the Paris Agreement are related only to reporting and other procedural obligations. One of provisions tied to the 'hard law' obligation, the purpose of the Agreement, is climate finance mobilization article 9(3), which seeks to attract capital for climate-friendly investments.

Because of this mixture of norms varying in terms of normative nature, it is vital to understand that the Paris Agreement is addressed to states and not to private investors or development financiers. Treaties binding upon states only are binding upon states and not directly binding upon the organs of that state.[83] This is the case also for bilateral DFIs, many of which are entirely state-owned or at least have states as major shareholders. International environmental law does not directly apply to private enterprises,[84] such as private equity investors. For this reason, treaty ratification is an issue that must be noted.

The Paris Agreement, similarly to the UNFCCC, has been widely ratified. The European Union (EU) ratified the Paris Agreement in October 2016, followed by Finland's ratification in November 2016 when the Agreement also entered into force. This implies

[79] *Pickering et al.* 2019, p. 21.
[80] See, for example, *Pickering et al.* 2019 who refer to the Paris Agreement's innovative approach as a 'Crème Brûlée' due to featuring both hard law and soft law obligations.
[81] *Rajamani* 2016, p. 337.
[82] *Bergkamp – Stone* 2015, p. 15.
[83] *Nollkaemper* 2014, p. 130.
[84] *Majean-Dupois – Richard* 2013, p. 93.

that for the EU countries, the Paris Agreement will be implemented both at the EU and national levels, the EU-level implementations influencing operations of development financiers such as the European Investment Bank and national-level implementation affecting bilateral development financiers' operations. Despite the Agreement covers years from 2020 onwards, solutions for GHG emission reductions have been sought already before year 2020.[85] Because the Paris Agreement needs to be implemented in some countries due to not being self-executing, implementation measures vary. For this reason, I will examine the provisions of the Paris Agreement and not its implementation measures.

Since the Paris Agreement does not replace the UNFCCC but rather complements it, it is useful to look at what new the Agreement brings to the regime. The Paris Agreement has taken important steps in recognizing the role of non-state actors, making it a novelty also in this regard. As *Hale* notes, both non-state and sub-state actions now belong to the core features of international governance and they have also reached a large scale.[86] Among these actors are for instance development financiers and private investors. The Paris Agreement is similar to the UNFCCC in terms of substance matter and keeps up rather bifurcated obligations for developed and developing countries implying, *inter alia*, a more prominent role for developed countries in mitigating climate change and leveraging finance for the purposes of combating climate change and its adverse effects. Nevertheless, it is noteworthy that also developing countries have to submit their emission reduction plans. As a practical consequence, foreign investors engaging in blended finance in developing countries should consider these plans as they might give regulatory signals regarding legislation a country is about to adopt in the future to tackle its GHG emissions. The Paris Agreement also differs from the UNFCCC's Kyoto Protocol in that it follows a 'bottom-up' approach leaving a vital role for national mitigation plans. For this reason, examining these national plans becomes worth understanding.

2.4.3 National plans under the climate regime

Both under the UNFCCC and the Paris Agreement national mitigation plans were adopted.[87] Under the Paris Agreement national mitigation plans are called Nationally

[85] *Finnish Ministry of the Environment* 2018.
[86] *Hale* 2018, p. 3.
[87] Non-binding national plans adopted within the spheres of the United Nations climate change regime include NAMAs, NAPAs, NAPs, INDCs and NDCs, of which NAMAs and (I)NDCs focus on climate

Determined Contributions (NDCs). Intended Nationally Determined Contributions (INDCs) were provided by countries before the Paris Conference where the Agreement was adopted. It is year 2020 when parties to the Paris Agreement have to submit new, updated and more ambitious NDCs. The Parties to the Agreement are under an obligation to prepare their NDCs and update them every five years to make them more updated and ambitious. This obligation is one of the hardest, and most binding provisions of the Paris Agreement.

NDCs themselves are not binding but often detail mitigation and adaptation efforts better than the Paris Agreement itself. (I)NDCs show countries' priorities, circumstances and capabilities. They give non-state actors next five years' policy directions which may result in changes also in regulation. For this reason, national mitigation plans have also relevance for macro risks, in particular for regulatory risks. Formally speaking NDCs are not a part of the Paris Agreement although they make references to it.[88] The Paris Agreement does not oblige parties to the Agreement fulfil their NDCs as they are only required to pursue measures "*with the aim of achieving the objectives of such contributions*".[89] The Paris Agreement cannot be criticized for lack of ambition, but the provisions dealing with GHG emission reductions do not oblige country parties to the Agreement heed them.[90] *Bergkamp – Stone* argue that NDCs "*may be binding*", as parties to the Agreement rely on other parties' pledges.[91] I consider NDCs to be relevant for the mere reason that in the future they might include also finance-related commitments.[92]

As the Paris Agreement was unprecedent in that sense it required all parties to the Agreement, including low-income countries such as the Least Developed Countries, to make commitments in terms of climate change mitigation, understanding the significance of national plans becomes vital. This is because these plans can shed light on the future regulatory and executive priorities in developing countries. As the Paris Agreement in its

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change mitigation. NAMA is an abbreviation of Nationally Appropriate Mitigation Action, NAPA of National Adaptation Programmes of Action, NAP of National Adaptation Plan, and (I)NDC from (Intended) Nationally Determined Contributions. The (I)NDCs are commitments made under the Paris Agreement whereas the other national plans are made under the UNFCCC.

[88] *Bodle – Overthürn* 2017, p. 93.

[89] *Bodle et al.* 2016, p. 7.

[90] *Ogbumgbada* 2016 for critical notions of the Paris Agreement.

[91] *Bergkamp – Stone* 2015, p. 15. Bergkamp – Stone also argue that in cases of non-compliance with NDCs, countries might invoke an exception or defence. About the uncertainty regarding whether NDCs are legally binding or not, see also *Scott* 2018, p. 619–620.

[92] This possibility has been brought up by e.g. *Whitley et al.* 2018, p. 32. Whitley et al. have referred to the country-driven nature of NDCs when assessing the possibility of governments to include finance-related commitments to NDCs.

preamble refers to taking full account of national development priorities,[93] national plans give more detail in this regard detailing which kind of investments support and which are not in par with this objective. Moreover, national plans highlighting country's development priorities might be useful in that sense they enable PE/VC investors to access specific risk mitigating insurance schemes, an issue which I will examine in chapter four. National plans made under the UNFCCC and more recently under the Paris Agreement are nevertheless not the only non-binding legal instruments that are relevant for my research. I will explain the nature of these instruments next.

2.4.4 Soft law

Soft law refers to different legal instruments that are not legally binding but may nevertheless be influential in terms of guiding behaviour of various actors such as development financiers engaging in blended finance. Soft law is particularly important for blended finance because instruments regulating blended finance operations are yet to take more binding forms. Thus, relevant legal instruments on blended finance are, well, soft. They have emerged outside the previously presented UN climate law regime, which is not exceptional in the context of the complex and multi-layered climate change law regime. Soft law instruments are diverse, and they cover, *inter alia*, declarations of principles and action plans adopted at international conferences, international recommendations adopted by international institutions, operational procedures, and safeguard policies.[94] Various legal instruments put forward by the OECD and the World Bank Group fall into this category.[95] For my research, the most relevant soft law instruments are blended finance principles, which have been adopted by both the OECD and the IFC, which is an organ of the World Bank Group. Later in my research I refer to these principles as 'blended finance soft law'.

But is soft law worth considering, really? Powerful organizations behind these soft instruments, such as the OECD, do not always choose to use their 'hard law' powers in influencing states' and non-state actors' conduct. Soft law should not be considered weak or worthless just because it is soft. As *Blutman* notes, soft law instruments should not be considered to be of inferior or lesser value when it comes to influencing or controlling the conduct of those operating at international level.[96] Whereas companies might not

[93] The Paris Agreement preamble.
[94] *Friedrich* 2013 provides a complete analysis on different soft law instruments.
[95] *Friedrich* 2013, p. 40–45 and 52–55.
[96] *Blutman* 2010, p. 608.

always adhere to soft law recommendations in their own conduct, in blended finance it should be recognized that development finance actors often carefully follow non-binding regulations put forward by international organizations such as the OECD. This adherence of development financiers to blended finance soft law can also be important from a PE/VC investor point of view because the recommendations of the OECD and the IFC certainly bring up concerns that can be critical for these investors. Such issues include e.g. desired impact, performance measurement, growth, and commercial viability in general. Whereas private equity investors can consider these issues independently in their own investments, the situation is different when both development financiers and PE/VC investors invest in the same portfolio companies.

2.5 Chapter conclusions

In this chapter I have introduced general terms surrounding blended finance, and private equity/venture capital and development finance as its components. Whereas developing countries and particularly low-income countries have failed to attract private finance in adequate amounts in the past, blended finance seeks to transform the situation by rebalancing risk-return ratios of foreign investments in these countries. I noted that the objectives of PE/VC investors and development financiers align at least partly due to the fact that both PE/VC investors and development financiers strive towards job creation and technological innovation. Due to the aligned objectives, the ability of development financiers to add value in blended finance operations, and the high growth rates of low-income countries, blended finance *prima facie* seems a feasible alternative also for PE/VC investors.

In this chapter I have also briefly introduced the climate law regime built around the UNFCCC focusing on the newest international agreement on climate change: the Paris Agreement. The key issue of the Paris Agreement is that it entails provisions falling to different spots in the soft law–hard law spectrum, while emphasizing the role of Nationally Determined Contributions in achieving the key objectives of the Agreement. While the Paris Agreement includes clear obligations only on procedural matters and whereas the status of NDCs remains contested, this should not be considered as rendering the Agreement meaningless and as something private equity investors should pass. Reasons for this include the fact that national plans shed light on national priorities, an issue whose acknowledgement might be required also by some blended finance instruments.

In the next chapter I will lay down the basis for examining ways how blended finance instruments can mitigate/transfer different macro risks associated with investing in developing countries and low-income countries in particular. The next chapter focuses on the climate finance mobilization article of the Paris Agreement and examines how the term ‘climate finance mobilization’ relates to the term ‘blended finance’, which has been adopted outside the UN climate regime. If these terms regulate the same substance matter, this could have implications for the application of blended finance soft law in climate-friendly investments.

However, separately it should be established whether the soft law instruments regulating blended finance are actually applied by development financiers in the aligned substance matter area. This depends upon the legitimacy of these instruments as well as practical situations where these instruments should be disregarded. Blended finance soft law, i.e. the principles on blended finance, is vital for private equity investors because it addresses concerns these investors need to consider in all their investments, such as scalability and commercial viability in general. Without addressing these concerns blended finance would likely fall short from its objectives. This is particularly the case when development financiers and PE/VC investors own equity in the same companies.

3. CLIMATE FINANCE MOBILIZATION AND BLENDING

3.1 Paris Agreement provisions on climate finance mobilization

3.1.1 What is climate finance mobilization?

The Paris Agreement seeks to leverage private finance for specific purposes just as blended finance does, i.e. by trying to attract different types of private finance (debt, mezzanine, equity) to these ends. Despite the Paris Agreement leaves the content of the terms climate finance and its mobilization unclear, Article 9(3) of the Agreement nevertheless refers to climate finance mobilization from a wide variety of instruments, sources and channels. This is the only hint regarding the content of these two terms that the Paris Agreement gives in its treaty text. Also, the *travaux préparatoirés* of the Paris Agreement do not further define 'climate finance' or its 'mobilization'.[97]

Regarding climate finance, a distinction can be made between climate-specific finance and climate-relevant finance, the former referring to capital flows targeting low-emission and climate-resilient development with (in)direct GHG mitigation or adaption outcomes or objectives. The latter term refers to all other flows which do not directly target mitigation or adaption but still might have relevance for GHG emissions or vulnerability to climate change.[98] Despite the Paris Agreement does not use these terms in its treaty text, for the purpose of my research, climate-specific finance is on the focus. This choice stems from the fact that previously presented impact investing is focused on explicitly achieving environmental/social impact objectives and because also blended finance seeks explicitly to attract private finance for the purpose of sustainable development. According to *Romano et al*., the role of climate finance is to support sustainable economic growth.[99]

Climate finance mobilization as a term can be understood as leveraging new sources of finance into low-emission and climate-resilient projects. Mobilization means crowding in finance that otherwise would not have been committed, so to say without the involvement of public providers of finance. Despite the term is seemingly straightforward, it does not only refer to attracted private finance which is co-invested with public finance. In climate finance mobilization the key element is *additionality*: private finance that would not have

[97] Not providing the content for the terms 'climate finance' and its 'mobilization' should not be considered problematic because the Paris Agreement is built upon the UNFCCC. When negotiating the Paris Agreement, there was a consensus that the older finance obligations would apply. For more, see for example *Bodle et al.* 2016, p. 11. See also *Halonen et al.* 2017, p. 11.

[98] *Van Calster – Vandenberghe – Reins* 2015, p. 510.

[99] *Romano et al*. 2018, p. 31.

been invested without the involvement of public or development finance. *Lütken* defines 'leveraging' as meaning the mechanics that ensure that small actions in the public financing sector lead to greater and significant moves in the private sector.[100]

Mobilization of climate finance should be understood as *attracting further, commercial finance for low-emission and climate-resilient investments*. This means making such financial arrangements by e.g. development finance providers (DFIs and MDBs) that encourage private investments for low-emissions and climate-resilient projects. In its core, mobilization of climate finance seeks to attract such private finance that otherwise would not have been committed. Climate finance mobilization should accommodate those concerns of private investors that in the past have deterred them from investing in developing countries. Mobilization as a term comes close to blended finance because the institutions mobilizing private finance such as MDBs and DFIs use financial instruments such as guarantees to attract private finance (equity, mezzanine and debt).

Despite climate finance and its mobilization have not been defined in the Paris Agreement or its preparatory works, the sources from which climate finance should be mobilized have gained some attention within the UN climate change law regime. A report by the High-Level Advisory Group on Climate Change Financing (AGF) specified 'a wide variety of sources' to cover sources that are "*public and private, bilateral and multilateral, including alternative sources of finance, the scaling up of existing sources and increased private flows"*.[101] Although the AGF worked on climate finance mobilization by year 2020,[102] its notion on the sources of finance serves the purposes of understanding mobilization channels since the Paris Agreement leaves possible sources undefined. Based on this notion, *climate finance* should be understood as referring to local, national and transnational finance drawn from public, private and alternative sources.

This broad notion of mobilization sources is further supported by the history of the Paris Agreement. When the Paris Agreement was under its way, there was a consensus that the financial obligations of UNFCCC Annex II countries, i.e. developed countries, would continue to apply.[103] A real life consequence of this essentially refers to the amounts

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[100] *Lütken* 2014, p. 40.
[101] Report of the Secretary-General's High-Level Advisory Group on Climate Change Financing 2010. In addition, the Copenhagen Accord 2009, p. 7 provided a similar content for a 'wide variety of sources'.
[102] The High-Level Advisory Group on Climate Change Financing 2010, para. 5.
[103] *Bodle et al.* 2016, p. 11.

expected to be mobilized and the sources from which finance should be mobilized. The Paris Agreement does not include specific quantitative finance objectives or even refer to the goal of 100 billion which was made earlier in Copenhagen.[104] The UNFCCC parties agreed that this sum could come from public and private, bilateral and multilateral sources.[105] By this broad reference the Agreement does not exclude any source of finance that can be used to mobilize further finance into low-emission and climate-resilient activities. Considering this notion of diverse mobilization sources in connection of the purpose of the UNFCCC and the Paris Agreement, climate finance should be understood as finance that is aimed at climate change mitigation or adaptation purposes. In the Paris Agreement these purposes carry names 'low-emission' and 'climate-resilient' development, respectively.[106]

3.1.2 Key provisions affecting climate finance mobilization

No man is an island, and the same can be said of the provisions of the Paris Agreement – articles such as the climate finance mobilization article of the Agreement, Article 9(3), cannot be considered in isolation of the key articles of the Paris Agreement. As I noted in the beginning of my research, the Paris Agreement is built around the main, overarching objective of keeping the rise of the global temperature well under 2 degrees Celsius, referring also to the limit of 1.5 degrees Celsius.[107] The Agreement also sets a corresponding GHG emission reduction goal.[108] As the objective article of the Agreement, Article 2(1) of the Paris Agreement guides the interpretation and implementation of the other articles of the Agreement.

Besides this key objective regarding the rise of global temperature, another provision in the core of and also one mentioned in Article 2(1) of the Paris Agreement is "*making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development*".[109] As the Standing Committee on Finance notes, this does not mean that all climate finance flows must have "*explicitly beneficial climate outcomes*", but rather that they "*must reduce the likelihood of negative climate outcomes*".[110] *Bodle – Overthür* have brought up also a third provision mentioned in

[104] *Bodle et al.* 2016, p. 11.
[105] *Condon* 2013,p. 202.
[106] Article 2(1) of the Paris Agreement.
[107] Article 2(1)(a) of the Paris Agreement. See also *Bodle – Overthür* 2017, p. 95.
[108] *Höhne et al.* 2016, p. 17 making a reference to Article 4(1) of the Paris Agreement.
[109] The Paris Agreement Article 2(1)(c).
[110] *UNFCCC* 2018, p. 9.

Article 2(1): increasing the ability to adapt.[111] These three key provisions guide the implementation and interpretation of the Paris Agreement.

The Paris Agreement preamble offers further guidance for the interpretation of these key provisions of the Agreement. The Paris Agreement undisputedly qualifies as a treaty under international law,[112] thus being subject to the rules of the Vienna Convention on the Law of Treaties (VCLT). Pursuant to Article 31(1) of the VCLT, a treaty "*shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*". Article 31(2) and 32 of the VCLT highlight that also preambles and annexes to the treaties among other relevant documents shall guide the treaty interpretation.[113] The Paris Agreement is no exception to this rule, and the overarching objectives regarding limiting the rise of global temperature, making finance flows consistent with climate-resilient development and adaptation perspective shall guide the interpretation and implementation of the Agreement.

3.1.3 Role of public funds

The Paris Agreement builds on the UNFCCC's key objectives and rules, reflecting the UNFCCC's well-known "*common but differentiated responsibilities*", and the bifurcated responsibilities between developed and developing countries. Climate finance mobilization provision embodies this approach, and the Paris Agreement's developed country parties "*should continue to take the lead in mobilizing climate finance from a wide variety of sources, instruments, and channels, noting the significant role of public funds, through a variety of actions, including supporting country-driven strategies, and taking into account the needs and priorities of developing country Parties. Such mobilization of climate finance should represent a progression beyond previous efforts*".[114] In this sense the Paris Agreement's climate finance mobilization article is similar to blended finance, which also seeks to leverage finance to developing countries. This provision of the Paris Agreement places a duty of mobilizing climate finance for developed countries who should consider developing countries' needs, priorities, and

[111] *Bodle – Ovethür* 2017, p. 95.
[112] *Bodle – Overthür* 2017, p. 92.
[113] Articles 31(2) and 32 of the Vienna Convention on the Law of Treaties.
[114] There is a broad consensus that the current level of action is not nearly enough to keep the rise of global temperature under 2 degrees Celsius. See, for example *Höhne et al.* 2016. As this notion is a few years old, it must be noted that the level of inaction from the viewpoint of achieving the Paris Agreement's key objectives still remains. To this end, see, for example, *UNEP* 2019, p. XIII.

country-driven strategies when fulfilling this duty. This article, Article 9(3) of the Agreement, essentially implies that the finance for climate finance mobilization should come from wealthier nations. This finance can be used, for example, to finance bilateral or multilateral DFIs or it can contribute towards financing of MDBs.

Article 9(3) emphasises the role of *public* finance in climate finance mobilization as it notes "*the significant role of public funds*" in mobilizing climate finance. This article of the Paris Agreement is interesting due to its emphasis on public finance. However, because my study focuses on the role of development financiers such as DFIs and MDBs in mobilizing climate finance, it must be asked whether development finance counts as 'public' within the meaning of the Paris Agreement. As previously acknowledged, definitions of blended finance vary, and some do not mention the sources from which finance should be mobilized, whereas some definitions refer to public or development finance, some mentioning also philanthropic finance as finance used for mobilizing further, commercial finance.[115] In the heart of blended finance concept is the "*strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries*", additional finance referring to commercial finance that does not have an explicit development purpose.[116] Therefore, the Paris Agreement's 'climate finance mobilization' term and 'blended finance' embody similar ideas when examined from the perspective of mobilizing entity and entities from whom climate finance should be mobilized, i.e. the private sector.

But is development finance public? In their research paper, *Whitley et al.* use a "*narrow definition of public finance*" when focusing on "*majority government-owned financial institutions and funds*",[117] thus suggesting that at least development finance from bilateral sources is public finance. Although the treaty text of the Paris Agreement speaks in terms of *public* and not *development* finance, many DFIs have states as their majority shareholders with private shareholders in minority shareholder positions.[118] Despite some authors have defined DFIs to be situated between public aid and private investment spheres,[119] finance provided by DFIs which are entirely or primarily state-owned, having

[115] *OECD* 2018, p. 49–50 makes a list of different definitions of blended finance as developed by institutions, development actors and researchers.
[116] *OECD* 2018, p. 13.
[117] *Whitley et al.* 2018, p. 19.
[118] For example, Finnfund has the Finnish state as its majority shareholder with 94.4 per cent together with Finland's export credit agency Finnvera (5.5 per cent) and the Confederation of Finnish Industries (0.1 per cent). Data from 7 November 2019.
[119] *Dickinson*, p. 1.

other state agencies as minority shareholders, should not be regarded as not falling to the public finance category. This suggestion is consistent with the finding of Whitley et al., and more importantly this view is supported by the broad wording of Article 9(3) of the Paris Agreement. This is because this article refers to a wide variety of sources, instruments, and channels and just emphasizes the significant role of public funds, not implying that funding used for climate finance mobilization should be *entirely* public. If an opposite would have been meant, it seems reasonable to expect that a different phrasing would have been used in the Paris Agreement.

The case of finance provided for multilateral DFIs and development banks is more complicated. Naturally, public funding is provided to these institutions, a part of which is official development aid.[120] Because Article 9(3) indeed only notes the *significant* role of public funds, not requiring it should be the only source of finance used for mobilization, it seems feasible to argue that also multilateral DFIs and development banks are among entities which have a significant role in climate finance mobilization. It cannot be concluded that public finance means the same as development finance and development finance should rather be considered to be a component of public finance.

Several reasons, among which the broad wording of Article 9(3) of the Paris Agreement, thus support the argument that development finance should be considered as public finance when it is provided by states through DFIs or used to finance MDBs. Based on these remarks it seems feasible to suggest that finance provided for development financiers is at least primarily public finance within the meaning of the Paris Agreement. Because of this also development finance, similarly to other public finance, has a notable role in mobilizing climate finance pursuant to the Paris Agreement. The definition of blended finance of the OECD refers to 'development finance',[121] whereas other definitions make references also to public and philanthropic finance implying that the mobilizing entities are more diverse and encompassing in the case of blended finance than in the case of climate finance mobilization term employed in the Paris Agreement. Common to the different definitions of blended finance seems to be the role of concessional, i.e. non-commercial finance in the mobilization of private finance. Thus, the Paris Agreement and definitions of blended finance essentially both note the importance of development finance. Moreover, both the Paris Agreement and the OECD

[120] See, for example, *OECD* 2019, p. 1.
[121] *OECD* 2018, p. 13.

definition of blended finance also use the term 'mobilization' of additional finance. They both also seek to leverage private finance to developing countries, the Paris Agreement additionally mentioning that such finance should be primarily mobilized by developed countries. Thus, the remaining issue relates to the purpose for which private finance should be mobilized. I will address this issue next.

3.1.4 Purpose of mobilization

The content of the climate finance mobilization term used by the Paris Agreement seems to match rather well with the essence of a number of definitions of blended finance, leaving only the alignment of the purposes of private finance mobilization open. Various, if not all, definitions of blended finance embody the notion of mobilization that additional finance should be mobilized for the purpose of sustainable development. The Paris Agreement, on the other hand, does not explicitly state the purpose of mobilization in its climate finance mobilization article, Article 9(3). This provision only makes a vague reference to the needs and priorities of developing country parties to the Paris Agreement. However, as previously noted, the purpose article of the Paris Agreement, Article 2, is vital also when considering other articles of the Agreement, including the climate finance mobilization article. The ultimate purpose of the Paris Agreement, limiting the rise of global temperature well under 2 degrees Celsius, is linked to the climate finance mobilization article through Article 3 of the Paris Agreement. Article 3 requires parties to the Paris Agreement to undertake "*ambitious efforts*" as defined in certain other articles of the Agreement, such as Article 9 containing the climate finance mobilization requirement. Thus, it is clear that finance should be mobilized for purposes which support the fulfilment of the Paris Agreement's purpose. This refers to such purposes which: i) help to keep the rise of global temperature well under 2 degrees Celsius; and ii) help to adapt to adverse impacts of climate change.[122] Later in my research I refer to these purposes as 'low emission and climate-resilient development'.

Besides the overarching objectives of the Paris Agreement and Article 9(3) on climate finance mobilization, the Paris Agreement has also other provisions relevant from the viewpoint of climate finance mobilization. The Agreement's preamble emphasizing the

[122] The Paris Agreement has been concluded to have three overarching purposes: i) limiting the rise of global temperature well under 2 degrees Celsius; ii) adapting to the adverse impacts of climate change; and iii) making global finance flows consistent with the objective of low-emission and climate resilient development. As this third objective seeks to make financial flows with the consistent with the two first objectives, I did not include it as its own element of the purpose of the Paris Agreement in my research.

needs of developing countries, protection of human rights and decent working conditions, combating hunger, protecting biodiversity and action based on best available science shall guide in the interpretation of the Agreement. However, the preamble does not itself create obligations or rights for the parties to the Paris Agreement.[123] Rather, its meaning is to shed light on concerns parties to the Agreement considered valuable. The fact that these issues have been mentioned in the preamble means that they alone cannot get the status of a treaty text but shall rather guide in the interpretation of the Agreement unless these objectives are specially mentioned also in the treaty text.

As blended finance aspires to strategically attract private finance for the purpose of sustainable development, it seems that the only difference between climate finance mobilization and blended finance is the purpose for which private finance is leveraged. Whereas blended finance seeks to attract finance for sustainable development generally, the Paris Agreement seeks to attract finance for climate change mitigation and adaptation activities, i.e. low-emission and climate-resilient development. Thus, a question about the relation of the Paris Agreement and sustainable development arises. Next, it will be established how the purposes for which climate finance should be mobilized under the Paris Agreement, i.e. low-emission and climate-resilient development, are related to sustainable development.

3.1.5 The Paris Agreement and sustainable development

In the 1987 Brundtland Report, sustainable development has been defined as "*development that meets the needs of the present without compromising the ability of future generations to meet their own needs*".[124] Sustainable development has then continued be on the agenda of states although the exact definition of the term has caused discussion.[125] Whereas definitions of sustainable development vary, this should not be made more problematic than it really is. Because the Paris Agreement does not make any explicit references to the definition of sustainable development, the exact content of the definition is not critical.

It is certain that the Paris Agreement is intrinsically linked to sustainable development and the Sustainable Development Goals. The Paris Agreement supports sustainable

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[123] *Rajamani* 2016, p. 343.
[124] *Brundtland et al.* 1987, p. xi.
[125] See, for example, *Gehring – Newcombe* 2011.

development and the preamble and various provisions[126] of the Paris Agreement make explicit references to sustainable development. Among these provisions is also the overarching Article 2(1) spelling out the purpose of the Agreement.[127] Many of the concerns raised in the preamble of the Paris Agreement are also mentioned in the 2030 Agenda for Sustainable Development which introduced the SDGs.[128] I conclude, that many of the objectives mentioned in the preamble of the Paris Agreement reflect the SDGs.[129] Therefore, it seems feasible to suggest that the Paris Agreement – due to sustainable development references of the preamble, the objective article, and several other articles – indeed supports sustainable development.

However, separately it must be established how the purposes for which climate finance should be mobilized, low-emission and climate-resilient development, is linked to sustainable development. Because the purpose article of the Paris Agreement makes an explicit reference to sustainable development,[130] there seems to be an evident link between sustainable development and climate finance mobilization article. This is further supported by the fact that the preamble of the Paris Agreement makes several references to sustainable development. As a result, 'climate finance mobilization' seems to be a part of blended finance, the latter term being more encompassing and broader. Because blended finance seeks to mobilize private finance for the purposes of sustainable development, and the Paris Agreement seeks to mobilize finance for low-emission and climate-resilient development, blended finance and the Paris Agreement both partly govern the same substance matter, i.e. low-emission and climate-resilient development.

A noteworthy point is that mobilization is not limited to specific forms of finance (debt, mezzanine, equity) and that countries have different ways to fulfil their climate finance mobilization commitments. This implies that mobilizing climate finance through bilateral and multilateral DFIs and MDBs is just one way for states to fulfil their mobilization pledges made under the Paris Agreement and other options could include e.g. contributions to the climate funds of the UN climate regime, such as the Green Climate

[126] Articles 2, 4, 6, 7 and 8 of the Paris Agreement specifically mention sustainable development.
[127] This provision is formatted as enhancing the response to climate change "*in the context of sustainable development*".
[128] The Agenda introduced the Sustainable Development Goals, and it was adopted with the United Nations General Assembly Resolution A/RES/70/1.
[129] Sustainable Development Goals cover 17 global goals, of which many are mentioned in the preamble of the Paris Agreement despite not making an explicit reference to SDGs. These include climate change action, no poverty, zero hunger, decent work (and economic growth), gender equality, good health and well-being, life below water, life on land, partnerships for the goals, and responsible production and consumption.
[130] Article 2(1) of the Paris Agreement.

Fund. However, because the UN climate funds essentially seek to mobilize private finance from institutional investors such as pension funds, examining these funds would go outside the scope of my research because my research is focused on climate finance mobilization from PE/VC investors.

Now I have established that 'climate finance mobilization' and 'blended finance' are very similar terms and partly govern the same substance matter. Blended finance seeks to mobilize finance towards sustainable development, whereas climate finance mobilization seeks to mobilize finance for a narrower field, namely low-emission and climate-resilient development. Another difference between the two terms is that climate finance mobilization highlights the role of public funds whereas blended finance definitions do not particularly emphasize any source of finance. However, in the heart of both terms is development finance, which should be understood as a component of public finance. Thus, 'blended finance' and 'climate finance mobilization partly govern the same area: low-emission and climate-resilient development. Investments that would fall under this umbrella could include e.g. technological innovations which curb emissions or help local communities to adapt to adverse effects of climate change such as water shortages.

Earlier in my research I stated that the aligned substance matter of 'climate finance mobilization' and 'blended finance' could have implications for the consideration of blended finance soft law, and thus PE/VC investors' perspective, in climate investments. Whereas the aligned substance matter area, low-emission and climate-resilient development itself does not mean that legal instruments, the Paris Agreement and blended finance soft law, covering it should be simultaneously applied,[131] the aligned substance matter has other consequences. Because it has been now established that blended finance is a broader term than climate finance mobilization, blended finance soft law applies to a broader range of issues than the climate finance mobilization article. As such, blended finance soft law covers also low-emission and climate-resilient development. Thus, the application of the Paris Agreement by development financiers when mobilizing private finance to low-emission and climate-resilient development does not matter. Therefore, it can be concluded that blended finance soft law should be considered by development

[131] This is because the aligned substance matter does not automatically mean that the legal instruments addressing this area should be simultaneously considered. Even though 'climate finance mobilization' and 'blended finance' do govern the same substance matter, this does not mean that the legal instruments regulating them, the Paris Agreement and blended finance soft law, should be simultaneously considered by development financiers (DFIs, MDBs). Making such an assertion would require understanding whether development financiers are required to adhere to the Paris Agreement.

financiers (DFIs, MDBs) when mobilizing climate finance into low-emission and climate-resilient development. Next, I will examine blended finance soft law instruments adopted by the OECD and the IFC outside the UN climate change law regime.

3.2 Soft law on blended finance

3.2.1 OECD soft law

To start, it must be recalled that so far instruments regulating blended finance are soft law in nature and have emerged outside the formal UN climate change law regime. Such a soft law instrument has been put forward by the Organization for Economic Cooperation and Development (OECD). As noted previously, the OECD is an organization shaping international and national environmental policies and law through its soft law instruments.[132] Although the organization's decision-making body (OECD Council) can adopt also adopt decisions binding upon OECD member states, it has rarely utilized this alternative in environmental matters,[133] and blended finance is no exception to this. The OECD's instruments relevant for blended finance have taken other, softer forms.

The OECD Development Assistance Committee (OECD DAC) has developed five principles on blended finance emphasizing the importance of commercial sustainability. The five principles put forward by the OECD DAC are: i) anchor blended finance use to a development rationale; ii) design blended finance to increase the mobilization of commercial finance; iii) tailor blended finance to local context; iv) focus on effective partnering for blended finance; and v) monitor blended finance for transparency and results.[134]

Pursuant to the first principle development finance in blended finance should strive towards maximizing development impact and outcomes. The second principle seeks to address market failures and ensure additionality for crowding in commercial finance. In other words, development finance should only be used in sectors and in locations where it is most urgently needed. The second principle also highlights the importance of concessional, i.e. non-commercial finance, including having a clear strategy with regard to the duration and exit of concessional finance. The third principle highlights the importance of supporting local development priorities alongside with developing local financial markets. This principle entails e.g. working with local financial sector when

[132] *Friedrich* 2013, p. 40.
[133] *Kiss – Shelton* 2004, p. 92.
[134] OECD DAC Principles of Blended Finance.

possible and underlines the role of blended finance in meeting local development needs. The fourth principle recognizes that blended finance works when both commercial and development objectives can be achieved, and it also underlines respect for different mandates. This principle also relates to addressing risk-return profiles to catalyse private sector investment and affirms the importance of scalability. In addition, it recognizes that development financiers should not compromise on their standards, including international standards e.g. in the design, terms and execution of interventions. Lastly, the fifth principle on monitoring blended finance for results and transparency recognizes, *inter alia*, the need for agreeing upon a common set of performance indicators in transactions. The OECD is not the only international organization that has developed recommendations for blended finance investments. Indeed, also the World Bank Group has come up with its own recommendations on blended finance, which will be examined below.

3.2.2 The World Bank soft law

Strictly speaking, the blended finance recommendations have been given by the International Finance Corporation (IFC), which is an organ of the World Bank Group. The World Bank's operational policies are 'internal' in character, i.e. they are directed to the institutional organs that are part of the World Bank Group.[135] Such institutional organs encompass, for example, the IFC. Some of the five elements of the OECD DAC's blended finance principles are also present in the IFC's principles guiding blended finance operations. The five principles of the IFC's blended finance recommendations are: i) additionality and rationale for blended concessional finance; ii) crowding in minimum concessionality; iii) commercial sustainability; iv) reinforcing market failures and v) high standards.[136] It is notable that these principles have been incorporated into the Enhanced Blended Concessional Finance Principles for DFI Private Sector Operations, which have been approved by the heads of MDBs and the management of the European Development Finance Institutions (EDFI).

The first principle of the IFC Blended Finance Principles makes a reference to a contribution that is beyond what is available and otherwise absent from the market. The second principle means that development finance seeks to contribute to catalysing market development and mobilization of private finance while keeping the portion of

[135] *Friedrich* 2013, p. 51.
[136] IFC Principles on Blended Finance. These principles have also been referred to in Finland-IFC Blended Finance for Climate Program.

concessional finance as small as possible. The third principle on commercial sustainability states that the achieved impacts should be sustainable and contribute towards commercial viability. The fourth principle states that blended finance should address market failures, minimize the risks of market distortions and crowding out private finance. Lastly, the fifth principle means that development finance should adhere to high standards i.e. in the areas of environmental impact, corporate governance, integrity, transparency and disclosure.[137] These five principles have gotten, so to say, meat over their bones in the Annex I of the previously mentioned Enhanced Principles on Blended Finance.[138]

These five principles in part anchor the principles put forward by the OECD DAC but the OECD's and the IFC's blended finance principles also have some differences. Both the OECD and the IFC principles mention the rationale for blended finance and the additionality of blended finance as principles, while both strive for the effectivity of blended finance. The main differences between the OECD's and the IFC's principles is that the OECD mentions monitoring of blended finance and tailoring blended finance to local contexts whereas the IFC's principles do not mention this. In addition, the OECD's principles recognize the need for effective partnering to achieve desired outcomes. The IFC's principles in their turn make references to commercial sustainability, high standards and reinforcing market failures that lack from the OECD's principles.

Whereas the blended finance soft law put forward by the OECD and the IFC are not the only instruments addressing blended finance or mentioning it, I condemn them to be the only instruments put forward by international organizations that have relevance for blended finance operations. This assertion is rooted to the fact that other international instruments touching upon blended finance, such as the Addis Ababa Action Agenda, do not have direct implications for blended finance operations because they are rather addressed to the head of states, not blended finance participants. I acknowledge that blended finance principles put forward by the OECD and the IFC can be incorporated and integrated at other levels, as previously mentioned, but it goes beyond the scope of my research to establish how blended finance is implemented in every country. I only want to note that such a possibility remains open.

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[137] IFC Principles on Blended Finance.
[138] *DFI Working Group* 2019, p. 25–26.

Now I have established the relevant soft law on blended finance, it must be examined whether these soft law instruments can actually be expected to be applied by development financiers in the area where climate finance mobilization and blended finance govern the same substance matter. From *de jure* perspective, blended finance soft law should be applied by development financiers when mobilizing private finance for low-emission and climate-resilient development. However, making conclusions based on *de jure* perspective alone would be fundamentally flawed, if the application of blended finance soft law in real life, *de facto* perspective, is not examined. I define this to be an issue of legitimacy and application restrictions, i.e. conflicts. Because my research focuses on development financiers, DFIs and MDBs, legitimacy and possible conflicts are considered from the point of view of these entities. First, I will explain why the application of blended finance soft law matters for PE/VC investors after which I will be clarifying the application of blended finance soft law at a theoretical and practical level.

3.3 Application of blended finance soft law

3.3.1 Does soft law on blended finance matter for PE/VC investors?

In the beginning of my research I asserted that soft law on blended finance matters for PE/VC investors. The application of blended finance soft law in blended finance investments matters if it adds value to these operations. A critical notion is that blended finance instruments only add value if they bring something valuable to operations where it otherwise would be missing. Blended finance soft law of the OECD and the IFC capture notions which relate to operational issues PE/VC investors need to consider in all their impact investments. The issues impact investors need to consider in their investments include, but are not limited to, desired impact, growth and scalability. Whereas private equity investors can consider these issues seemingly independently in their own investments, the issue is different in blended finance operations because in these operations, PE/VC investors need to consider also the mandates of DFIs/MDBs and comply e.g. with higher environmental and social standards.[139]

But do the blended finance principles of the OECD and the IFC take into account these concerns, i.e. does the application of these principles matter for PE/VC investors? I assert that to a certain extent they do, for which reason blended finance soft law matters for PE/VC investors. As noted in *Convergence's* study, most successful blended finance

[139] The OECD and the IFC Blended Finance Principles.

operations have e.g. identified development impact objectives, outputs and outcomes.[140] These are issues touched upon also by the OECD's and the IFC's blended finance recommendations. For example, the OECD's principles highlight the importance of respecting blended finance participants' different mandates. This entails a notion that blended finance participants, development financiers and private equity investors, must consider the other participant's objectives, which can relate to e.g. outputs. The IFC's blended finance principles also highlight commercial sustainability, stating that investments should contribute towards commercial viability.

Moreover, of the OECD's principles I would underline elements of principles which affirm the importance and scalability and respecting development financiers' and PE/VC investors' different mandates and agreeing upon common performance indicators. In a similar fashion, of the IFC's principles I would underline the importance of commercial sustainability and high standards.[141] I highlight particularly the element of commercial viability because some other elements are considered by development financiers in any case, i.e. not depending on the application of soft law.[142]

Without considering issues related to private investors' perspectives and commercial sustainability present in blended finance principles of the OECD and the IFC, it would be hard, if not impossible, to make blended finance investments attractive for PE/VC investors. Thus, having some guarantees that development financiers indeed consider these issues in blended finance operations through adhering to soft law on blended finance is valuable for PE/VC investors participating in blended finance. Moreover, if these issues would not be considered in ways represented by blended finance soft law, attracting capital from PE/VC investors would be little more than a desperate attempt. However, considering that blended finance soft law would only have positive implications for PE investors, would give a too rosy picture of these instruments. Also, some elements of these principles are neutral from the viewpoint of PE/VC investors. Blended finance operations, whether utilizing soft law on blended finance or not, should in any case be

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[140] *Convergence* 2018, p. 17.

[141] In the Enhanced Blended Finance Principles 'commercial sustainability' means high scrutiny of commercial viability. In these principles the 'high standards' has been understood as adhering to international best practice industry standards or guidance, including ESG standards (See, *DFI Working Group* 2019, p. 25).

[142] A prominent example of this is, for example, sustainability. Multilateral development financiers have already addressed climate change concerns long before the emergence of the concept of 'blended finance'.

built around attracting private finance. Without this objective in mind, blended finance could attract very little, if any, private finance.

Because blended finance soft law only adds value to blended finance operations for PE/VC investors if the principles embodied in blended finance soft law are not otherwise considered, it must be noted that some principles are considered by development financiers anyway, independently from blended finance instruments. For example, some concerns regarding commercial viability are considered by development financiers such as DFIs and MDBs due to their impact measurement objectives. Traditionally important measurement of development has been job creation[143] with some variance *in casu*. Thus, it seems that issues of scalability and growth are in any case considered at least to some extent. Moreover, considering that bilateral DFIs have dual mandates, it seems feasible to suggest that also concerns related to e.g. commercial sustainability are in any case considered at least by bilateral DFIs. Not all principles can be expected to be respected by development financiers on the basis of other legal instruments, and such principles relate to, for example, respecting PE/VC investors' mandates. This stems alone from the fact that there is no need to consider private investors' aspirations when they are not present in the same operations with development financiers.

Also, certain risk mitigation/transfer instruments such as insurances from multilateral development financiers have been around for several decades so asserting that these instruments are dependent on the concept of blended finance or the application of blended finance soft law would be deceiving. Whereas certain elements of the OECD's and the IFC's principles may be valuable for private investors, thinking that all principles would provide value for private investors would be pretentious, as some principles have only importance for development financiers.[144] I acknowledge that the relevance of blended finance soft law can vary between blended finance instruments because this soft law highlights notions that are particularly valuable when development financiers and PE/VC investors invest in the same portfolio companies. This is because both development financiers and PE/VC investors seek to influence the management of portfolio companies

[143] *Massa* 2013, p. 2 notes that job creation has been one of the top priorities for development finance institutions such as the International Finance Corporation, African Development Bank and European Investment Bank.

[144] Such principles include, *inter alia*, the rationale for the use of blended finance, i.e. attracting private finance to investments that otherwise would not attract it (this notion is present in both the OECD's and the IFC's Blended Finance Principles). Moreover, principles which seek to attract private finance in increasing amounts while trying to decrease the amounts of concessional finance cannot be seen as particularly interesting from the viewpoint of private investors.

particularly through board management – having board members pulling to different directions regarding desired performance, impact and growth would make it very hard to manage a portfolio company and conduct business.

As now it has been asserted that the application of these principles does matter for PE/VC investors at least to a certain extent, it must be considered whether development financiers actually consider blended finance soft law when mobilizing finance for low-emission and climate-resilient development.

3.3.2 Legitimacy of blended finance soft law

The OECD and the IFC Principles of Blended Finance are strictly speaking addressed at providers of concessional finance (DFIs, MDBs) and not private sector investors. The previously introduced soft law on blended finance and the Paris Agreement's climate finance mobilization provision both partly govern the same substance matter, low-emission and climate-resilient development. This is the answer to my first research question. My second question related to the application of blended finance soft law by development financiers. Obviously, it needs to be considered when mobilizing finance for low-emission and climate-resilient development. However, a separate question, and my second research question is whether blended finance soft law can *actually* be expected to be applied by development financiers (DFIs, MDBs) in the area where climate finance mobilization and blended finance govern the same substance matter? Which factors can result in not considering these instruments? An important component of an answer to this question is legitimacy.[145] In this context I use the term 'legitimacy' to describe legitimacy among development financiers, DFIs and MDBs. In this regard, a difference must be made between the IFC's soft law on one hand, and the OECD's soft law on the other hand.

As blended finance and soft law surrounding it are novelties, academic research on the influence of blended finance soft law on blended finance operations is not only limited, it is non-existent. Thus, assumptions about legitimacy are limited to the influence of other soft law instruments adopted by the OECD and the World Bank. As *Jürgen* notes, the legitimacy of soft law instruments can vary in terms of degree of influence and from one instrument to another.[146] For this reason it cannot be expected that soft law on blended

[145] This choice is based on the notion that legitimacy is an important component of enhancing compliance with soft law instruments. See, *Jürgen* 2013, p. 378.
[146] *Jürgen* 2013, p. 379.

finance is followed exactly to similar extent as other soft law instruments put forward by the OECD and the IFC. In the past, the World Bank's soft law has been relatively legitimate, despite a 'mission creep' outside its relatively narrow development mandate.[147] However, it must be acknowledged that despite the World Bank's soft law has been relatively legitimate in the past, this doesn't translate as exactly similar legitimacy of the IFC's soft law particularly when the entities amongst whom legitimacy is measured are different. Because the IFC's principles on blended finance have been accepted by the heads of MDBs and the management of EDFI, from this point of view it seems feasible to assert that the IFC's blended finance soft law enjoys a great degree of legitimacy among development financiers, both DFIs and MDBs. Moreover, the IFC's blended finance principles can be expected to carry more weight in operations where the IFC engages in blended finance operations with national bilateral DFIs.[148]

Traditionally, the OECD's non-binding guidelines have enjoyed great legitimacy among those for whom they are addressed at. The OECD's blended finance principles can be expected to be more likely followed by the OECD DAC member countries, such as Finland compared to countries which are not OECD DAC member states. In addition, it must be noted that the OECD's non-binding instruments have another dimension: the organization's recommendations have generally been successful in terms of influencing the content of national legal systems and policies.[149] Indeed, *Bayne* notes that the soft law activities undertaken by the organization have a profound influence on the making of hard law outside the organization.[150] However, this remark should be approached with caution namely because blended finance soft law, being addressed at development financiers and not states themselves, will not necessarily take harder forms in the form of legislation. This is because the conduct of development financiers is essentially modified through softer standards and policies.

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[147] *Jürgen* 2013, p. 52. In his research, Jürgen examines soft law in the field of international environmental law also examining the role of the World Bank in this field. Jürgen points out to a narrow development mandate of the World Bank and to the fact that the Bank has gotten more active in terms of addressing also environmental issues. Whereas this 'mission creep' raises issues of legitimacy, Jürgen nevertheless considers this to be justified, referring to subsequent state practice as well as a modern interpretation of development objectives of the World Bank which cannot be considered in isolation from the concept 'sustainable development'.
[148] One example of such blending is the Finland-IFC Program on Blended Finance. For more, see *Finnish Ministry for Foreign Affairs* 2018.
[149] *Jürgen* 2013, p. 42.
[150] *Bayne* 2016, p. 350.

Often DFIs follow these non-binding recommendations and sometimes even make explicit references[151] to them. In such cases, these non-binding recommendations can be expected to carry more weight. DFIs may be bound to follow blended finance soft law such as those of the IFC and the OECD because these soft law guidelines might have been incorporated into other policies DFIs are required to follow.[152] Moreover, approved by the heads of MDBs and European Development Finance Institutions (EDFI) management,[153] the IFC principles can be expected to have a heavy influence on the way blended finance operations are carried out in practice. Because the OECD's principles have not yet been accepted in a similar fashion, they have a little more limited importance, although they may shape future policies as has occurred in the past with the OECD's soft law.

I conclude that from a legitimacy point of view, the OECD's and the IFC's blended finance principles seem to enjoy legitimacy among development financiers despite the degree of legitimacy might vary between the IFC's and the OECD's principles. It must also be noted that due to the soft nature of these principles, development financiers do not have to heed them in all situations. This issue brings us to possible situations where blended finance soft law could be disregarded, i.e. conflicts. While reading the next section it must be borne in mind that tensions would not render an entire soft law instrument useless, but rather the conflicting part of it should be disregarded.

3.3.3 Blended finance soft law in conflicts

Because blended finance soft law might be helpful in offering guarantees for PE/VC investors that some concerns of the operational side are actually considered in blended finance operations, it must be established whether this soft law should be disregarded in specific situations, and if so, in which ones. Besides legitimacy concerns, disregarding soft law is essentially dependent upon other applicable legal instruments and is related to a topic loved by international academics, conflicts[154] between legal instruments. Whereas

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[151] For example, in the Finland-IFC Blended Finance for Climate Program, Finnfund follows IFC Principles of Blended Finance.

[152] For example, the European Development Finance Institutions have incorporated Blended Finance Principles into their own, enhanced principles that need to be respected by European DFIs.

[153] *DFI Working Group* 2019, p. 4.

[154] *Mehling* 2013, p. 20–22 classifies conflicts between *legal instruments* into four classes: i) conflicts of objectives; ii) divergent regulatory approaches; iii) constitutional doctrines and fundamental rights; and iv) different regulatory planes. *Van Asselt* 2014 53–54 in his turn examines situations where interactions between *regimes* could lead to conflicts and proposed following classes: i) incombatible norms; ii) diverging objectives; iii) the use of different principles and concepts; iv) opposing economic incentives; and v) 'negative' diffusion and learning.

considering tensions between soft law instruments and binding legal instruments such as treaties and their implementation measures might seem artificial, if not even silly, it must be recalled that even soft law instruments might get a 'harder' status later.[155] This is no oddity in the field of global environmental governance, where non-binding instruments might get a hard law status later.[156] Perhaps more importantly, development financiers can be bound to follow blended finance soft law based on other grounds, such as belonging to associations which require compliance with such standards.[157] Keeping an eye on such situations, understanding possible tensions makes up a feasible idea. However, in their current form, if in conflict with other, binding legal instruments, blended finance principles should be disregarded due to treaty interpretation rules. This follows from the maxim *lex superior derogat lex inferiori*, a hierarchically superior norm takes priority over the weaker norm.[158]

However, it needs to be established whether blended finance soft law could lead to any conflicts. To start, from a theoretical perspective two different situations must be separated: i) tensions between blended finance soft law and the Paris Agreement and its implementation measures; and ii) tensions between blended finance soft law and other legal obligations binding upon development financiers (DFIs, MDBs). The reason why in the first scenario also the implementation measures of the Paris Agreement must be considered is because the Paris Agreement is not self-executing in every country that has ratified it. Regarding the first scenario it must be acknowledged that this scenario is not always even possible when development financiers are mobilizing climate finance. This is because this study makes no conclusions regarding the application of the Paris Agreement by development financiers. My study only notes that states can fulfil their climate finance mobilization pledges made under the Paris Agreement through DFIs and MDBs, which means that in these scenarios conflicts between 'climate finance mobilization' and 'blended finance' could theoretically be possible. Tensions between

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[155] *Van Asselt* 2014, p. 50–51 considers this kind of hardening of soft law as one way how soft law and hard law interact. In his research van Asselt provides for two additional ways how soft law interacts with hard law, namely, soft law softening hard law obligations and soft law complementing hard law obligations. I have left out these two ways of interaction outside the scope of my research because blended finance is yet to take 'harder' forms.

[156] See, for example, *Vihma* 2013, p. 155. Vihma makes a reference to the climate regime in addition to the biodiversity regime and the ozone regime.

[157] The Association of European Development Finance Institutions is a prominent example of this.

[158] *Van Asselt* 2014, p. 68.

the Paris Agreement and blended finance soft law cannot naturally occur in situations where development financiers do not have to follow the Paris Agreement.

As noted in chapter three, the OECD's principles are: i) anchor blended finance use to a development rationale; ii) design blended finance to increase the mobilization of commercial finance; iii) tailor blended finance to local context; iv) focus on effective partnering for blended finance; and v) monitor blended finance for transparency and results. Of the OECD's recommendations particularly principles four and five seem the most relevant for PE/VC investors engaging in blended finance. The IFCs principles are: i) additionality and rationale for blended concessional finance; ii) crowding in minimum concessionality; iii) commercial sustainability; iv) reinforcing market failures and v) high standards. Of the IFC's principles I would highlight principles three and five. Below I will propose which elements of the OECD's and the IFC's principles could lead to conflicts between these principles and other legal instruments binding upon development financiers, DFIs and MDBs. Despite the OECD's and the IFC's blended finance recommendations are rather flexible instruments due to their nature as principles, this does not mean that they could not be part of conflicts due to this feature alone.[159]

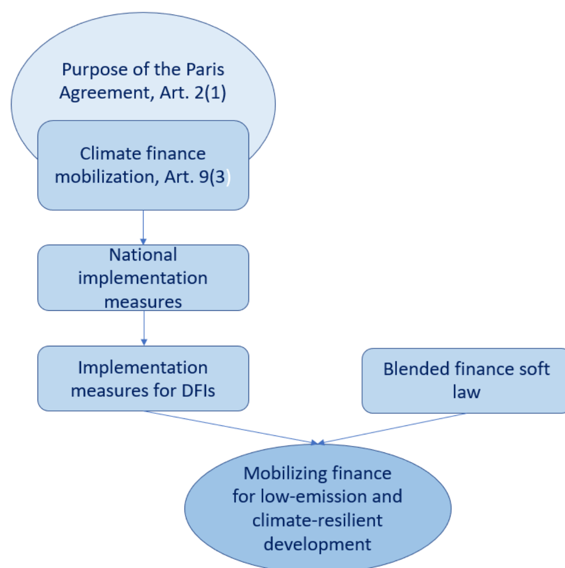
3.3.4 Blended finance soft law and the Paris Agreement

Regarding tensions between blended finance soft law and the Paris Agreement and its implementation measures the following can be noted. The terms 'blended finance' and 'climate finance mobilization' partly govern the same substance matter, low-emission and climate-resilient development. Because the Paris Agreement follows a bottom-up approach, it leaves flexibility regarding the implementation of its climate finance provision.[160] This translates into diverse national implementation measures such as DFI

[159] *Mehling* 2013, p. 21 illustrates possible conflicts that could stem from the use of flexible instruments using the overlap of emission trading and voluntary declarations of climate protection done by private entities as an example.

[160] This is emphasized also by the broad wording of Article 9(3) of the Paris Agreement. This article makes a vague reference to a wide variety of sources, instruments, and channels from which climate finance should be mobilized. The fact that the Paris Agreement has provisions taking spots at different places in soft law–hard law spectrum means that some provisions leave more room for flexibility in terms of incorporation. Climate finance mobilization is an example of such a provision. For example, Finland addresses climate change through various initiatives, UN funds, partnerships and Finnfund. Even regarding its mobilization commitments, Finland does not limit itself to only one instrument. This also reflects the way Article 9(3) of the Paris Agreement is phrased.

internal policies which accommodate concerns of the Paris Agreement.[161] The following graph illustrates the situation.



As long as blended finance soft law is consistent with the Paris Agreement's key objective of keeping the rise of global temperature well under 2 degrees Celsius, any tensions could not arise. It seems that from the OECD's principles only the principles regarding increasing mobilization levels (principle no. two) and effective partnering (principle no. four) could arise any tensions. Of the IFC's principles commercial sustainability (principle no. three) and reinforcing market failures (principle no. four) seem to be principles that could lead to tensions. Of the OECD's principles I considered principle no. four and of the IFC's principles no. three the most relevant from the viewpoint of PE/VC investors, because both these principles highlight considering PE/VC investors' perspective and commercial sustainability.

However, it remains only a theoretical possibility that these elements of blended finance soft law would lead to tensions between them and the Paris Agreement. I conclude this to be the case because tensions could arise only if blended finance instruments would be in conflict with the Paris Agreement's key objectives, which are rooted in sustainability as previously acknowledged. Because blended finance already by definition strives towards sustainability and because development financiers are mandated to consider sustainable

[161] For example, in Finland the Paris Agreement has been integrated into the Finnish development policy and the annually updated memorandum on corporate governance of Finnfund, which provides further guidance for the operations.

development issues in their operations, I do not see any tensions arising between blended finance soft law and the Paris Agreement, and its national implementation measures.

3.3.5 Blended finance soft law and other legal instruments

Regarding the second theoretical scenario, conflicts between blended finance soft law and other legal instruments binding upon development financiers (DFIs and MDBs), I note the following. In the context of bilateral DFIs these other legal instruments could include e.g. treaty obligations that states fulfil through their DFIs but they could also include weaker commitments which might stem from the applicable national legislation and internal policies of DFIs.[162] Bilateral DFIs could be bound by e.g. development cooperation objectives such as poverty reduction in their investments as well as sustainability standards of international entities such as the IFC. The same goes for multilateral DFIs and MDBs with a difference that MDBs do not necessarily incorporate any specific countries' climate finance mobilization pledges but rather consider sustainability issues *proprio motu*.

Whereas giving a perfect overview of all policies and regulations needed to be considered by development financiers would be a mission impossible, an assumption about the nature of these rules can be made. Because DFIs and MDBs are driven by dual mandates or purely development mandates, the applicable laws they follow are primarily development-bound or at least do not undermine sustainability. However, it must be acknowledged that bilateral DFIs can be sensitive to government policies. For this reason, tensions between blended finance soft law and other instruments needed to be considered by bilateral DFIs remain possible. However, it seems very unlikely that any tensions between blended finance instruments and DFI/MDB commitments would exist due to the flexible nature of blended finance principles and the development-geared nature of development financiers' other legal obligations. Moreover, considering that the most relevant blended finance principles from the viewpoint of PE/VC investors relate to commercial viability and scalability, it is useful to recall that growth is already in the minds of most development financiers due to their impact measurement objectives such as job creation.

[162] For example, the Finnish DFI Finnfund is regulated by national law. In addition, it, similar to other DFIs, follows various other internal policies as well as non-binding recommendations set by international organizations and agencies such as the OECD and the IFC.

In the absence of any conflicting norms, I conclude that there does not seem to be any tensions that could lead to disregarding blended finance soft law when private finance is mobilized by development financiers (DFIs, MDBs) for low-emission and climate-resilient development investments. Thus, the fact whether blended finance soft law is applied or not relates only to the legitimacy of such instruments among development financiers. Because the blended finance soft law from the IFC has been already acknowledged and accepted by the highest level of governance of development financiers, it seems feasible to suggest that the lack of legitimacy does not impede the application of at least the IFC soft law. The OECD's soft law can be expected to have influence too, particularly in guiding formatting other legal instruments covering the field of blended finance. Because the soft law instruments on blended finance put forward by the OECD and the IFC are principles, which by definition guarantee a degree of flexibility, it seems that possible tensions that could theoretically arise between blended finance soft law and other legal instruments could be accommodated without the need to disregard blended finance soft law.

3.4 Chapter conclusions

The Paris Agreement has been noted for recognizing the role of climate finance in meeting its key objectives. The Agreement's Article 9(3) emphasises the role of public funds in climate finance mobilization but leaves open the channels, instruments and sources from which climate finance should be mobilized. However, it is not only the Paris Agreement which guides states' climate finance mobilization efforts. Outside the United Nations climate law regime several soft law instruments addressing private finance mobilization have emerged, but these instruments use the term 'blended finance'. The terms 'climate finance mobilization' and 'blended finance' essentially embody the same idea with a difference that blended finance focuses on a broader range of actions contributing towards the Sustainable Development Goals whereas climate finance mobilization focuses only on climate change adaptation and mitigation activities, namely, low-emission and climate-resilient development. Thus, climate finance mobilization appears to be a narrower part of blended finance. In both cases, development financiers seek to mobilize private finance to developing countries although blended finance does not underline the role of public finance in mobilizing private finance. Blended finance and climate finance mobilization partly govern the same substance matter, low-emission

and climate-resilient development. This answers my first research question regarding the alignment of the terms ‘climate finance mobilization’ and ‘blended finance’.

My second research question was tied to my first question and focuses on the application of blended finance soft law in the aligned substance matter area by development financiers (DFIs and MDBs). My second research question examined whether blended finance soft law can actually be expected to be applied by development financiers in this aligned substance matter area. Obviously, this soft law should be applied by development financiers when mobilizing private finance into developing countries for low-emission and climate-resilient development projects. This is *de jure* perspective to the application of blended finance soft law. I want to highlight that this stems from the broader concept of blended finance and is not dependent upon the application of the Paris Agreement by development financiers. Low-emission and climate-resilient investments can cover e.g. renewable energy projects and projects that help local communities to adapt to the adverse effects of climate change.

Because considering only *de jure* perspective would give a flawed picture of the application of blended finance soft law by development financiers, I also considered factors that might hinder the application of this soft law. Thus, I considered *de facto* perspective of the application of soft law on blended finance considering this to be the issue of legitimacy and lack of situations where blended finance soft law should be disregarded. I considered these issues from the perspective of development financiers (DFIs and MDBs). I noted that the IFC’s blended finance principles have already been acknowledged by the management of EDFI and the heads of MDBs. Whereas the OECD’s blended finance principles have not yet reached a similar status, in the past the OECD has been successful in shaping national policies through its soft law instruments. Therefore, it seems feasible to suggest that the soft law instruments on blended finance enjoy a great degree of legitimacy among development financiers while acknowledging that the seeming legitimacy can be sensitive to e.g. the board management in DFIs and MDBs. The issue of disregarding soft law in blended finance operations thus seems to be primarily an issue of conflicts between blended finance soft law and other legal instruments binding upon development financiers.

I briefly assessed two situations where conflicts involving blended finance soft law could arise when private finance is mobilized for low-emission and climate-resilient investments by development financiers. The first situation concerned tensions between

blended finance soft law and the Paris Agreement, which requires climate finance mobilization. I did not see possible causes for conflicts in this relation because the Paris Agreement and blended finance soft law principles both are deeply rooted in sustainable development. I note that this scenario was only relevant for cases where development financiers need to consider the Paris Agreement and its implementation measures.

The second relation related to possible conflicts between blended finance soft law and other legal instruments followed by development financiers (DFIs and MDBs). Whereas these instruments are diverse and could theoretically leave more room for conflicts, it is unlikely that at least partly development-mandated DFIs and MDBs would need to follow other regulations that undermine sustainability. Thus, it seems safe to say that there are no situations in which blended finance soft law should be disregarded due to conflicts. Thus, blended finance soft law can be expected to be applied when development financiers (DFIs, MDBs) mobilize private finance for low-emission and climate-resilient investments. This is the answer to my second research question, i.e. when can blended finance soft law be expected to be applied by development financiers in the aligned area of 'climate finance mobilization' and 'blended finance'.

The assertation that there seems to be no situations where blended finance soft law should be disregarded has practical implications for PE/VC investors. I assert the principles contained in the OECD's and the IFC's blended finance principles matter because they bring up issues that PE/VC impact investors need to consider in all their investments, such as scalability, performance standards, and commercial viability. Some of these issues are not otherwise considered by development financiers, an example of such an issue being respecting the mandates of PE/VC investors. It shall be borne in mind that some of blended finance principles are considerations that development financiers need to take into account whether they are engaging in blending or not, an example of this being sustainability. I also acknowledge that the relevance of blended finance soft law might vary between blended finance instruments because the alignment of objectives matters particularly in the board management of portfolio companies. In situations where development financiers participate in blended finance without being shareholders of portfolio companies, blended finance soft law can have less importance.

If issues brought up by blended finance soft law related to consideration of PE/VC investors' point of view are not considered in blended finance operations, it could possibly be detrimental from the viewpoint of profitability. Certainly, neglecting notions

contained in blended finance soft law would make it hard to attract private capital to investments in developing countries. Thus, the application of blended finance principles matters for both private investors and blended finance, at least to a certain extent. Simultaneously, it must be borne in mind that these principles should not be given too much weight, as they cannot be expected to address macro risks faced by PE/VC investors in developing countries such as low-income countries.

Now I have established the importance and limits of soft law on blended finance, it is time to examine which macro risks are commonly associated with investing in developing countries such as low-income countries. After providing an overview of different risks, I proceed to examine different blended finance instruments available for equity investors and how these instruments address macro risks commonly associated with investing in developing countries.

4. BLENDED FINANCE AND MACRO RISKS

4.1 Risks associated with investments in developing countries

4.1.1 Macro risks

The purpose of my research is not to provide a complete and perfect overview of all risks associated with investing in developing countries such as low-income countries. Nor, the purpose of my research is to provide a complete overview of risk mitigation/transfer instruments available for PE/VC investors who invest in these countries. Rather, the purpose of this research and my third research question is to provide an overview of *blended finance* instruments available for equity investors and establish how these instruments address risks typically associated with investing in developing countries. Whereas the risks explained below generally exist in developing countries, I am writing particularly from the perspective of low-income countries. It must be noted that the scope of risks varies from a country to country, countries such as low-income countries having different characteristics than other developing countries. For example, the less developed countries generally have weaker financial markets, and many have undergone conflicts during the recent years.

Risks, of course, are inherent for any investment whether it is in a developing or a developed country, but some risks are more prevalent in developing countries than in other societies. In this chapter, I have divided different types of risk into risk groups, a choice which has been guided by aspirations of a systematic approach. I note that other categorizations have been employed e.g. by the OECD.[163] In the literature different risk groups e.g. political risks can cover different risks,[164] so in my analysis I am paying attention to the risks covered, and not only to the name of the risk group.

The emphasis of my research is on the ability of blended finance instruments to address *macro risks* hindering private investment in developing countries such as low-income countries. Macro risks cover risks that can affect all businesses operating within a nation, and examples of these risks are, *inter alia*, political risks, regulatory risks, or events outside of control of the ruling government such as currency fluctuations. It must be

[163] For example, the *OECD* 2018, p. 79–80 uses two broad risk classes: macroeconomic and business risks, and regulatory and political risks.

[164] *Surminski* 2013, p. 245 makes a reference to the term ‘political risk’, which in the insurance industry covers e.g. currency convertibility, expropriations, political violence, breaches of contract and not honouring financial obligations. For my research, I have further divided these risks into different sub-groups under macro risks for the sake of systematic approach.

acknowledged that the factors explaining low flows of private capital into poorer developing countries are not necessarily related to climate-friendly investments only, as many of the barriers apply also to mainstream finance and development finance as well.[165] This underlines the importance of examining primarily macro risks.

4.1.2 Macro risks in my research

Despite much praise and talk surrounding blended finance, capital has not been flowing at sufficient rates and several reasons have attempted to explain this. Although investments in developing countries may possess positive projected returns, associated risks and uncertainty may deter commercial investors from investing in these projects.[166] In the case of private investors, investment decisions are strongly driven by the expected risk-return ratio and projects falling short of these exceptions do not likely attract enough investments. Blended finance aims to address exactly risk-return ratio, making investments in certain developing countries such as low-income countries attractive also to private sector investors. For the sake of clarity, I group macro risks into three risk groups: regulatory risks, political/institutional risks, and financial (macroeconomic) risks. All other risks which could arise in the connection with foreign investment I classify as project risks (commercial risks). This approach is similar to *Yescombe's* classification which divides risks into political/regulatory risks, financial risks (macroeconomic risks) and project risks (commercial risks).[167] This choice also reflects risk mitigation/transfer instruments and their coverage.

Regulatory risks cover e.g. regulatory uncertainty, tax barriers, and inconsistent tariffs.[168] In the heart of regulatory risk is the host country changing its regulations in a way which negatively influences the value of the investment. In the case of low-carbon and climate-resilient investments regulatory risks could include, for example, a denial of a license to operate. *Political/institutional risks* cover issues related to political instability, corruption, and lack of strong and transparent legal systems[169]. In fragile states political risks could entail civil disturbances and wars that destruct a business. Weak institutions make it more

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[165] *Halonen et al.* 2017, p. 8–9.
[166] *OECD* 2018, p. 22.
[167] *Yescombe* 2014, p. 197. Yescombe employs three categories of risk: project risks (or commercial risks), macroeconomic (or financial risks) and political/regulatory risks. My risk classification is different from Yescombe's in that sense I classify political, regulatory and macroeconomic risks further under title 'macro risk'.
[168] See, for example: *World Economic Forum – OECD* 2015, p. 10. World Economic Forum – OECD reference concerns the risks whereas the grouping of the risks into four groups is my own choice.
[169] See, for example: *World Economic Forum – OECD* 2015, p. 10.

difficult, if not impossible, for private equity investors to enforce their rights. Considering that private equity heavily relies on contract-based rights and obligations, this is a notable risk for PE/VC investors. A significant risk is also corruption: according to Transparency International, many sub-Saharan countries ranked very high in terms of perceived corruption.[170] Sub-Saharan countries are almost entirely low-income and lower-middle income countries. Research also implies that rule of law, political stability, voice and accountability, and property rights positively affect investor confidence despite this relationship is also controlled by issues such as real GDP growth, inflation, interest rate spread, and country credit ratings.[171]

This brings us to *financial risks* (also known as macroeconomic risks) which being related to any investments, are nevertheless perceived to be even higher in developing countries: these risks cover risks such as foreign currency risks and countries having poor credit ratings.[172] As currencies might be highly volatile in developing countries,[173] foreign investors often prefer to make deals in more stable currencies such as USD or euros and this strategy has also been preferred by some DFIs. Volatile currencies can at worst make promising deals empty, and private equity investors as a rule mention currency risk as a key risk when investing in Africa,[174] a home to many low-income countries. Emerging economies have seen several currency and fully-fledged financial crises in the past.[175] Under-developed financial markets, including equity markets, may also prove difficult and bring uncertainty whether the investor can get their money back.[176] I understand this to relate to the phase where PE investors are trying to leave the company but due to weak financial markets initial public offering (IPO) is not feasible. Among PE investors, an initial public offering has been deemed to be the most sought-after exit strategy because of its profitability.[177] Thus, financial (macroeconomic) conditions might directly affect the profitability of the investment due to lack of feasible exit alternatives.

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[170] *Transparency International* 2018. A study by Transparency International also made links between the level of democracy and perceived corruption. Perhaps unsurprisingly, autocratic countries ranked the highest in terms of perceived corruption.
[171] *Ayemang et al.* 2017, p. 911.
[172] See, for example, *OECD* 2018, p. 25. The OECD notes that albeit financial risks are associated with any investments, they are often exacerbated in developing countries which can stem from the nature of the investment or the host country itself.
[173] A prominent example of currency crisis is the hyperinflation in Zimbabwe which began in 2007.
[174] *Private Equity International*.
[175] *Mishkin* 2016, p. 338, 343.
[176] *World Economic Forum – OECD* 2015, p. 10.
[177] *Johan – Zhang* 2016, p. 136.

It has also been noted that financial markets in emerging economies generally suffer from lack of orderly secondary market and higher price volatility among other factors.[178] Long-term capital in the form of equity has essentially been non-existent for small and medium-size enterprises in Africa.[179] Many LDCs are located in sub-Saharan Africa with less development financial markets[180]. When judged even by measures applicable to low-income countries, many African countries have undeveloped financial markets.[181] This highlights the necessity of addressing particularly financial risks in low-income countries such as the LDCs.

In the literature macroeconomic risks have been explained as risks relating to external economic effects that are not directly related to the project.[182] Macroeconomic conditions in investment host countries have been among the make-or-break factors when it comes to the profitability of foreign direct investments, thus being among factors private investors should prioritize in mitigating risks associated with their investments. The International Finance Corporation has highlighted the importance of macroeconomic conditions stating that 60% of the institution's returns could be attributed to macroeconomic conditions.[183] Macroeconomic conditions have gone also past individual project factors highlighting the need to mitigate risks related to them.

These are examples of major macro risks associated with investing in developing countries such as low-income countries. Now, one might wonder why climate change is not mentioned. After all, in the beginning of my research I stated that particularly developing countries will be vulnerable for it and that climate risk is in the minds of several investors. This is true. Climate change is a phenomenon of macro level and has a very diverse set of implications. However, following Yescombe's risk classification it seems that climate change neatly falls to no category. Rather, climate change translates into macro risks classified as regulatory, political/institutional and financial (macroeconomic) risks. Climate change has implications for the regulatory sector, and it can fuel political instability. I acknowledge that climate change can amplify macroeconomic (financial) risks because it can negatively affect e.g. GDP growth and

[178] *Homaifar* 2004, p. 355.
[179] *Otchere et al.* 2017, p. 3. Otchere et al. explore constraints for accessing capital for African firms.
[180] *Toroyan – Anayiotos* 2009, p. 3.
[181] *Otchere et al.* 2017, p. 1.
[182] *Yescombe* 2014, p. 197. Yescombe notes that these risks can also be called financial risks. Yescombe employs three categories of risk: project risks (or commercial risks), macroeconomic (or financial risks) and political/regulatory risks.
[183] *Office of Evaluation and Oversight* 2017, p. 18.

monetary policy through, *inter alia*, physical damage and gradual warming.[184] Because climate change translates into macro risks while being able to amplify existing macro risks, also the consequences of climate change fall within the purview of my study.

Next, I will provide a brief overview of project risks, i.e. commercial risks. Whereas the focus of my study is on macro risks, I wanted to provide a brief overview of project risks because blended finance instruments can also mitigate these risks.

4.1.3 Project risks

Project risks refer to risks that can arise in the context of the investment but are not at a macro level. Project risks are also known as commercial risks and are inherent in the project itself.[185] These risks can be e.g. environmental risks, revenue risks or input supply risks.[186] Although project risks are not prone only to developing countries, they are as a rule different in developed and developing countries. These risks entail e.g. operational and contract risk, such risks that have direct implications for a company's cash flows, as well as costs required to make the transaction to happen.[187] An example of a notable project risk is environmental risk which in the context of low-emission and climate-resilient development could be e.g. a risk arising from environmental damage. Moreover, companies can be held accountable for climate-related damage,[188] for which reason project risks can be significant from the viewpoint of profitability. However, it must be noted that as my research focuses on blended finance and its instruments, environmental risks look very different for blended finance investments compared to investments that do not consider sustainable development issues to such a high extent.

Other project-level risks in low-income countries such as the LDCs result from the fact that in these countries investors often must be willing to commit extra time and resources in the preparatory phase and accept the risk that the business will not get from the ground.[189] Other problems relate to bankable project pipelines.[190] *World Economic Forum*

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[184] See, for example, *Batten – Sowerbutts – Tanaka* 2019 for a comprehensive analysis on the ways how climate change can affect macroeconomics.
[185] *Yescombe* 2014, p. 197.
[186] *Yescombe* 2014, p. 200.
[187] *UNCDF* 2018, p. 29.
[188] *Grantham Research Institute on Climate Change and the Environment – Centre for Climate Change Economics and Policy*, p. 7. It must be noted that litigations related to climate change have focused on major carbon emitters. Such litigations are unlikely to occur in cases of blended finance investments where venture capital is involved because these investments are of smaller size and because development financiers require adherence to high sustainability standards.
[189] *UNCDF* 2018, p. 35.
[190] See, for example, *McKinsey & Company* 2016a, p. 30.

– *OECD* list e.g. business model risks, technical feasibility, corporate governance risks, funding shortfalls, and liquidity risks as possible risks investors engaging in foreign direct investment (FDI) in emerging markets face.[191] Whereas I draw a line between macro risks and project risks, I want to note that blended finance instruments targeting macro risks can also indirectly mitigate project risks. Whereas I acknowledge this possibility, I will not make a comprehensive analysis regarding this alternative due to the focus of my research. Macro risks can also extent to project risks: for example, the lack of weak institutions can also translate into higher contract risks, and corruption into corporate governance risks.

The risks listed above, macro risks and project risks, are not something blended finance instruments cannot mitigate or transfer. Next, I will examine how blended finance instruments address macro risks while paying particular attention to political risk insurance schemes and their ability to tame macro risks such as regulatory risks, political/institutional risks, and financial (macroeconomic) risks.

4.2 Financial blended finance instruments

4.2.1 General

Blended finance seeks to address those risks that have hindered private sector investments into projects and companies in developing countries such as low-income countries, such as those risks listed in the previous sections. Various blended finance instruments have emerged: junior equity, insurances against political risks, technical assistance, and grants being examples of them.[192] In my research I will represent the first two instruments, with an emphasis on insurances provided by multilateral entities. Some of the instruments are provided by both bilateral and multilateral DFIs, whereas some are provided by multilateral entities, such as the Multilateral Investment Guarantee Agency. In addition to risk mitigation/transfer instruments offered by bilateral and multilateral development financiers, a scheme of instruments provided by private sector actors such as insurance companies exits. However, these schemes fall outside the scope of my research, for which reason I will not examine them in further detail.

[191] *World Economic Forum – OECD* 2015, p. 10.

[192] *OECD* 2018 p. 78 also mentions instruments such as credit lines, bonds and technical assistance. I have left these instruments outside my research, as I am focusing only on equity investments and not debt investments.

I group blended finance instruments into non-financial and financial ones, both of them being instruments that require private equity investors' investments to be environmentally sound if not meeting even higher environmental standards. When blended finance by definition is "*strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries*", the requirement of living up to high environmental standards set for private investors engaging in blended finance is hardly surprising. A reason behind environmental soundness in the case of development financiers (DFIs and MDBs) is partly tied to their mandates which might have some variance depending on the institution. The following list detailing blended finance instruments available for PE/VC investors aspires to be exhaustive, but it acknowledges the possibility that other blended finance instruments[193] aimed at private equity investors might be under development. Indeed, such development has been encouraged in certain sustainable development conferences.[194]

4.2.2 Junior equity

Junior equity[195] is one of blended finance instruments and it refers to equity that is subordinated to more senior equity meaning that in case of default, the holders of senior equity, such as PE/VC firms, will be paid first. In this sense, letting development financiers take a junior equity position in portfolio companies protects PE/VC firms from the first losses. Secondly, senior equity dividends are different from those of junior equity and are often also greater than those of common stock.[196] Other blended finance instruments can help private equity investors to hedge against risks associated with dividend payments.[197] Typically, it have been founders, employees and management that have taken junior equity – or common stock – positions in portfolio companies.[198] Several development actors have involved junior equity in their mobilization strategies, among these actors the Global Environmental Facility. Despite development financiers take junior equity positions in blended finance operations, senior equity positions reserved for private sector investors should not obliviously be considered "risk-free" in case of

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[193] *OECD* 2018.
[194] An example of such a conference is the one held in Addis Ababa in 2015. The outcome of the conference was the Addis Ababa Action Agenda, which encouraged states to develop new financial innovations in order to better achieve sustainable development objectives.
[195] Junior equity means "common stock" of a company. Senior equity in its turn refers to "preferred stock".
[196] *Global Environmental Facility*, p. 1.
[197] I will address the currency inconvertibility and transfer restriction scheme from the Multilateral Investment Guarantee Agency in section 4.3.5 of my research.
[198] *Talmor et al.* 2011, p. 373.

company liquidations, as debt is senior to equity.[199] This is sensible because private equity is in any case a much riskier investment than a debt investment.

Junior equity offers protection for investors against different risks, which might result in company liquidations. I do not consider junior equity to be the go-to option, at least not the only one, in countries where macroeconomic conditions are extremely weak, such as conflict-affected and fragile states in sub-Saharan Africa. These are mostly low-income countries. I am of this opinion because junior equity does not offer protection against macro risks. In other words, macro risks pertain regardless of the level of seniority of the investor's position in portfolio companies. Other blended finance instruments such as insurance schemes are better tailored to offer protection specifically against macro risks. I consider junior equity to best suited to situations where PE/VC investors and development financiers such as DFIs have aligned impact objectives and where risks are rather at project-level as opposed to macro level. Whereas this excludes quite a many low-income countries such as LDCs characterized by volatile currencies, political/institutional risk and regulatory risks, this does not imply that these risks could not be avoided when other blended finance instruments are employed alongside junior equity.

Junior equity positions bring up impact investing considerations related to desired impacts and profits. Development financiers can accept higher risks and lower financial returns in exchange for higher development (social, environmental and economic) impact.[200] As not all PE/VC investors are not willing to comprise financial returns at the expense of impacts,[201] it must be considered how both objectives can be simultaneously fulfilled. It is in junior equity positions where the aligned objectives of development financiers and PE/VC investors regarding job creation and technology development can result in outcomes that are on the list of PE/VC investors in any case. However, there are some variances regarding development objectives between development financiers, and the outcomes looked for may differ between DFIs and MDBs.[202] Variances exist also among PE/VC investors and the aligned objectives must be established case-by-case.

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[199] *Global Environmental Facility*, p. 1.

[200] *World Economic Forum – OECD* 2015, p. 15.

[201] *GIIN* 2017, p. 10 establishes that 48 per cent of investors surveyed primarily target risk-adjusted, market-rate returns whereas 31 per cent of investors surveyed targeted primarily below-market rate returns.

[202] Development finance institutions generally have dual-mandates, i.e. creating both financial results and impacts. Multilateral development banks on the other hand have development mandates (for instance, the

I conclude that impact measurement will be particularly relevant in the context of junior equity in the investment assessment phase, whereas it might not be that vital when using other blended finance instruments. This does not mean that ESG concerns are not critical when other blended finance instruments are employed because all blended finance instruments require meeting certain environmental and social standards. *The method of measuring* impact is important to establish in connection with junior equity to determine how well a PE/VC investor's impact objectives align with those of a development financier. As acknowledged in the previous chapter, blended finance soft law also refers to measuring impact and striving towards high standards.[203] Agreeing upon performance indicators among development financiers and PE/VC investors helps investors to determine whether junior equity would be an option worth considering. Agreeing upon performance indicators is also an idea supported by blended finance soft law from the OECD.

4.3 Insurance schemes

4.3.1 Political risk insurance

Another blended finance instrument at disposal of PE/VC investors is a political risk insurance provided by a multilateral entity. Whereas insurances are provided also by private companies, they are fundamentally different from those offered by multilateral entities as private companies base their insurances on risk premiums and making profit. Multilateral actors in turn have a development mandate and might be in a better position to provide insurances, alone due to the fact they also provide financial support for developing countries. Of these multilateral organizations, I am focusing on the Multilateral Investment Guarantee Agency (MIGA), which is an organ of the World Bank Group. I have chosen MIGA, as it is one of the few actors offering insurances also for equity investors. MIGA has also mobilized the most private finance into the Least Developed Countries within time period 2012–2017 annually whereas the International Finance Corporation ranked second of established institutions.[204] Some DFIs may also offer guarantees for private sector investments and they differ depending on the size of investment and risk among other factors. MIGA was set up to address political risks and

World Bank has two mandates which relate to reducing extreme poverty and to promoting shared prosperity).

[203] IFC and OECD Principles on Blended Finance.

[204] *OECD – UNCDF* 2019, p. 33. The statistics show that after MIGA, the United States and France ranked as second and third and the IFC ranked as fourth in mobilizing private finance.

despite national insurance programs exist, they can be quite volatile for changes in political leadership.[205]

MIGA offers four coverage options for equity investors: expropriation cover, war and civil disturbance cover, breach of contract cover, and currency inconvertibility and transfer restriction cover.[206] MIGA refers to these four risk coverages as political risk insurances. For the sake of clarity, I will examine expropriation, war, terrorism & civil disturbance, breach of contract, and currency inconvertibility and transfer restriction coverages separately. Political risks and especially hostility from host countries can be really expensive for companies.[207] Hostility from foreign governments includes e.g. indirect expropriations. MIGA's insurance coverages cover, *inter alia*, equity investments and for these investments cover is up to 90 per cent.[208] An insurance from MIGA comes with a price tag, and the premium is usually 1–2 per cent of the size of the investment made. MIGA insurance is open for investors from MIGA member states such as Finland.

It must be duly acknowledged that MIGA can also assist in settling investment disputes. MIGA also offers *ex ante* project development assistance for covered projects. Coverages from MIGA assume not only financial and economic viability, but projects earning coverage are also expected to be environmentally sound and consistent with the host country's development objectives.[209] Nationally Determined Contributions reflect these priorities, which are guided by climate change adaptation and mitigation objectives. As set out by MIGA itself, "*MIGA supports investments that are developmentally sound and meet high social and environmental standards*".[210] Thus, it seems that already getting an insurance from MIGA can help to address regulatory risks related to sustainability. Moreover, insurance from MIGA can also mitigate project risks such as environmental standard due to making private investors adhering to high social and environmental standards. However, because project risks are not on the focus of my study, I will not focus on these risks more but recognize that insurances provided by development financiers can also mitigate these risks.

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[205] See, for example, *Donovan* 2004, p. 12.
[206] MIGA 2019. For debt investors, other products are available, namely coverages of non-honouring of sovereign financial obligations and non-honouring of financial obligations for state-owned enterprises.
[207] *Gamso – Nelson* 2019, p. 2.
[208] *Winpenny* 2005, p. 29.
[209] *Winpenny* 2005, p. 29.
[210] *MIGA* 2019.

Multilateral financiers can also provide investors an extra layer of security: host country governments are less likely to engage in adverse behaviour against foreign investors when a multilateral development financier is present.[211] However, it is vital to note that this has been affirmed only in the case of MIGA and might not hold up in the case of bilateral DFIs.[212] Also *Tan* has noted that political risk insurances (PRI) have a dual-function: in addition to offering compensation they have a feature that Tan calls as a broader disciplinary function.[213] Thus, political risk insurances obtained from MIGA can mitigate the possibility that a host country government engages in adverse conduct against private equity investors altogether.

Political risk insurance is one of the oldest options MIGA has to offer for private sector investors. Political risk insurance has emerged as a crucial element in the regime of international investment offering foreign investors security against certain non-commercial risks, among which currency and financial transfer risks, contract breaches, expropriation, and war and terrorism.[214] Despite PRIs can be understood broadly, encompassing coverages against political/institutional, regulatory and financial (macroeconomic) risks, I explore different parts of PRIs separately for the sake of clarity and systemic approach. This choice also reflects the coverage of various insurance coverage alternatives MIGA has for private equity investors. Next, I will examine how different PRIs from MIGA address regulatory, political/institutional and financial (macroeconomic) risks.

4.3.2 Insurance against expropriations

In this section, I will focus on MIGA's expropriation coverage. MIGA's expropriation coverage offers protection from nationalization and from acts of government that make it impossible to operate the project through discriminatory measures. Expropriation, and particularly its indirect version has been stated to be one of the primary non-commercial risks that investors face when investing in developing countries.[215] MIGA defines expropriation as "*any executive or administrative acts or omissions, or any legislative*

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[211] See, for example, *Jensen et al.* 2019, p. 27. Jensen et al. conclude that reputation costs deter host governments from expropriations and breaches of contracts. Home countries and multilateral actors (such as MIGA, World Bank) put pressure for the host country to uphold contracts. This view is also supported by *Friedrich* 2013, p. 262. Friedrich makes a reference to loan policies of multilateral agencies such as the World Bank in the context of compliance with environmental standards.
[212] *Jensen et al.* 2019, p. 27.
[213] *Tan* 2015, p. 177.
[214] *Tan* 2015, p. 174.
[215] *Donovan* 2004, p. 1.

action (but in all cases excluding any judicial action or omission) in one or a series of events attributable to the [h]ost [g]overnment that directly or indirectly" affects investors' ownership or control rights in the guaranteed investment or otherwise deprives all or substantially all economic value of the investment, with certain exceptions.[216]

Indirect expropriation refers to a series of acts that result in expropriation-like effects due to e.g. denial of necessary licenses, introduction of inconsistent tariffs, and introduction of regulatory changes that deprive the investor of the value of the investment. Acknowledging the possibility of a host country changing its regulations is relevant from the viewpoint of low-emission investments, because low-carbon sectors such as the renewable energy sector have been and continue to be hugely dependent on public policy.[217] As a result, regulatory changes e.g. in the field of clean energy can render a PE/VC investor's investment practically worthless. I conclude that the risks that MIGA's expropriation cover offers protection from align well with my classification of regulatory risks which cover e.g. regulatory uncertainty (regulatory changes) and inconsistent tariffs. MIGA's expropriation coverage offers protection against certain government actions that can either reduce or eliminate control over or ownership of, or rights to the insured investment.

Naturally, MIGA does not offer protection from all regulatory risks. It is critical to note that MIGA's insurance does not protect investor from losses that directly or indirectly result from laws, degrees and regulations in force in the investment host country as of effective date.[218] Similarly, acts or omissions of host country governments are protected if they took place before the effective date.[219] MIGA therefore limits its insurance scope to such acts or omissions that came to the investor as a surprise and of which the investor could not have known. This approach is consistent with arbitral tribunals' approach to the issue as arbitral tribunals have often expected an investor to be prudent. MIGA's approach is less stringent in that sense it does not expect investors to anticipate regulatory changes unlike many arbitral tribunals seem to expect.[220]

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[216] *MIGA* 2018, p. 15. Exceptions concern e.g. the nature of the government measure. For example, *bona fide* government measures fall outside the scope of indirect expropriations.

[217] *Surminski* 2013, p. 249 also notes that political dependency and political uncertainty regarding sudden policy changes can make investments unprofitable.

[218] *MIGA* 2018, p. 17. The effective date MIGA refers to is the date when the insurance was underwritten between MIGA and the investor.

[219] *MIGA* 2018, p. 18.

[220] Several authors in the field of international investment law have researched host country's regulatory right and investor protection in this regard. See, for example, *Rigo Sureda* 2012, p. 79–80 who states that

The expropriation coverage's most notable weakness is that it only focuses on expropriations and thus does not extend its scope to any kind of regulatory changes that have a negative effect on the value of the investment. However, this aspect arises an interesting question regarding the definition of indirect expropriation employed by MIGA, namely, does an indirect expropriation as a term have the same content in the practice of MIGA as it has in the practice of arbitral tribunals. As already stated, MIGA defines indirect expropriation as "*any executive or administrative acts or omissions, or any legislative action (but in all cases excluding any judicial action or omission) in one or a series of events attributable to the [h]ost [g]overnment that directly or indirectly*" affects investors' ownership or control rights in the guaranteed investment or effectively deprives all or substantially all economic value of the investment, with certain exceptions.[221]

Bonnitcha refers to indirect expropriation as a situation "*in which an investor's legal title is not extinguished but the acts of state are, in legally significant aspects, analogous to direct expropriation*".[222] In *Starrett Housing* the Iran-US Claims Tribunal concluded that indirect expropriation occurs when property rights *"are rendered so useless that they must be deemed to have been expropriated"*.[223] Moreover, Bonnitcha's research suggests that arbitral tribunals interpret differently phrased expropriation provisions in a rather similar way: thinking that they all embody the same concept of indirect expropriation.[224] In the practice of arbitral tribunals the economic effect of regulatory changes has been in the heart of indirect expropriation assessment.[225] In its expropriation definition, also MIGA highlights the economic effect of government acts. Therefore, the content of expropriation regarding its effects on the investment seems to be in the heart of both

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investment tribunals expect foreign investors to have a certain degree of experience and savviness, who have conducted adequate due diligence about both the business and country conditions bearing in mind how political changes might change them in the future. Nevertheless, *Dolzer – Scheurer* 2012, p. 169 conclude that based on the past case-law and literature it seems that the legal environment existing at the time of making the investment has been a decisive criterium for the investor's legitimate expectations.

[221] *MIGA* 2018, p. 15.

[222] *Bonnitcha* 2014, p. 230. Bonnitcha represents direct expropriation as a situation "*in which a state formally transfers or extinguishes an investor's title to property*", p. 229–230.

[223] Starrett Housing, para. 155.

[224] *Bonnitcha* 2014, p. 271.

[225] In the practice of arbitral tribunals, expropriation has traditionally required a degree of severity from the introduced regulatory changes. This has been an issue of substantial deprivation of the economic value of the investment. *Vinuales* states that some expropriation claims have been dismissed by tribunals on the basis that investors failed to establish *why* environmental regulations have not substantially deprived the investment of its value. To determine this, two issues are considered: has the investor been deprived a substantial value of the investment; and if so, ii) is this due to the introduction of the regulation. (*Vinuales* 2012, p. 308).

expropriation definitions adopted by MIGA and arbitral tribunals. MIGA makes a reference to control rights and ownership rights which can be essentially be thought to mean the same as property rights.

Thus, the definition of indirect expropriation employed by MIGA seems to be rather compatible with the definition adopted in the academic literature and arbitral practice. This suggests that the threshold of indirect expropriations adopted by arbitral tribunals can be acknowledged when making conclusions about regulatory risks which pertain regardless of the expropriation coverage. Next, I will examine a war, terrorism and civil disturbance coverage from MIGA and how this coverage protects foreign private investors from political risks.

4.3.3 War, terrorism and civil disturbance coverage

MIGA also has a *war, terrorism and civil disturbance coverage*. This coverage protects foreign investors from damage to, destruct to, disappearance of, and loss of tangible assets and from total business interruptions which have been caused by politically motivated acts of war or civil disturbances.[226] In the context of low-income countries, of which many are sub-Saharan African LDC countries, and of which many have undergone conflicts in the recent past or are still undergoing them, it is good that MIGA's coverage protects foreign investors from political violence resulting from the conduct of other countries as well. Because the extent of war, terrorism and civil disturbance risk is heavily tied to country circumstances, it is not possible to give estimations of the size class of this risk. Nor it is possible due to the methods used in this research.

Within my risk grouping, this coverage covers political instability in its different forms, but does not provide protection from corruption and lack of strong institutions. The reason why strong institutions are critical for mitigating risks associated with equity investments is because PE investment is essentially a contract-based[227] transaction. As such, a PE/VC investor's ability to enforce contracts becomes a critical issue. This is even more crucial considering the possibility of PE/VC investors to transfer other risks such as project risks by aligning these risks to other parties by means of contracts. If these contracts cannot be properly enforced, they become essentially worthless. Although MIGA has an insurance protecting lenders from state-owned, sovereign and sub-sovereign enterprises when they

[226] MIGA makes a reference to revolution, insurrections, coup d'états, terrorism and sabotage.
[227] *Lerner – Schoar* p. 10. Lerner – Schoar note that the relationship between PE investor and the founder of the company is essentially a contractual one.

do not honour their *financial* obligations, this coverage alternative is not available for equity investors.[228] Thus, the war, terrorism and civil disturbance coverage from MIGA does not help to enforce investors' rights, and as such, it does not protect investors from risks stemming from lack of strong and transparent institutions. For this purpose, MIGA has a breach of contract insurance which provides protection from these risks to some extent.

4.3.4 Breach of contract insurance

Above, I have examined protection offered by MIGA against regulatory risks and political instability. MIGA also offers breach of contract insurances. MIGA offers coverage against losses that result from a government's breaches and repudiations of a contract with a foreign investor. MIGA offers a breach of contract coverage in cases of arbitral award defaults by government when MIGA has determined that the government has failed to honour its obligations set out in key project documents.[229] These key documents include e.g. off take agreements and concessions,[230] which set conditions for the investor–host country relation. Thus, in essence, this coverage offers protection in situations where a host state has breached its key obligations and fails to heed a given arbitral award on the matter.

As a rule, this coverage from MIGA sets as a pre-condition obtaining an arbitral award. If a government has defaulted in that sense the investor has not: i) been able to obtain the award due to the foreign government frustrating its efforts; or ii) the government has not paid the amount specified in the award, MIGA starts a dispute settlement e.g. by means of mediation to determine whether the government has dishonoured its contractual obligations. This issue is solemnly for MIGA to determine. In cases where the government has defaulted in a manner specified above, MIGA pays compensation.

Invoking the dispute resolution mechanism (such as arbitration) set forward in the investment treaty is as a rule a precondition for receiving compensation on the basis of a contractual breach. MIGA has not put forward criteria for the content of the award, i.e. to which extent the award should recognize that the host state has failed to honour its financial obligations set out in key agreements concluded between the host state and the

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[228] *MIGA* 2019. This coverage is only available for lenders.
[229] *MIGA* 2019. MIGA determines this through dispute resolution such as arbitration.
[230] The former is an arrangement between producer and buyer regarding upcoming goods and their purchase or sale. The latter is a contract between a company and the host government regarding the company's right to operate its business in the government's jurisdiction subject to certain conditions.

investor. Exceptions to the rule requiring investors to obtain an arbitral award concern cases where: i) an investor does not have a recourse to a dispute resolution mechanism; or ii) there is unreasonable government interference from the host government. MIGA's breach of contract scheme protects investors from situations where a government interferes with dispute resolution – which in low-income countries often is arbitration – or does not honour the arbitral award, i.e. pay the amount specified in the award to the investor.

In my risk classification MIGA's breach of contract insurance addresses political/institutional risks as it helps to transfer corruption risk and the risk that stems from lack of strong and transparent institutions from private investors to MIGA. It is noteworthy that in my categorization 'political/institutional risk' is partly covered by MIGA's war, terrorism and civil disturbance coverage, and partly by the breach of contract coverage. Breach of contract insurance and expropriation coverage are similar in that sense that they protect the investor from a foreign government's conduct: the latter from regulatory risks and the former from the government not honouring its obligations. The protection of a foreign investor against the possibility of a host country not respecting its obligations specified in key project documents can be considered to mitigate/transfer also project risks, because offtake agreements can be critical for ensuring financial viability of a project. It is notable that the breach of contract coverage only limits itself to investor-state relation, and other relations fell outside the scope of this coverage. As a result, contractual obligations not honoured by third parties such as company founders are not covered. These contractual breaches can be determined e.g. in arbitration between the investor and the third party in breach of obligations.

But who should choose a breach of contract coverage for their investment? Breach of contract and regulatory risk cover require significant amount of legal input, making these insurances rank high in transaction costs.[231] Thus, they might not be a feasible option for smaller venture capital investments. However, a breach of contract insurance might help to hedge against project risks such as revenue risks due to requiring the host country to respect its commitments defined e.g. in offtake agreements and concessions. For this reason, a breach of contract coverage might be warranted in developing countries such as low-income countries.

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[231] *Winpenny* 2005, p. 55.

4.3.5 Currency inconvertibility and transfer restriction scheme

The Multilateral Investment Guarantee Agency also provides protection from a foreign investor's inability to convert or transfer dividends or loan payments due to foreign exchange restrictions.[232] This coverage protects foreign investors from the inability to transfer local currencies to hard currencies such as dollars, euros and yens and/or transferring hard currencies outside the host country where such situations is due to a government action or omission. Such actions or omissions can stem from a wide range of issues. MIGA includes capital, interest, principal, profits, royalties, and other remittances under this coverage. As such, in terms of subjects covered, this coverage is quite comprehensive, and by including royalties under the protective umbrella this coverage seems a feasible option also for innovative companies. The price of premium for this coverage varies depending on e.g. the volatility of host country currency rate among other factors.[233]

I acknowledge that this coverage addresses risks that fall into the class of financial (macroeconomic) risks in my risk grouping. However, saying that this coverage covers all financial (macroeconomic) risks associated with investing in developing countries such as low-income countries would be a faulty assertation in its core. This coverage does not protect foreign investors from currency depreciation, which can occur as a result of different causes. For example, currency depreciation can occur because of a monetary policy or a central bank intervention but it can also be a consequence of political instability. Currency risk has several implications for PE investors, as it can affect the price of assets, and the net value of assets. Thus, it seems that MIGA's currency inconvertibility and transfer restriction coverage leaves open risks resulting from currency depreciation, which can be detrimental for private equity investors when left unaddressed. As a consequence, private equity investors engaging in blended finance wanting to hedge against currency risk could explore foreign exchange (FX) risk instruments available in the private market.

Besides currency depreciation, the currency inconvertibility and transfer restriction coverage from MIGA does not afford protection from financial risks which are related to weak financial markets. This means that the coverage will not make an IPO any more feasible option as it is without a coverage. This coverage also does not provide protection

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[232] *MIGA* 2019.
[233] *Homaifar* 2004, p. 350.

from other financial (macroeconomic) risks often present in developing countries such as low-income countries. As such, this coverage from MIGA does not address most financial (macroeconomic) risks associated with investments in developing countries such as low-income countries, which have been infamous for their weak financial markets. Moreover, considering the possibilities how climate change can weaken macroeconomic conditions even further, MIGA's insurances leave significant financial (macroeconomic) risks unaddressed.

4.3.6 Risks left unaddressed by blended finance instruments

Above I have provided a brief overview of various macro risks (regulatory, political/institutional, and financial/macroeconomic risks) and project risks commonly associated with investing in developing countries, examined from the viewpoint of low-income countries in particular. I have also considered various blended finance instruments, i.e. ways to mobilize private finance into developing countries by means of rebalancing risk-return ratios which have in the past deterred private investors from investing in developing countries. Despite various risk mitigation/transfer instruments exist, some macro risks nevertheless persist. To start, blended finance alternatives targeting currency risk seem to be the most limited at least for equity investors. Thus, currency depreciation still is a considerable risk for PE/VC investors engaging in foreign investment in low-income countries. MIGA's currency inconvertibility and transfer restriction scheme also leaves most macroeconomic risks unaddressed such as those resulting from weak financial markets. This translates into weaker exit possibilities, limiting opportunities where an IPO is a feasible exit alternative.

Junior equity can absorb first losses in cases of company liquidations, providing a layer of security for PE/VC investors holding a senior equity position in portfolio companies. Nevertheless, alone junior equity seems inadequate to offer protection against macro risks. This stems from the fact that financial (macroeconomic) risks such as currency fluctuations and regulatory risks such as influential regulatory changes can render the investment virtually worthless, and without explicit protection against macro risks a portfolio company might need to be liquidated. Moreover, the appropriateness of other blended finance instruments stems from the fact that multilateral development financiers can impede expropriations from occurring in the first place due to a broader disciplinary function of political risk insurances. Thus, it cannot be said that junior equity offers protection from macro risks. Rather, junior equity offers protection against the

consequences of macro risks against which a PE/VC investor has failed to obtain adequate protection, such as a political risk insurance.

Regarding regulatory risk, i.e. a chance that a host country changes its regulations in a way that negatively affects the value of the investment of a foreign investor, a question regarding the scope of protection of MIGA's expropriation coverage arises. This stems from the fact that not all regulatory changes having a negative impact on the value of the investment result in indirect expropriations and a vast majority of damages are non-compensable[234]. As a consequence, there will be plenty of situations where host countries can adopt regulations negatively affecting the value of the investment, but these regulations do not lead to an obligation to compensate the damage caused for foreign investors. Regulatory risks not meeting the threshold of indirect expropriations thus persist regardless of MIGA's expropriation insurance. It must also be noted that an expropriation insurance still expects prudency from the foreign investor in terms of being aware of the current state of regulations. The expectations regarding prudency required from a foreign investor are nevertheless more relaxed when obtaining an expropriation coverage from MIGA compared to the degree of prudency required by arbitral tribunals.

Political/institutional risks are partly covered by MIGA's breach of contract coverage and partly by its war, terrorism and civil disturbance coverage. Main issues with MIGA's coverages available for equity investors aiming at mitigating and transferring political/institutional risks relate to the requirement of obtaining an arbitral award in most cases as well as to the problems regarding contract enforcement. Whereas MIGA provides a coverage against breaches of contracts in the investor-state relation, relations between investors and third parties such as company founders are not covered. Thus, when PE/VC investors try to transfer project risks (such as environmental risks) to third parties,[235] they can face difficulties when enforcing their rights. Taking into account weak judiciaries in low-income countries as well as high degrees of corruption, this remains problematic. MIGA's breach of contract thus does not remove institutional weaknesses associated with low-income countries and their judiciaries but rather offers protection against these risks

[234] In the case-law of arbitral tribunals, the threshold for indirect expropriations has been set remarkably high. Certainly, only in few cases compensation has been awarded on the basis of indirect expropriations. Arbitral tribunals have put heavy weight on the effects of adopted regulations, requiring them to deprive the investor virtually the whole value of the investment. *Vinuales* 2012, p. 307 argues that changes to general regulations are the rule and will only rarely result in indirect expropriations.

[235] *Yescombe* 2013, p. 198 makes a reference to allocating risks to the extent possible to appropriate parties in the provisions of project contracts.

only in part of all cases, namely in the investor-state relation. Political/institutional and regulatory risk protection can also come with a hefty price tag due to high transaction costs.

Next, I will provide a brief overview of the relationship of blended finance soft law and macro risks, and regulatory risks in particular. I will take a look at regulatory risks blended finance instruments leave unaddressed in relation to low-emission and climate-resilient investments, i.e. climate finance investments.

4.4 Scope of existing regulatory risks

4.4.1 Blended finance soft law and macro risks

Above I have concluded that the biggest macro risks left partly unaddressed by blended finance instruments are financial (macroeconomic) risks, and regulatory risks. In addition, weaknesses regarding contract enforcement in relationships between a foreign investor and actors other than states, i.e. third parties remain problematic. Due to existing financial (macroeconomic) risks, feasible exit opportunities remain more limited because financial markets are weak, which can have implications for the profitability of investments. Moreover, currency depreciation can affect the value of assets among other factors. However, albeit blended finance *instruments* (junior equity and political risk insurances) cannot necessarily mitigate/transfer these risks it should not be concluded that blended finance *soft law* could not affect the scope of these risks.

The previously addressed *blended finance soft law*, i.e. blended finance principles from the OECD and the IFC, can also affect the scope of macro risks faced by private equity investors in developing countries such as low-income countries. In chapter three I concluded that blended finance soft law matters for PE/VC investors as it adds value to blended finance operations because of considering the key objectives of PE/VC investors. Whereas blended finance soft law itself cannot address financial (macroeconomic) risks left unaddressed by blended finance instruments, these soft law instruments signal an active role for development financiers in enhancing the quality of local financial markets[236] which can be presumed to contribute to the development of local financial markets in developing countries. Thus, blended finance can indirectly contribute to an increasing number of feasible exit options in developing countries. This is because

[236] Both the OECD and the IFC Blended Finance Principles mention contributions to the development of local financial markets as blended finance principles. See, the third principle of the OECD Blended Finance Principles and the fourth principle of the IFC Blended Finance Principles.

stronger financial markets make IPOs more attractive exit alternatives. Whereas strong financial markets are not itself valuable for private equity investors, they enable exit alternatives which can be more profitable and feasible compared to other exit alternatives. As such, developing local financial markets is valuable also for private equity investors.

However, it would be a faulty assertation that blended finance soft law mitigates financial (macroeconomic) risks such as those associated with weak financial markets often associated with low-income countries. Whereas blended finance soft law can mention an objective of striving towards financial markets development, the extent to which development financiers can do this remains unclear and should be subjected to further studies. Moreover, it remains questionable whether market development could be achieved within the investment horizon of PE/VC investors participating in blended finance. Thus, it cannot be concluded based on my research alone that soft law on blended finance mitigates financial (macroeconomic) risks associated with investing in low-income countries. Whereas blended finance soft law pays attention to the duration and exit opportunities of concessional, i.e. non-commercial finance, it stays silent about exits of commercial finance. Blended finance soft law, however, mentions paying attention to the perspective of private investors. It remains to be seen to which extent the perspective of PE/VC investors is considered in blended finance investments of the future. Therefore, blended finance instruments considered together with blended finance principles of the OECD and the IFC still leave financial (macroeconomic) risks unaddressed.

Although blended finance soft law does not directly deal with regulatory risks, it still has connections also to regulatory risks. Because blended finance engagement is essentially tied to sustainability, regulatory risks look very different for blended finance investors compared to other investors.

4.4.2 Blended finance and existing regulatory risks

Blended finance instruments, or political risk insurances to be exact, leave significant regulatory risks unaddressed because the threshold of indirect expropriations has generally been set high. The grey area where host countries can adopt regulations negatively affecting the value of foreign investors' investments without this resulting to indirect expropriations and thus compensation is large and encompasses both environmental and non-environmental regulations. When PE/VC investors engage in low-emission and climate-resilient development projects, a portfolio company's host

country's ability to maintain the stability of the regulatory framework becomes critical to assess because regulatory changes related to the protection of the environment or climate can significantly affect the value of the investment made. This is particularly the case when portfolio companies operate in the field of low-emission and climate-resilient development. This stems from the fact that energy sector continues to be dependent on policy.

Whereas *Steckel – Jacob* note that the risk that a host country reverses its climate policies could be added to PRI schemes or could be obtained from a development bank,[237] I note that at least the MIGA's expropriation scheme namely concerns only expropriations and not any kind of regulatory changes. I assert that there are three situations that might be relevant from the viewpoint of foreign investors in relation to climate related regulatory changes: i) tightening regulations to meet the goals of the Paris Agreement; ii) withdrawing from the Paris Agreement; and iii) failing to enforce/implement the Paris Agreement. The first situation seems to have a rather limited relevance because private investors are already required to comply with rather high sustainability standards when engaging in blended finance. On the other hand, it should not be assumed that PE investors engaging in blended finance should ignore the Paris Agreement.

The reason why private investors engaging in blended finance should not neglect the Paris Agreement relates to the status quo and the inadequacy of climate action. It is clear the current level of climate action under the Paris Agreement is clearly not in par with its key objective,[238] and more ambitious[239] action is required. Whereas the key objective of the Paris Agreement seeking to keep the rise of global temperature well under 2 degrees Celsius is not strictly speaking binding upon non-state actors such as private investors, the provision will certainly determine which projects will stay financially viable. As *Boissinot – Samama* estimate, policy changes and shifts in both consumer and investor behaviour will likely directly affect not only companies but also industries, possibly spanning through the economy.[240] Thus, it seems reasonable to assume that more climate-related legislation is coming up, as countries are fulfilling their pledges made under the Paris Agreement. Whereas this might have fewer implications for PE investors engaging

[237] *Steckel – Jacob* 2018, p. 26.
[238] *Höhne et al.* 2016, p. 19. Also, more recent sources of data are consistent with this finding from 2016.
[239] Article 3 of the Paris Agreement makes a reference to ambitious action as defined in several other articles of the Agreement.
[240] *Boissinot – Samama* 2018, p. 184.

in blended finance, which by definition is tied to sustainable development, the possibility of tightening climate policies must nevertheless be acknowledged. This is because tighter regulations could e.g. translate into denials of operating licenses.

It seems clear that private equity investors cannot neglect regulatory changes that may take place when countries are adopting tighter climate-related regulations. Low-income countries seem to be no exception to the rule. For example, much of the recent regulatory and policy actions in the LDCs have focused on building frameworks aiming to both promote and enable green growth and low-carbon and climate-resilient development.[241] The issue is nevertheless not as simple as it looks, and changes in political leadership in low-income countries might have a detrimental effect on climate policies, and as a consequence, climate-related activities. Thus, private investors engaging in blended finance cannot blindly rely on the host countries' compliance with the Paris Agreement. This brings us to questions regarding withdrawing from the Paris Agreement and failures to enforce and implement the Paris Agreement.

Whereas withdrawing from the Paris Agreement is possible and the first withdrawal from the Agreement has already been seen, a more likely occasion is that a host country fails to comply with the Agreement. The Paris Agreement is a relatively soft treaty and it contains no sanctions of breaches of the Agreement. Its provisions and GHG emission reduction goals do not oblige country parties to heed them.[242] As *Bergkamp* notes, the gap between the Paris Agreement-style collective ambition and individual country obligation seeks to apply pressure for national democracies.[243] However, there are no guarantees that this will work. Furthermore, Nationally Determined Contributions (NDCs) are not binding upon the countries that adopted them. These issues highlight the notion that foreign investors cannot expect host countries to blindly follow the Paris Agreement and comply with it.

However, simply assuming that states will not comply with the Paris Agreement's provisions due to its soft nature and lack of sanctions is as naïve as is the opposite. Article 9(6) of the Agreement makes a reference to a global stocktake which takes account of information provided by developed country parties regarding climate finance efforts. As Rajamani notes, rigorous oversight mechanisms, including global stocktake, positively

[241] *Nachmany* 2017, p. 64.
[242] *Ogbumgbada* 2016 for critical notions of the Paris Agreement.
[243] *Bergkamp* 2016, p. 36.

impact states' compliance with their commitments and their ability to demand compliance from others.[244] Other mechanisms present at the Paris Agreement, such as transparency, have been acknowledged to positively influence compliance with treaty obligations.[245] Although a degree of uncertainty always remains when discussing compliance beforehand,[246] the climate package adopted at COP 24 in Katowice took concrete steps to facilitate and promote compliance with the Paris Agreement.

Thus, although the Paris Agreement raises questions regarding states' compliance with it, the issue should not be considered black or white and it is rather one of the famous shades of grey. Whereas the Paris Agreement entails no sanctions for its breaches, notions regarding compliance enhancing factors as represented in the academic literature must be noted. Because the issue of compliance is not a straight-forward one, PE/VC investors engaging in blended finance cannot blindly rely on the host country's compliance with the Paris Agreement for which reason regulatory changes even in the climate change law sector remain possible. For this reason, it is reasonable to ask how climate-related regulatory risks can be managed by other means than blended finance instruments.

4.4.3 Means to manage regulatory risks

Whereas blended finance instruments cannot mitigate or transfer all risks, this should not be interpreted to mean that these risks could not be managed by other means. Whereas MIGA's expropriation coverage is rather limited and only in limited cases foreign investors can receive compensation based on occurred expropriations, there are other means to receive compensation due to regulatory changes introduced by a host country government. This is an issue of international investment law and further research should be conducted to determine the scope of existing regulatory risks related to the Paris Agreement that remain for private equity investors engaging in blended finance.

Regulatory risks left unaddressed by blended finance instruments have remarkable connections to international investment law regulating the relationship between a foreign investor and a host country. As previously acknowledged, besides the alternative of a host country tightening regulations under the Paris Agreement, an option regarding the host country leaving the Agreement or failing to implement or enforce the Agreement remain

[244] *Rajamani* 2016, p. 343.
[245] See, for example, *Bodhe* 1996, p. 13–38.
[246] *Steckel – Jacob* 2018, p. 23–25 discuss political de-risking associated with countries' ability to follow through their climate policies.

possible. For example, when a host country decides to depart from the Paris Agreement, this could lead to invoking the fair and equitable treatment standard[247] present in most international investment agreements. Similarly, the fair and equitable treatment standard can be expected to come in play when a host country having ratified the Paris Agreement fails to implement and enforce it. Therefore, further research could be conducted e.g. on the role of the Paris Agreement in investor-state dispute settlement (ISDS).

Another interesting question relates to the role of NDCs in ISDS, because these national plans are not formally speaking a part of the Paris Agreement. Whereas the status of NDCs in investor-state arbitration remains unclear, they are expected to play a role in the future. In the literature it has been estimated that Nationally Determined Contributions will "*no doubt be closely scrutinized by states (and tribunals)*" to determine the scope of investor obligations and host countries' rights to prevent GHG emissions from investments.[248] However, the role of NDCs is yet waiting to receive attention in investor-state arbitrations. Assessing the content of NDCs might step in e.g. when assessing the extent of host country's regulatory right, i.e. did a host country have the right to introduce regulatory changes that negatively affected the value of the investment. This would be an issue of legitimate expectations standard.

Other venues where international investment law could interact with the Paris Agreement in a way relevant for blended finance operations remain possible. Nevertheless, it deserves to be recalled that the links between the Paris Agreement and international investment law cannot be said to mitigate risks, as they rather relate to anticipating outcomes of investor-state arbitration.

4.5 Chapter conclusions

In this chapter, I have examined risks associated with investing in developing countries such as low-income countries. For the sake of clarity, I grouped these risks into two categories: macro risks and project risks, dividing the former into three sub-categories: regulatory risk, political/institutional risk, and financial (macroeconomic) risks. To

[247] Fair and equitable treatment (FET) standard has two key components from the indirect expropriation point of view: i) providing a stable regulatory framework; and ii) the well-known legitimate expectations standard. FET standard can, due to its connection to regulatory changes via legitimate expectations component and its application in cases of unstable regulatory environment offer protection against indirect expropriations. Of different investor protection clauses, FET clause has become perhaps the most contested provision and a 'catch all' clause when expropriation claims fall short.

[248] *Miles – Swan* 2017, p. 120.

project risks belong e.g. environmental risks and revenue risks. Whereas my research focused only on macro risks, I chose to feature project risks for the sake of understanding which risks are not covered by blended finance instruments as well as acknowledging that blended finance instruments seeking to mitigate/transfer macro risks can indirectly also affect the scope of project risks. Of the risks generally associated with investing in developing countries, I sought to establish how blended finance instruments accommodate these risks. For equity investors two blended finance instruments were available: junior equity and political risk insurance schemes. Of these insurance schemes, I focused on coverages offered by the Multilateral Investment Guarantee Agency.

Based on my research on different macro risks and how blended finance instruments address them, I note the following. Junior equity might seem an attractive option for PE/VC investors engaging in blended finance because development financiers and PE/VC investors generally seem to have rather aligned objectives. However, junior equity does not offer protection against macro risks *per se* but rather offers protection against PE/VC investors' failure to mitigate/transfer macro risks through other means, such as political risk insurance schemes.

The Multilateral Investment Guarantee Agency offers protection against macro risks, but it does not offer a cover-it-all solution against all macro risks. Financial (macroeconomic) risks such as currency depreciation remain largely unaddressed by blended finance instruments available for equity investors. This is because MIGA's currency inconvertibility and transfer restriction coverage does not shield foreign investors from currency depreciation risks. Thus, equity investors wanting to hedge against these risks could want to examine options available in the private market. Considering that MIGA's currency inconvertibility and transfer restriction has a rather limited coverage, it does not address most macroeconomic risks such as those stemming from weak financial markets. Because of this, chances that an IPO is a feasible exit alternative remain rather limited, and thus, as a rule foreign investors need to rely on other, perhaps less profitable, exit alternatives. Whereas blended finance soft law mentions an objective of developing local financial markets in developing countries, it cannot be said that such actions mitigate financial (macroeconomic) risks in the blended finance operation at hand. It must be also noted that climate change can worsen macroeconomic conditions even further, making existing macroeconomic conditions issues that certainly warrant careful attention.

Another notable risk left partly unaddressed by blended finance instruments is regulatory risk, such as regulatory uncertainty, because only indirect expropriations are covered by MIGA's expropriation coverage. Not all regulatory changes negatively affecting the value of the investment result in indirect expropriations, because in a majority of cases the threshold of severity is not exceeded, and compensation as a result of indirect expropriation is not awarded. MIGA's expropriation coverage also assumes a certain degree of prudency from foreign investors regarding awareness of existing regulations in a host country, although expectations regarding foreign investors' prudency are not as stringent as adopted by arbitral tribunals. Previous studies have also shown that political risk insurances such as those offered by MIGA can serve a broader disciplinary function and provide protection from the host country government. As such, insurance schemes can provide an extra layer of security for PE/VC investors engaging in blended finance.

Whereas political/institutional risks are to a certain extent covered, some gaps in protection remain. The war, terrorism and civil disturbance coverage from MIGA offers protection against political violence and therefore, it might be warranted in most low-income countries, many of which have undergone conflicts in the recent past. This coverage together with the breach of contract coverage from MIGA offers protection against political/institutional risks. The most problematic issues regarding the breach of contract insurance relate to the limited scope of protection – MIGA only covers breaches of contract by the host country and not those done by third parties, such as company founders. Thus, when PE/VC investors want to use contracts to transfer risks by allocating them to third parties, these contractual obligations do not fall within the scope of MIGA's breach of contract coverage. MIGA's breach of contract coverage does not remove the risk associated with weak institutions when it comes to relationships between third parties and the foreign investor. Therefore, it might be hard to uphold these contracts in countries which have suffered from high degrees of corruption, which is common for most low-income countries. In addition, the breach of contract coverage from MIGA comes with high transaction costs. This is also because the breach of contract insurance from MIGA as a rule requires foreign investors to resort to arbitration if compensation is wanted.

It must be borne in mind that blended finance instruments can also mitigate project risks such as environmental risks due to the stringent environmental and social policies of development financiers participating in blended finance. Moreover, blended finance instruments can also help to mitigate project risks such as revenue risks due to the

experience of multilateral development financiers in developing countries. This might also stem from the broader disciplinary function of political risk insurance schemes, a topic which has been examined in other studies than this one. The presence of development finance providers in blended finance operations offers a certain degree of security for private investors because host countries are less likely to engage in adverse behaviour when multilateral development financiers are present. However, because these appear to be consequences of the *involvement of development financiers* in blended finance operations and not consequences of *blended finance instruments or blended finance soft law*, these issues were not researched in further detail in this study and were rather just interesting points to keep in mind.

I also noted that regarding regulatory risks it must be acknowledged that regulatory risks related to changing climate policies remain different for PE/VC investors engaging in blended finance than for other private equity investors. Whereas tighter climate policies can be expected due to the Paris Agreement, I asserted that tighter climate regulations are not the biggest threat for PE/VC investors engaging in blended finance because blended finance instruments require adherence to relatively high environmental standards. However, PE/VC investors cannot blindly expect host countries to comply with the Paris Agreement. This stems from the nature of the Agreement which accommodates harder and softer obligations and entails no sanctions for breaches of its provisions. Nevertheless, questioning the efficacy of the Paris Agreement to promote compliance with the obligations contained in the treaty text just because of the soft nature of the Agreement would also be naïve. The compliance with the Paris Agreement is not a black-or-white type of issue, and the Agreement contains factors positively associated with enhancing compliance with treaty obligations. Although host countries' compliance with the Paris Agreement might remain unclear, this does not mean that regulatory uncertainty or regulatory changes would automatically harm the foreign investor engaging in low-emission and climate-resilient projects. This simply means that such issues must be managed through other venues, a notable option being investor-state dispute settlement.

5. CONCLUSIONS

5.1 Relationship between blended finance and the Paris Agreement

As my first research question I asked *whether the Paris Agreement's term 'climate finance mobilization' implicitly refers to blended finance*. I concluded that 'climate finance mobilization' is a narrower definition of 'blended finance', and in the area of low-emission and climate-resilient development they govern the same substance matter. Because blended finance emerged outside the United Nations climate change law regime, I considered the recommendations of OECD and the International Finance Corporation. The soft law on blended finance put forward by these two organizations details principles that should guide blended finance operations. These principles address, *inter alia*, commercial viability, consideration of private investors' objectives, scalability, and adherence to high environmental, social and corporate governance standards.

I asserted that these principles are worth consideration, as neglecting the notions embodied in them could be detrimental for private equity investors. Failure to consider the aspirations of PE/VC investors would make blended finance operations unattractive to private investors, the very opposite blended finance seeks to achieve. However, it must be noted that some of the concerns embodied in blended finance principles such as sustainability and high standards need to be considered by development financiers in any case, regardless of engaging in blended finance. Nevertheless, issues related to the consideration of the perspective of private equity investors are less likely to be considered by development financiers without engaging in blended finance. Thus, the application of blended finance principles to blended finance operations matters for PE/VC investors to a certain extent, although it is not the only determinant.

However, the mere fact that the soft law instruments concerning blended finance are not legally binding raise additional questions regarding their application in blended finance investments. Thus, as my second research question I considered *can the blended finance soft law actually be expected to be applied by development financiers in the area where blended finance and climate finance mobilization govern the same substance matter*. This aligned area is low-emission and climate-resilient development, as affirmed in the answer to my first research question. I considered that the application of these recommendations depends on two issues: legitimacy and the lack of situations where these recommendations should be disregarded. I examined the application of blended finance soft law from the viewpoint of development financiers (DFIs and MDBs). I suggested

that these recommendations generally enjoy a great degree of legitimacy among development financiers, although it cannot be asserted that both the OECD's and the IFC's principles enjoy a similar degree of legitimacy. For example, the IFC's blended finance principles have been accepted by the management of the Association of European Development Finance Institutions and the heads of multilateral development banks. Whereas the blended finance principles of the OECD have not yet been acknowledged in a similar fashion than those of the IFC, the OECD's soft law has been rather successful in influencing the content of national legislation in the past. Although these recommendations can be asserted to enjoy legitimacy amongst development financiers, it must be borne in mind that due to their non-binding nature, they can be sensitive to e.g. board management in DFIs and MDBs.

In addition to legitimacy, possibilities regarding situations where these recommendations should be disregarded were examined. Because these soft law instruments from the OECD and the IFC are rooted in sustainability and are by nature rather flexible, it seems safe to say that they do not likely result in conflicts with other legal instruments development financiers (DFIs and MDBs) need to consider in their investments. In any case, there seems to be no apparent conflicts between blended finance soft law and the Paris Agreement climate finance mobilization provision, which is guided by the purpose of the Paris Agreement, limiting the rise of global temperature well under 2 degrees Celsius. I concluded this to be the case because both blended finance and the Paris Agreement are deeply rooted in sustainable development.

I also asserted that whereas there remains more space for conflicts between blended finance soft law and other legal instruments binding upon development financiers, it would be unlikely that at least partly development-mandated development financiers would have to follow regulations that undermine sustainable development. Moreover, this assertation is supported by the fact that some of the notions embodied in blended finance principles, among which high sustainability requirements, would be anyway considered by development financiers. Thus, the answer to my second research question is that blended finance soft law can be expected to be applied when private finance is mobilized by development financiers (DFIs and MDBs) for low-emission and climate-resilient development. This conclusion takes into account both *de facto* and *de jure* perspectives.

The conclusion that there appears to be no situation where blended finance soft law, or the content embodied by it, would be disregarded is comforting. It offers some guarantees

for PE/VC investors that their vital concerns will be addressed in blended finance operations. I acknowledge that the chosen method employed in this study is not the only way to arrive at this conclusion. Moreover, I want to note that the relevance of blended finance soft law can vary between blended finance instruments alone from the reason that these principles highlight notions that are particularly relevant in board management, i.e. when development financiers invest in the same portfolio companies as PE/VC investors by taking junior equity positions. However, adherence to blended finance principles is far from offering adequate protection because these instruments do not accommodate macro risks faced by private equity investors in developing countries. For this reason, I considered how different blended finance instruments (junior equity, political risk insurance schemes) address different macro risks generally associated with investing in developing countries such as low-income countries.

5.2 Blended finance addressing macro risks

My third research question concerned different blended finance instruments and how they address macro risks generally associated with investing in developing countries. In my research, I considered these risks particularly from the perspective of low-income countries which have characteristics that make them different from more developed developing countries. In my study, I focused on macro risks, which I grouped into three groups: financial (macroeconomic), political/institutional and regulatory risks while acknowledging that blended finance instruments can also mitigate project risks. To project risks belong e.g. environmental risks, cost overruns and other risks associated with the project itself. Whereas in the focus of this study was not how project risks can be mitigated, project risk mitigation can be a practical consequence of engaging in blended finance. However, such conclusions cannot be made based on this study alone and should be examined in further research.

In my study, I focused on two different blended finance instruments available for private equity investors who invest in portfolio companies abroad. I acknowledge that further instruments might be under development, but in this study, I considered junior equity and political risk insurance schemes. Of political risk insurance schemes, I examined insurances offered by the Multilateral Investment Guarantee Agency (MIGA). To start, junior equity might seem an attractive alternative for PE/VC investors engaging in blended finance because it offers a layer of security in situations where the portfolio company defaults. Because generally speaking the key objectives of PE/VC investors and

development financiers align, junior equity might seem a feasible option. However, junior equity does not offer protection against macro risks *per se* but rather offers protection against PE/VC investors' failure to mitigate/transfer macro risks via other means, such as through political risk insurance schemes.

In my research, I concluded that political/institutional risk, referring to issues related to political instability, corruption, and lack of strong and transparent legal systems, is covered by MIGA's two coverages: i) war, terrorism & civil disturbance coverage; and ii) breach of contract insurance. The former might be certainly warranted in most low-income countries, as many of them have undergone conflicts in the recent past. However, I acknowledge that the methods employed in this study cannot give a more sophisticated picture of political violence in developing countries such as low-income countries.

The breach of contract coverage from MIGA is tricky. The most problematic issues with breach of contract insurance relate to the limited scope of protection – MIGA only covers breaches of contract by the host country and not those of third parties. Thus, when PE/VC investors want to use contracts to transfer risks by allocating them to third parties, these contractual obligations do not fall within the scope of MIGA's breach of contract coverage. Because of this, MIGA does not provide means to hold up the commitments of third parties such as company founders. Considering that private equity investments are essentially contract-based in nature, this has implications for contract-based risk allocation through which private equity investors can transfer project risks, such as environmental risks. Thus, the breach of contract coverage from MIGA does not itself protect foreign investors from institutional weaknesses and corruption in all cases but only in investor-state relation. In addition, high transaction costs of breach of contract insurances might deter some private equity investors from resorting to this coverage from MIGA. Moreover, the breach of contract insurance from MIGA as a rule requires private investors to resort to arbitration which can be a cost risk itself especially in cases of small-scale venture capital investments.

Besides political/institutional risks, financial (macroeconomic) risks remain partly unaddressed. Currency risk, namely currency depreciation, seems to be the least-addressed risk in developing countries, although MIGA has a currency inconvertibility and transfer restriction coverage. This coverage covers exactly what is in its name, but it does not address currency depreciation risk which has been described to be a prominent risk for private equity investors investing in developing countries such as low-income

countries. However, currency hedging options to mitigate foreign exchange risk not offered by development finance providers certainly exist but addressing them would have gone outside the scope of my research.

MIGA's currency inconvertibility and transfer restriction coverage also cannot be said to mitigate financial (macroeconomic) risks such as risks stemming from weak financial markets, which can translate for example into more limited exit opportunities. The fact that there is no protection against weak financial markets can have profitability-related implications for PE/VC investors for example because weak financial markets limit the feasibility of an initial public offering and as a consequence other, perhaps less profitable, exit alternatives must be used. Thus, macroeconomic risks remain one of the largest risks not addressed by blended finance instruments. This is a notable issue given the importance of macroeconomic conditions and their implications for profitability, an issue that has been confirmed by a study from the International Finance Corporation. Moreover, because climate change can amplify macroeconomic (financial) conditions, existing macroeconomic (financial) risks certainly warrant a closer look. Whereas blended finance soft law from the OECD and the IFC highlights the need to develop local financial markets, this cannot be concluded to mean that development financiers can mitigate financial (macroeconomic) risks at least within the investment horizon of PE/VC investors' blended finance investments. Therefore, it can be suggested that blended finance instruments of the future should pay closer attention to financial (macroeconomic) risks, if the rise of global temperature is really wanted to be kept well under 2 degrees Celsius.

As political risk insurance schemes from MIGA leave mentionable gaps in terms of providing protection from political/institutional and financial (macroeconomic) risks, it is not surprising that gaps regarding protection also against regulatory risks pertain. Regulatory risks cover risks such as regulatory uncertainty and inconsistent tariffs. Of MIGA's political risk insurance coverages the expropriation coverage shields foreign investors from regulatory risks. It must be noted that MIGA's expropriation insurance does not avail private equity investors from their prudency obligations, such as being aware of the state of regulations in the host country when making the investment. As such, MIGA's expropriation coverage does not excuse lack of prudency from private equity investors although the degree of prudency expected by MIGA is less stringent compared to the expectations of arbitral tribunals. Regulatory risks pertain because MIGA's

expropriation coverage is limited only to the cases of expropriations and thus leaves regulatory changes not qualifying as indirect expropriations outside the scope of protection. This is notable because only few cases count as indirect expropriations and the threshold for expropriations has generally been set remarkably high. It must be noted that this conclusion was based on the aligned definitions of indirect expropriation adopted by MIGA, arbitral tribunals and academics. It was not reached by examining cases compensated by MIGA, for which reason it cannot be asserted that the threshold of indirect expropriations adopted by MIGA is exactly as high as the threshold adopted by arbitral tribunals. Nevertheless, it can be asserted that not all regulatory changes, insured or not, count as indirect expropriations. Thus, regulatory changes remain a risk even when an expropriation coverage from MIGA is obtained by foreign investors. Regulatory risk is notable because regulatory changes can have significant negative effects on the value of the investment, and particularly companies operating in the energy sector can be vulnerable for regulatory changes.

However, it must be noted that pertaining regulatory risks remain different for PE/VC investors engaging in blended finance compared to other private equity investors. As acknowledged in the very beginning of my research, tighter climate-related measures can be expected as countries are incorporating their pledges made under the Paris Agreement into their national laws. As such, regulatory risk relating to changing climate policies remains possible. Whereas it would be wrong to say that *all* regulatory risks are different for blended finance investors compared to other investors, it can nevertheless be asserted that regulatory risks regarding climate policies remain different for blended finance investors than most other investors. This is because development financiers require private investors engaging in blended finance to adhere to high sustainability standards. This is also because soft law instruments on blended finance require striving towards sustainability and high standards. Thus, it seems appropriate to suggest that private investors engaging in blended finance have to worry less about the compatibility of their investments with the Paris Agreement, which sets the direction for further, national regulation.

Although tighter regulations in the climate change sector remain possible imposing e.g. tighter emission reduction requirements on foreign investors' portfolio companies, it cannot be asserted that the most notable risk related to climate policy for blended finance investors is tighter regulatory risk, i.e. more stringent standards related to climate policy.

This is because the Paris Agreement, due to its rather soft approach, places significant weight on national implementation. Thus, questions regarding host countries' ability to implement and enforce the Paris Agreement as well as host countries' compliance with the Paris Agreement arise. For private equity investors engaging in blended finance host countries' compliance with the Paris Agreement as well as their ability to properly enforce and implement it are relevant, because blended finance operations are built around sustainable development aspirations. The Paris Agreement strongly favours these aspirations, and as a consequence host countries' compliance with the Paris Agreement is valuable for PE/VC investors investing in projects that support low-emission and climate-resilient development.

Whereas host countries' compliance with the Paris Agreement is not a black-or-white type of issue, the Agreement entails features aimed at enhancing compliance with the Paris Agreement. Whereas the exact scope of compliance with the Agreement cannot be predicted and whereas it cannot be predicted how well host countries can enforce or implement the Paris Agreement, this does not mean the issue cannot be brought up through other venues, namely investor-state dispute settlement.

5.3 Suggestions for further research

Blended finance is no panacea and as previously acknowledged, some risks pertain regardless of the use of blended finance instruments. An example of this is the possibility of a host country changing its climate policies in a way that negatively affects the value of the investment of the foreign investor. Nevertheless, whereas blended finance instruments leave open questions regarding e.g. host countries' compliance with and their ability to implement/enforce the Paris Agreement, existing risks can be addressed through other means, a prominent avenue being investor-state dispute resolution in the case of regulatory risks. However, a critical remark must be presented here. It cannot be asserted that resorting to investor-state arbitration *mitigates* risks. Rather, understanding investor-state arbitration gives insights into possible outcomes of future arbitrations.

As acknowledged in my research, remaining regulatory risks are very different for blended finance investors and other investors partly because development financiers require that private investors engaging in blended finance heed high sustainability standards. In addition, blended finance soft law underlines the importance of sustainability. However, it should not be taken for granted that the Paris Agreement is

properly implemented or enforced. This is where international investment law steps in. For example, failure to enforce and implement the Paris Agreement and withdrawing from the Agreement could be assessed under the fair and equitable treatment standard. Similarly, host countries changing their regulations could result in situations which could be assessed in light of the fair and equitable treatment standard. Whereas investors might not receive compensation on the basis of occurred expropriation, compensation can be obtained on other grounds, for example because a host country government was in breach of the fair and equitable treatment standard.

In addition to the links between pertaining regulatory risks and international investment law, future research could focus, for example, on the ability of blended finance instruments to mitigate or transfer project risks. This research has identified some gaps in the protection offered by development financiers against regulatory, political/institutional and financial (macroeconomic) risks. I have acknowledged that blended finance instruments such as junior equity and political risk insurance schemes can mitigate or transfer project risks such as environmental risks and cost overruns. I have also acknowledged that gaps in protection against macro risks might have implications also for mitigating/transferring project risks. An example of this is the limited scope of MIGA's breach of contract insurance, which does not help to uphold contracts in the relation between a foreign investor and non-state parties. Thus, future research could focus on clarifying the extent to which development financiers can mitigate/transfer project risks through blended finance instruments.

This study has provided an overview of blended finance that is essentially based on environmental law and international law. I acknowledge that addressing the topic from a company law viewpoint could provide new insights into blended finance. Although blended finance is no panacea and leaves certain aspects of macro risks unaddressed, it nevertheless is a step in the right direction of attracting more private finance into low-emission and climate-resilient development in developing countries. In its current form, blended finance addresses some concerns of private equity investors related to macro risks, but more work must be done to make blended finance a truly promising alternative. In particular, macroeconomic conditions of the poorest developing countries should be strengthened to meet the remaining infrastructure investment gap. Bridging the infrastructure gap and keeping the rise of global temperature well under 2 degrees Celsius is achievable if more conscious effort is put in.