The Blended Finance Approach to Adaptation: A Win-Win?

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According to the most recent UNEP Adaption Gap Report (2022), "estimated adaptation costs are currently between five to ten times higher than international adaptation finance flows". One of the most central policy instruments to remedy this situation (promoted by the UNFCCC's Green Climate Fund, the IMF, the World Bank and many others) is "blended finance" (BF). BF refers to financial instruments which use public resources to attract private funding for projects perceived as too risky by guaranteeing an attractive risk/reward profile for private investors. Central instruments of BF include interest rate subsidies, which lower financing costs in underdeveloped financial markets; loan guarantees, which ensure that private investors will receive repayment even if the project fails; and structured first loss finance, which ensures that initial losses in case of bankruptcy of a project fall on the public entity.

The normative case for BF is typically motivated in a twofold manner: First, by emphasizing the urgency of securing funding for vital climate projects, including adaptation projects that struggle to mobilize the necessary funds because they offer little prospect of profit. Second, by BF's potential to create win-win opportunities, which benefit both the public via promoting climate action, and private investors via guaranteed returns and assurances against losses.

Yet, despite its initial appeal, BF raises important concerns. BF threatens to violate strong intuitions of distributive justice by effectively creating a financial safety net for wealthy asset holders at the cost of less wealthy taxpayers. BF violates important intuitions of corrective justice by relieving wealthy private investors in fossil fuels of their remedial duties: Wealthy emitters should not be compensated for investing in adaptation measures via access to a class of essentially risk-free assets. Instead, they should offer to pay for adaptation projects to compensate for their investment emissions. Furthermore, because adaptation projects typically yield no cashflow, BF has little potential to raise investments in adaptation measures without offering private investors disproportionate financial benefits paid for by the public. Finally, because of their longevity, BF instruments threaten to limit climate policy space. Any political risks taken by the state will require further improving risk/reward profiles for private investors, thus threatening reluctance to adopt further climate regulation.

Our article is structured in three parts: In the first part, we present and discuss the normative case for BF. We conclude that the arguments presented in favor of BF do not succeed upon closer scrutiny. In the second part, we draw on the broader climate justice finance literature to illustrate that the drawbacks of BF are acknowledged by most climate justice approaches. In a last part, we present an alternative equity investment-based approach to BF which avoids many of these drawbacks while remaining compatible with standard desiderata of climate justice.

Currently, only ten percent of aggregate climate finance flows into adaptation finance. Around ninety-five percent of this amount comes from public sources, which indicates a severe lack of private funding for adaptation projects to many international institutions, including the IMF, the World Bank, and the UNFCCC's Green Climate Fund. The almost unanimous response from these organizations is to turn to blended finance. The promise of blended finance is that large investment gaps in adaptation finance will be closed if the public sector takes on the associated risks – but this move raises important practical and justice-related questions. On the practical side, blended finance initiatives have, to date, achieved mixed results in attracting private investors. Given the size of the investment gap and that adaptation projects typically do not generate profits, enthusiasm about attracting private investors might be misplaced. With regard to justice, blended finance threatens to invert the justificatory logic of the market: Instead of leaving financial risks with investors to justify why they ought to reap the benefits of their investments, blended finance proposes to shift investment risks to the public, while directing investment benefits disproportionately towards private investors. We should exercise caution when considering the promises of blended finance.