Investing in our future

Practical solutions for the UK government to mobilise private investment for economic, environmental and social policy priorities

Sarah Gordon

October 2023

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This work has been supported by the Grantham Foundation for the Protection of the Environment, Schroders and The Harriet Collington Foundation.

The views expressed in this report represent those of the author and do not necessarily represent those of the host institutions or funders. The author reports no conflict of interest in the preparation of the report. None of the finance initiatives mentioned in the report are endorsed by the author, the host institutions or the institutions' funders.

This report was first published in October 2023 by the Grantham Research Institute on Climate Change and the Environment.

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Suggested citation: Gordon S (2023) *Investing in our future: Practical solutions for the UK government to mobilise private investment for economic, environmental and social policy priorities*. London: Grantham Research Institute on Climate Change and the Environment, London School of Economics and Political Science

"Far more capital needs to be directed at transitioning our economy to net zero and crucially, mitigating its effects on communities in the UK and around the globe. This report provides practical pathways for the UK government to collaborate more effectively with the financial services industry, and to mobilise more private investment to address these policy priorities." **David Blood, Senior Partner, Generation Investment Management, and Chair, Social Finance**

"Governments face a significant challenge. There are huge environmental and social issues that need addressing and only limited resources to do so. But this challenge also presents an opportunity – to reimagine how to align public and private capital in support of a more sustainable and inclusive economy. As this excellent and timely report from Sarah Gordon and the Grantham Research Institute shows, blended finance initiatives can be a key part of the answer. Done well, they mobilise the capital needed to create more jobs, better health, increased housing and cleaner energy. The key ingredient now is the political ambition to make this potential real." **Kieron Boyle, Chief Executive, Impact Investing Institute**

"The UK has developed a highly sophisticated and competitive financial sector, yet many parts of the economy still struggle to attract the appropriate level of investment. Here is the two-fold challenge facing the UK in 2023: firstly and vitally, it is important to retain and enhance the leading global position of the City of London, thus attracting skills and capital to the UK which contributes significantly to the fiscus. Secondly, to channel an adequate portion of the substantial domestic long-term savings pool into productive investment. Government needs to tackle both these challenges with intent, and the proposals set out in this report provide practical ways for it to do so." **Hendrik du Toit, Founder and CEO, Ninety One**

"The case studies and proposals in this report provide concrete evidence of the power of blended finance to deliver solutions to some of the UK's most pressing challenges. In particular, they show how an outcomes-based approach can deliver both a highly effective use of taxpayers' money and lasting benefits in social housing, education, health and other sectors." **Michele Giddens OBE, Founder and Co-CEO, Bridges Fund Management**

"The UK government has a real opportunity to collaborate more ambitiously with asset owners and asset managers in order to attract more investment into the issues that matter most to us all. Working with the financial services industry and communities, the UK can become a global leader in using blended finance to address the environmental emergency, and to improve people's access to education, decent housing or better healthcare. I welcome the recommendations in this report that would support progress towards this goal." **Peter Harrison, Group Chief Executive, Schroders**

"The opportunity to bring private capital to the delivery of public benefit is much greater now than before. More investors are seeking to generate measurable positive impact alongside financial returns. This report demonstrates that there is now a proven set of opportunities to invest where this is possible, at increasing scale." **Stephen Muers, Chief Executive Officer, Big Society Capital**

"Directing more investment, both public and private, to address the social challenges the UK faces is a priority for government. It will create jobs, growth, public and private value in an exciting way for our country. This report demonstrates practical ways of achieving this, and how different types of investors can collaborate powerfully to deliver lasting solutions and returns." **Mark Norbury, Chief Executive, UnLtd**

"The economic transformation we need to reach net zero will require significant investment. Mobilising this capital will require a new approach to how we think about finance. This timely report outlines how public capital can be used catalytically to crowd in other sources of finance and provides practical, implementable solutions. The blended finance initiatives highlighted provide examples of the kind of innovative action that we urgently need." **Dr Rhian-Mari Thomas OBE, Chief Executive, Green Finance Institute**

"There are now many examples of institutional investors successfully working with government, Development Finance Institutions and other public organisations as well as the private sector to design innovative investment vehicles that can help us tackle the multiple challenges we face as a society. Blended finance is already an important solution, but one with so much more potential, especially in the credit space, given the enormous financing requirements these challenges present. Without a doubt it is a win–win for the private and public sectors, including playing an essential role in financing the climate finance gap and in achieving significant commercial capital mobilisation targeted towards much needed, high impact climate infrastructure projects. Ten years ago nobody thought of infrastructure debt as an asset class, and now it is firmly established as one. I fully expect blended finance to expand similarly, as it grows geographically and in terms of risk–return optionality." **Deborah Zurkow, Global Head of Investments, Allianz Global Investors**

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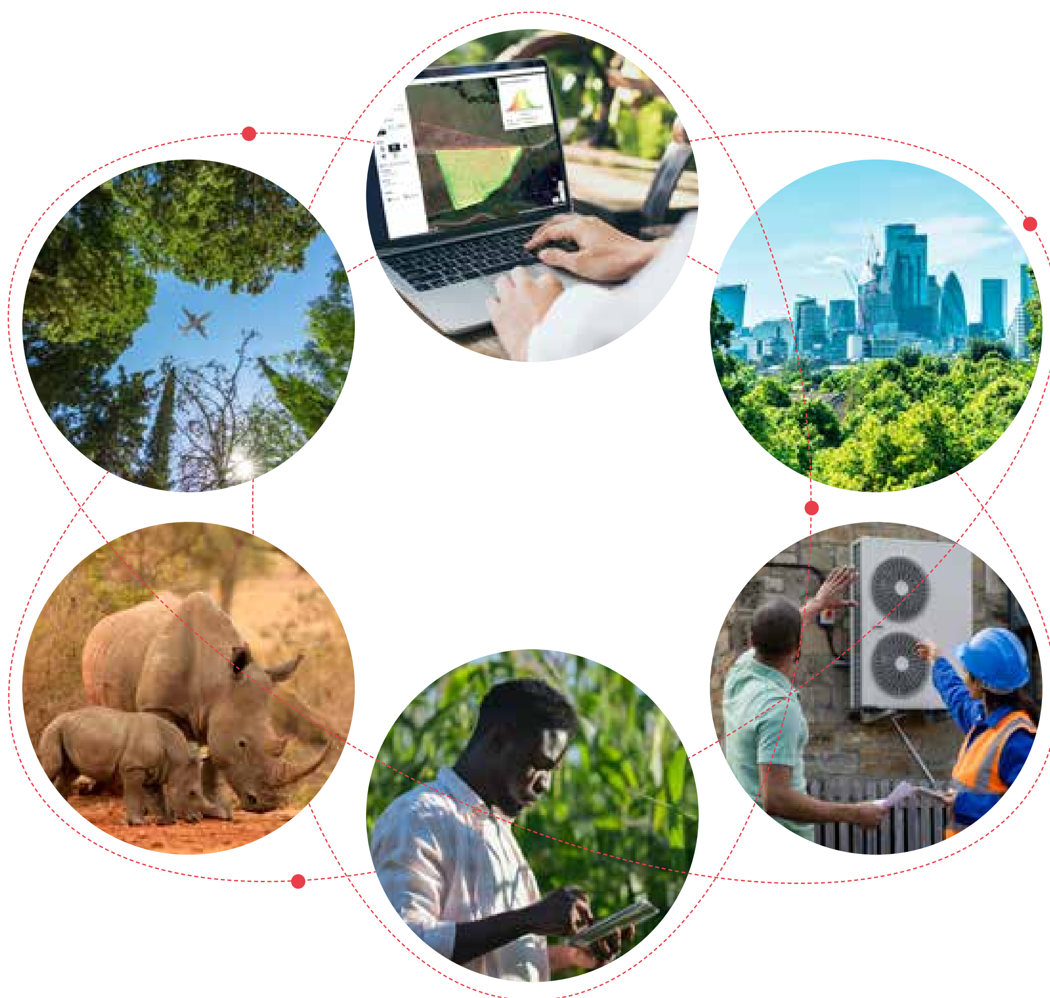

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Executive summary

Investment in the UK, both public and private, is chronically low as a share of GDP compared with the country's peers. It must increase if the UK is to see meaningful productivity growth, address regional disparities and meet its net zero climate commitments.

- With targeted action, the UK can redress the competitive imbalance with the United States and the European Union on private finance mobilisation, and direct greater amounts of productive investment into priority areas such as net zero and social housing.
- There are tried and tested pathways that have the potential to be swiftly replicated at scale. The case studies profiled in this report showcase the range of private actors (institutional asset managers, social investors, grant funders) who are demonstrating that 'blended finance' provides a tested model in which public and private investors can work together.
- This model needs to move from the realm of financial innovation to the mainstream in order to mobilise private investment at scale.
- Blended finance combines private capital in search of an investment return with other more risk tolerant 'catalytic' capital that mobilises the former.
- Government funding can be used effectively to 'catalyse' other, larger sources of capital in blended finance structures, whether private sector investment or philanthropic funding. This blend of capital sources, with their very different goals – from social outcomes to financial returns – can operate together successfully.
- Deployed well, blended finance enables budget-constrained organisations to crowd in multiples of private investment to address pressing economic, environmental and social challenges.
- There are also benefits to outcomes-based commissioning and financing – an approach that, if adopted more widely, would enable government to deliver better results from its public spending decisions across departments.

Summary recommendations

This report builds on current proposals by political parties, think tanks and others for an economic growth 'super-fund' to suggest practical and implementable ways such a fund could be focused, structured and run, and principles for how to best attract private investment into it:

- **First, we recommend the creation of a venture capital fund-of-funds, the UK Growth Fund**, to attract pension and other large pools of institutional capital and act as an umbrella vehicle for a portfolio of sector-specific funds. This would aim to raise £4.6 billion at launch, rising to at least £46 billion over five to 10 years.
- The sector-specific funds would, in turn, address market failures in priority areas for the UK's future prosperity and wellbeing. These funds would be designed to attract private equity investors, mainly venture capital investors, and the funds' portfolio companies would be incentivised to list publicly in the UK on exit. Providing investable opportunities in the UK Growth Fund's sector-specific funds could potentially attract £10 billion of venture capital financing, in addition to the investment in the umbrella fund-of-funds.
- **Second, we propose a new UK Community Growth Fund** to build on successful initiatives that were set up to support small businesses, social enterprises and charities during the Covid-19 pandemic. The UK Community Growth Fund would expand on precedents, including the £60 million Community Investment Enterprise Facility, and would target £100 million of commercial bank and social investment at launch, growing in size as additional financial institutions and investors took part.
- The two Growth Funds would be managed within the existing national finance institutions established by the UK government, and overseen by a new government unit to provide a centre of expertise on blended finance, hosted by HM Treasury, in coordination with the Cabinet Office and other relevant government departments.
- Both funds would be modelled on successful initiatives from the recent past, such as the work of the Green Investment Bank, and ongoing work by experienced organisations in the field, such as Social Investment Scotland. These demonstrate the benefits of a process that identifies market failures, then involves both state and private investors in the co-creation of investment vehicles to respond to them, and develops a track record of delivery which builds the confidence of private investors. All require a cooperative approach to co-designing solutions that meet the needs of different stakeholders.
- To lower existing barriers to and incentivise private sector investment into the new funds as well as other public policy priorities, three further 'enablers' are proposed: new guidance on fiduciary duty for institutional investors; reprioritisation of institutional mandates and incentive structures at key government-owned UK institutions; and the design of new investment incentives.

Based on the £4.6 trillion of current insurance and pension fund assets in the UK, these proposals together could potentially unlock £5 billion in private investment for public policy priorities at the time of the funds' launch, and at least £50 billion in the next five to 10 years.

Introduction

This report presents targeted proposals that can both redress the UK's competitive imbalance with the United States and the European Union on private finance mobilisation, and direct greater amounts of productive investment into priority areas such as net zero and social housing.

The current outlook for growth in the UK is weak and the public purse faces significant constraints. Therefore, taking action to increase the amount of private investment in long-term, productive and sustainable assets should be an urgent priority for the Government. Moreover, a strategic approach is needed to ensure that the UK, its cities and regions can build on current and potential strengths in services and areas of high value manufacturing (De Lyon et al., 2022). This includes strengths in green technologies (Curran et al., 2022) where, given the strong investment incentives being offered in the US and the EU, the UK risks falling behind.

Meanwhile, reaching net zero and achieving other pressing public policy priorities, such as the provision of quality affordable housing, requires a far greater quantum of capital than is being allocated to these challenges at a time when public spending is severely constrained. The Climate Change Committee estimates that getting to net zero alone will require additional annual investment in the UK of more than £50 billion by 2030, the bulk of this relating to electricity supply, residential buildings and surface transport (CCC, 2020). Retrofitting the existing social housing stock will cost an estimated £104 billion (Meanock, 2022), while in London alone the funding requirement for providing new social housing is forecast to be £22.2 billion between 2023–24 and 2027–28, or £4.9 billion a year (Savills and GLA, 2022).

The proposals set out in this report demonstrate various pathways the Government could take to significantly increase its mobilisation of private investment for public policy priorities. Implementing the proposals would enable the Government to use its own resources – taxpayers' money – to crowd in multiples of private capital. At a time of severe budget constraints, this would mean it could dedicate more investment to addressing a range of policy challenges.

The proposals present a range of benefits for policymakers: better-funded projects and improved potential to deliver on policy objectives in education, energy, health, housing and other sectors; an enabling policy and regulatory environment in which more capital can be effectively and accountably dedicated to improving growth sustainably and equitably; and more robust bridges of trust and better ways of working between government, asset owners, the financial services industry, philanthropic funders, business and communities.

Structure of the report

Section 1 introduces the opportunities that exist to deploy blended finance approaches at scale in the UK to deliver key policy objectives. Section 2 provides an overview of the blended finance actors and instruments that can be deployed.

Thirteen case studies describing effective use of blended finance from the UK and emerging markets are provided in Section 3, to illustrate models that could be replicated at scale in the UK.

Section 4 describes six regulatory or policy actions that, taken together, could transform the Government's ability to mobilise private capital for public policy ends.

Section 5 concludes.

Further engagement

This report has benefited from the input, experience and knowledge of many individuals and organisations in academia, the civil service, government, social investors and mainstream and impact financial services firms, through an iterative process of challenge and sign-off (see Acknowledgements). Further input is welcome and the author will be running an engagement programme from October 2023 onwards. Please contact Sarah Gordon at s.gordon3@lse.ac.uk to provide feedback or input, find out how to participate in a roundtable discussion, or explore any of the proposals in this report in more detail.

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1. Opportunities

Opportunities to deploy blended finance approaches at scale in the UK to deliver key policy objectives

A track record of national and international private capital mobilisation is ready to be replicated at scale to support public policy priorities from housing to transport to clean energy and achieving net zero greenhouse gas emissions.

Key points

- **There is a growing evidence base that capital can be invested to deliver positive real-world outcomes as well as financial return.**
- **Demand across the range of private investors for such opportunities is growing.**
- **A combination of the right financial structures and enablers could mobilise billions of pounds of private capital for public policy priorities across the UK.**
- **Mobilising more of the £4.6 trillion in pension and insurance assets for positive financial and economic outcomes would direct significantly greater flows of capital to public policy priorities in the UK.**

There is a body of evidence from the UK and elsewhere showing that capital can be invested effectively to deliver positive economic, environmental and social outcomes, while also delivering a financial return (Impact Investing Institute, 2022). Through 'blended finance' approaches, a variety of investment vehicles – across sectors, asset classes and geographical regions – are using public or philanthropic capital to catalyse additional investments of private sector capital at scale.

Blended finance combines private capital in search of an investment return with other, often more risk-tolerant 'catalytic' capital from public or philanthropic sources. These approaches allow government to take greater advantage of investor appetite for savings and investment products that deliver positive socioeconomic or environmental benefits alongside capital appreciation or income yield.

Blended finance has traditionally been deployed more in development finance contexts than in developed markets such as the UK, although the US and EU are now rolling out significant blended finance programmes. The Organisation for Economic Co-operation and Development (OECD) defines the term solely in the context of emerging markets.[1] As a result, blended finance has been too often defined narrowly as a tool to direct investment into developing economies, ignoring or downplaying its relevance and applicability to developed markets such as the UK. Yet, emerging markets have provided testing grounds for a range of successful blended finance approaches, such as loan syndication platforms (e.g. the International Finance Corporation's Managed Co-lending Portfolio Program) and co-investment by government entities and commercial asset managers (e.g. the Emerging Market Climate Action Fund, created by Allianz Global Investors and the European Investment Bank). Although the operating environments are very different, the design principles underlying these funds and approaches can be translated effectively into developed market contexts.

1. The OECD (2020) describes blended finance as: "the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries. It attracts commercial capital towards projects that contribute to sustainable development, while providing financial returns to investors."

UK-based examples of blended finance in action do exist – as the case studies in this report demonstrate – but they are generally relatively small-scale, and the Government risks missing the opportunity to deploy a blended finance approach in a much more ambitious manner. Concerted action now by government, the finance sector and civil society actors could take advantage of tried and tested models in emerging markets and elsewhere to mobilise private capital at the scale and pace now required to address the UK's most pressing priorities.

Radically increasing the scale of ambition to mobilise private sector capital for policy ends would deliver transformative change. By implementing the approaches outlined in this report, the next five to 10 years could potentially see a far greater percentage of pension and insurance assets in the UK directed to creating resilient and sustainable economic growth. These assets are worth £4.6 trillion, the second-largest pool of long-term capital in the world (Wright, 2023).

Currently, the majority of UK pension fund and venture capital assets are not invested in the UK, and the former has largely vacated the country's listed markets. Defined contribution and defined benefit pension funds in aggregate now allocate only 2% of their assets to directly held UK equities (Brandily et al., 2023). Meanwhile, in 2022, although the UK venture capital sector raised £25.3 billion of capital, slightly above the 10-year average, only 15% of this total was invested in the UK (British Private Equity and Venture Capital Association, 2022).

The proposals in this report are designed to redirect productive investment back into the UK and its private and listed markets, and into sectors that will make the country's economy mopre resilient *and* successful.

Patient capital: lessons from other countries

The conclusions of the Government's 2017 Patient Capital Review, which linked long-term investment with positive economic impact, have since been corroborated by numerous academic studies.

A May 2023 paper by the Economy 2030 Inquiry, jointly run by the London School of Economics and Political Science and the Resolution Foundation, highlighted how increased flows of intentional private investment into specific cities are correlated with significantly improved economic performance (Frick et al., 2023).

It explored how seven cities* across six countries that have faced severe economic shocks managed to break away from cycles of decline and transition to a more successful development path. Among other lessons for the UK that arose from this analysis, the authors called for intentionally designed systems that encourage private investment: "In sum, there needs to be a properly constructed set of institutional vehicles which foster private sector investment into economically weak areas."

The report also calls for greater discretion for UK pension funds in terms of where they can invest: "Potentially, it would be possible to assign some spatially preferential tax incentive in this regard, whereby targeted public funds and preferential tax treatment encourages private capital into priority areas most in need of investment."

*The cities were Dortmund and Duisburg in Germany; Bilbao in Spain; Lille in France; Newcastle in New South Wales, Australia; Windsor in Ontario, Canada; and Pittsburgh in Pennsylvania, USA.

Deep energy retrofit of Erneley Close, by Manchester City Council, an exciting example of a regeneration project in the UK. Nominated for a Passivhaus Award. Photo: Tim Bradley Photography

Trams in Manchester city centre. Photo: Alex West

2. Blended finance actors and instruments

Using a range of **blended finance actors and instruments** to catalyse investment at scale

There are a number of barriers to mobilising private sector capital to help finance public-sector initiatives. One is the risk (perceived or real) that such investments may involve - whether the risk of capital loss, uncertainty of return, or simply concerns about untested business models. Another is reconciling the different priorities of and outcomes sought by public and private investors. Examples from around the world show that these concerns can be addressed using blended finance.

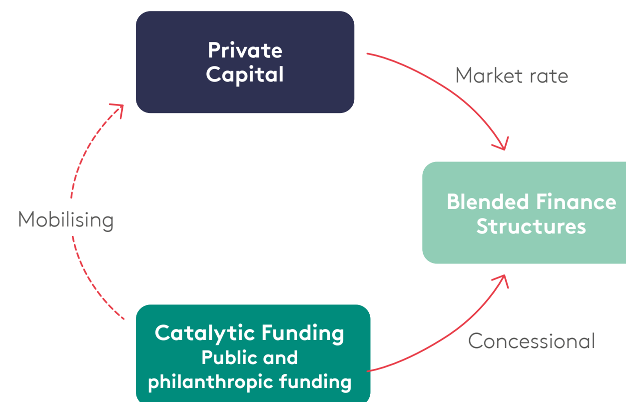
Key points

- Using public sector, philanthropic or other 'concessional' capital that is willing to mitigate risks, and where desired outcomes can be reconciled, can enable the creation of vehicles that deliver significantly greater flows of investment to achieve desired outcomes.
- In this way, public sector capital can 'catalyse' far larger amounts of private capital to help finance public policy priorities.

Blended finance combines private capital in search of an investment return with other, more risk-tolerant 'catalytic' capital that mobilises the former. The key elements are illustrated in Figure 2.1.

Blended finance can enable structures to be tailored to address specific risk/reward concerns of private or institutional investors (including return risk, credit, political and economic risks, and risks associated with untested and innovative business models). This, in turn, allows large, often mainstream, investors to increase exposure into less familiar opportunities, sectors or markets that present strong fundamentals but are associated with high perceived risk.

Figure 2.1. Key elements of blended finance
Combining private capital in search of an investment return with other more risk-tolerant 'catalytic' capital



Source: Adapted from Convergence (n.d.)

Private capital can be provided by major institutional asset owners such as pension funds and insurers, and by philanthropic funders such as charitable foundations. Investment managers may also support blended finance structures on a standalone basis or as part of a diversified strategy.

Catalytic funding providers are parties that can provide risk-tolerant capital to 'catalyse' funding from the private sector. These include public and government institutions (including national lotteries), philanthropic organisations (such as endowments and foundations), and Development Finance Institutions (DFIs), including Multilateral Development Banks (MDBs).

Other key actors in blended finance include social investors, who package and offer financing to charities and social enterprises, which often struggle to access affordable finance from mainstream banks. Blended finance can play a major role in social investors' activities – for example, by combining grant capital from philanthropic organisations or government with investment capital from a bank or investment manager to facilitate unsecured funding on attractive terms. Intermediary organisations and consultants may also link investors and investees, providing knowledge and capability to advise on, structure and market/distribute investment propositions, including blended finance structures.

Transactions that incorporate blended finance span many asset classes, including private equity, private debt/illiquid credit, and infrastructure. As shown in Table 2.1 below, a variety of proven and familiar instruments are also being incorporated into blended finance structures in order to address the needs of different investors and incentivise greater participation.

Table 2.1. Catalytic instruments and policy tools that can be used in blended finance structures

Category	Instruments	Key features	Commentary
Grants	- Repayable and non-repayable grants	Capital that is paid without any expected repayment or compensation	Uses include project/fund design and preparation and technical assistance, enabling projects to become commercially attractive, and early-stage R&D where there are positive externalities or risks investors cannot hedge.
Unfunded instruments/ contingent liabilities	- Guarantees - Insurance - First-loss facilities	Instruments to protect/compensate commercial investors for risk or loss	Can be off-balance-sheet for provider. Reduce tail risk for projects or portfolios, provide a floor on returns, or protect against a specific risk that the market cannot insure/hedge or misprices, including credit, liquidity or currency risks.
Anchor investment	- *Pari passu* [equal footing] equity or debt in sponsored funds and co-investment structures	Initial investment in a start-up, often to serve as a quality indicator to other, often more risk-averse, investors, or those less familiar with the potential investment(s)	A sponsor takes first-mover risk to create a portfolio because it has better information on investments and can monitor at lower cost/provide technical assistance. Crowds in investors as scale is created and risks are spread over a portfolio. Funds will often have different tiers for different risk/reward payoffs. Can be combined with first-loss tranche and/or guarantees.
Concessional return funded structures and securities	- Subordinated debt - Subordinated equity	Subordinated or junior capital protects senior investors by taking a lower ranking and hence prior losses on the value of the security	Commonly priced at a concessionary rate. May be combined with a guarantee or first-loss facility to ensure that the overall risk/return profile attracts commercial investors. A junior tranche introduces loss absorption for commercial senior tranches.
	- Securitisation	The process of transforming a pool of illiquid assets into tradable financial instruments either on a 'true sale' or 'synthetic' basis	Can be used to package loan portfolios from financial institutions into securities that can be tranched into a range of risk–reward profiles to meet the needs of different investors. Has the power to free up substantial amounts of funding on MDBs' and DFIs' balance sheets, providing them with additional capital to reinvest.
Results-based incentives	- Outcomes contracts - Outcomes funds - Development impact bonds	Offer investors incentives to achieve the desired outcomes or results, tying at least a portion of payments to achievement	The payments can go to both investors and service providers and reduce the upfront capital required, assuming targets are met. Results-based payments to investors will typically be funded through the government/DFI/philanthropic-backed element of a blended structure.
Policy instruments	- Tax credits - Subsidies - Risk reduction mechanisms e.g. price floors	Incentives funded by government to offset market failures – either through direct payments or reductions in cost/tax rebates	Can help to crowd in commercial investors by changing the risk/return profile or incentivise investment in areas where there are externalities/spillovers. Can provide markets for hedging risks where they do not currently exist.
Partnerships	- Syndication - Co-creation - Co-management	Typically, partnerships formed between MDBs/DFIs and commercial investors where the latter can benefit from the former's market knowledge, sourcing capabilities, or even their preferred creditor status	Syndication enables MDBs/DFIs to diversify large-scale lending among a range of institutional investors while remaining the sole contractual counterparty. Co-creation partnerships allow multiple parties to come together to form a vehicle or platform for investment. Co-management partnerships typically bring together a mainstream investment manager and a specialist impact manager/DFI to deliver a combined investment offering to attract large-scale investment.

Bristol City Leap – public and private finance collaboration for net zero

In Bristol, a 20-year partnership between the city council, a US cleantech business and a Swedish energy company is showing how government, business and private investors can work together to bring in private capital at scale to solve the country's most pressing challenges.

Bristol City Leap aims to decarbonise England's seventh-largest city by giving business and investors the policy certainty needed to commit for the long term. With an initial focus on the council's own assets, a partnership has been developed with Ameresco and Vattenfall that will direct about £630 million of public and private investment over five years into solar, wind, heat networks, heat pumps and other energy efficiency measures to help Bristol meet its target to be "carbon neutral and climate resilient" by 2030.

The challenges of designing such a partnership should not be understated, but nor should private sector appetite: more than 180 companies expressed interest in being involved. The partnership aims to deliver improved air quality, and higher housing standards and to create more than 1,000 local jobs.

An example initiative is the Bright Green Homes project, with Bristol City Council, North Somerset Council and Bath and Northeast Somerset Council. This funds and supports eligible households to install a range of insulation and low-carbon technologies, including external wall and loft insulation, air source heat pumps, and solar photovoltaic devices.

Which structure or instruments to use will depend on a variety of factors, including the potential risks and market failures to be mitigated, what would best incentivise potential investors in any given situation and the concessions or costs that catalytic/non-commercial investors are willing to accept. As the case studies in Section 3 show, many of these tools have the flexibility to be used individually or in combination to deliver the right proposition to each party.

How context matters in determining when to use blended finance

Blended finance is only one of the financial tools in policymakers' arsenal, and the decision when and whether to use it is not always clear-cut. The UK government is already deploying some of these tools – for example, the guarantee schemes run by the British Business Bank and the UK Infrastructure Bank.

Government will need to consider a number of factors before committing to using the approach to address a given policy need. These factors include identifying the market failure to be addressed, the risks to be mitigated and several other elements (as set out in Table 2.2) in order to ensure that blended finance is the most appropriate approach, and how best to structure an investment vehicle to deliver it.

Table 2.2. Factors to consider when choosing blended finance instruments

Factor	Key questions
Market failure	What market failure is being mitigated (e.g. externalities, capital market imperfections, information frictions [lack of/inability to access knowledge], what required and/or desirable policy priority is not currently addressed by commercial market)? Would the project or programme be funded if catalytic capital is not used?
De-risking	What risks are being mitigated? What tools – e.g. guarantees, first-loss tranches, insurance – would best address these?
Leverage	How can we create the greatest leverage (e.g. ratio of commercial capital to concessional capital/grants)?
Cost	How do we minimise concessionality or other costs to non-commercial funders?
Incentives	Which instrument will provide the optimal incentive structure to funders – both to invest and to achieve the intended outcomes/impacts?
Sustainability	Will the overall structure be sustainable and able to raise commercial funding on an ongoing basis?

In some cases, it can make sense – from a purely financial perspective at least – for government or commercial investors to fully fund a project, enabling interest on investment capital to offset potential losses on concessional capital. In addition, a number of initiatives in recent decades have demonstrated the complexities that blended finance design must take into account in order to achieve desired outcomes as well as value for money.

In particular, robust procurement considerations are vital to ensure that any given instrument maintains its focus on delivering the required public policy outcomes – economic, environmental or social – and that returns do not accrue solely, or disproportionately, to private investors. Social housing, whose funding has been substantially transferred from the public to the private sector, is widely regarded as not having brought the optimal outcomes for residents (The Housing Finance Corporation, 2022).

Careful design of the governance of blended finance structures is therefore critical to ensure that power imbalances between investors do not dilute the focus on the desired policy outcome in favour of a greater focus on financial return. Government will want to apply the lessons learnt from previous blended finance initiatives, such as private finance initiatives (PFI, also known as public–private partnerships) carried out in the late 1990s and early 2000s.

The legacy of PFI provides a disincentive to government to embrace the opportunities now offered by blended finance. Some PFI deals did deliver value for money and the desired outcome but overall, their history and the public perceptions around them are decidedly more chequered. A 2011 report by the House of Commons Committee of Public Accounts found that PFI deals "look[ed] better value for the private sector than for the taxpayer". Among the recommendations it listed to address this challenge in future were more robust analysis by government, more accurate assumptions around tax, and greater transparency of investor and contract information (House of Commons Committee of Public Accounts, 2011).

One way to strengthen government's ability to avoid repeating the mistakes of PFI would be a commitment to improving expertise and skills in both central and local government around blended finance. Intermediating capacity for blended finance deals in the UK is currently scarce, unlike in other countries such as the US where foundations have a strong track record in such a role. The recommendations in this report address how such capacity could be built and shared in future (see Enabler 6).

The approach advocated in this report is not for a new version of PFI, nor for the creation of financing structures that shift public responsibilities off the public balance sheet, or defer costs or liabilities for accounting ends. Instead, it seeks to raise government's ambition to work effectively with private investors for policy priorities, through collaboration, co-design and the use of investment vehicles that are appropriate and attractive to all parties. Blended finance encompasses a range of approaches, which can be tailored to the specific outcomes sought and investors involved. Financial, operational and delivery risk must be shared appropriately between public and private partners, and mistakes in the past, for example setting inappropriate price floors, should inform future project structures and design. It is also worth noting that taxpayer-funded catalytic capital does not have to be concessionary. Co-investment, where the Government acts as anchor investor and also receives a financial return, can be as effective in mobilising private investment.

Critically, there is now a track record across asset classes, sectors and geographies for blended finance approaches that work for all parties, as the case studies in the following section demonstrate. Experience so far also shows that a blended finance approach can present substantial additional benefits in addition to enabling government to achieve outcomes that would not otherwise be affordable.

"Careful design of the governance of blended finance structures is critical to ensure that power imbalances between investors do not dilute the focus on the desired policy outcome in favour of a greater focus on financial return."

For example, bringing together the expertise and perspectives of both public and private funders can deeply enrich the project process, providing opportunities for local authorities and others to increase their experience beyond grant funding by attracting and working with market finance. In turn, improved skills and confidence in this area are likely to encourage more use of non-government capital by local authorities in the future. Blended finance can also devolve decision-making to a more diverse, and often more local, group, potentially leading to better project outcomes, while involving other funders invites additional risk assessment, effectively reducing the risk to government.

Finally, and most importantly in terms of its contribution to speeding up the UK's sustainable economic growth path, blended finance can create a market for a public good, such as clean air or renewable energy, where one does not already exist. As the Green Investment Bank (GIB) demonstrated in the case of wind energy, government may ultimately be able to exit the financing arrangement, leaving behind a sustainable private funding model (see box, next page).

Green Investment Bank – mobilising private capital at scale

Many of the proposals in this report, and the approach towards mobilising private capital that it advocates, have been tried and tested. The Green Investment Bank (GIB), in particular, demonstrates what can be achieved by government-backed institutions with a clear mandate to attract private capital for specific outcomes.

The Government created the GIB in 2012 to bridge the gap between the then-current levels of investment and the amount of investment needed to transition the UK to a low-carbon economy. From 2012 to 2017, the bank provided £3.4 billion in direct funding for projects in energy efficiency, waste and bioenergy, offshore wind and onshore renewables (Matikainen, 2017).

As well as direct investment, the GIB mobilised private sector investment at a ratio of 1:3 – for every £1 the GIB invested, it mobilised another £3 in private capital. The GIB is widely credited with having created a functioning commercial market for offshore wind energy in the UK (Green Investment Group, 2017), and for successful investments in other environmentally significant sectors.

The GIB was able to act not just as a principal lender/investor but as a manager of third-party investment, via a subsidiary regulated by the Financial Conduct Authority. For institutional investors, this provided an initial, relatively low-risk way to 'test the water' in offshore wind projects, with the GIB selecting the investments and conducting due diligence, enabling them to build the confidence necessary to make direct investments themselves.

The GIB did not take venture capital-like positions. Its role was at a more structural, and higher ticket-size level, to reduce commercial and structural risks in the market. This makes it more comparable to the UK Infrastructure Bank, which has an indicative minimum ticket size (debt and equity) of £25 million and a guarantee minimum ticket size in excess of £100 million, than to the British Business Bank and its subsidiaries, which has a focus on small businesses.

In 2017, the Government sold the GIB to a consortium led by Macquarie Group Limited for £2.3 billion. Although a substantial profit was realised from the sale, concerns were raised at the time – and have been since – over whether the GIB's mission would be safeguarded after privatisation (Matikainen, 2017). For many, the decision to sell the GIB at a very early stage of its existence represented a missed opportunity for future targeted investment into sectors of the UK economy where there was both significant need for a state investor to address market weaknesses, and the potential for the UK to be a global market leader.

Whatever the pros and cons, the GIB provides useful lessons for policymakers seeking to replicate both its focus on sectors of the economy where investment needs to be stimulated, and its success in mobilising private capital at scale. These include ensuring that institutional mandates, such as framework documents, make clear that private capital mobilisation is a priority, and requiring the reporting of quantitative as well as qualitative key performance indicators associated with crowding in private investment – for example, a leverage ratio and/or quantum over time.

UK initiatives must also take into account the international context. Other governments are pursuing large-scale blended finance initiatives, which are successfully attracting investment both nationally and internationally. These include the US Inflation Reduction Act (IRA), which directs nearly $400 billion in federal funding to clean energy, with the goal of substantially lowering the nation's carbon emissions by the end of this decade (Jenkins et al., 2022). The funds will be delivered through a mix of tax incentives, grants and loan guarantees (Badlam and Cox, 2022), and analysts estimate that the IRA will unlock $3 trillion in private sector investments over the next decade (Boushey, 2023). In the EU, the Green Deal commits over €1 trillion to transition member countries to a sustainable economic model (European Commission, 2019). A key element of the Green Deal is the InvestEU programme, which aims to use guarantees from the EU budget to crowd in €372 billion in additional public and private investment (European Commission, n.d.). For further details on the IRA and the EU Green Deal, see Appendix 1.

Without a significant step-up in its own use of blended finance for sustainable growth, the UK risks falling further behind its global competitors. The following sections provide case studies demonstrating the range of blended finance solutions available to the UK, and a set of enablers that would significantly increase the flows of private capital into such solutions.

3. Case studies

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Case studies – blended finance in action

Initiatives in the UK and internationally show how blended finance could be scaled up to address funding needs across multiple sectors.

Key points

- There are many replicable examples of blended finance being deployed successfully to meet specific infrastructure, social care, environmental and climate action goals in the UK and internationally.
- Financing can be adapted to the risk appetites, outcome expectations and preferred investment terms of a variety of investors to attract scale investment.
- In addition, investors can be encouraged to enter new sectors and assets with a high level of comfort.

Blended finance has mobilised approximately $200 billion to date in developing countries (Convergence, n.d.). There are no current estimates of its total use in the UK, nor in other markets in the global North, but the previous section has described how the US and the European Union in particular are ramping up their use of blended finance to address their investment needs. The British Business Bank has used blended finance approaches in, for example, the Future Fund to support UK businesses during the pandemic, and the UK Infrastructure Bank has a target of deploying £2.5 billion in guarantees a year, but such activities are at a relatively small scale compared to the country's investment needs.[2]

2. It is worth noting that there is no data available on the total amount of blended finance deployed in the UK, nor evaluation of its impact.

There are a number of existing examples, though, that provide models which could now be replicated at scale. This section sets out 13 such case studies, from the UK and emerging markets, that demonstrate how blended finance is effective in supporting sectors in which the UK has comparative strengths: projects that can deliver support for dynamic small businesses, net zero objectives or the goal of improving opportunities for disadvantaged groups. These case studies showcase the range of private actors (institutional asset managers, social investors, grant funders) and demonstrate that blended finance provides a tested model in which public and private investors can work together.

Any of these initiatives could be replicated and adapted to different sectors and problems. But, as explained in Section 4, any could be emulated at greater scale if the right policy and regulatory support were put in place.

Note on methodology

Case studies and examples in this report have been chosen from a range of UK and international blended finance initiatives, either because they are long established and have a track record of success, or because they address specific and urgent policy priorities in the UK, such as the transition to renewable energy, or the need to provide housing for homeless people.

"These case studies showcase the range of private actors (institutional asset managers, social investors, grant funders) and demonstrate that blended finance provides a tested model in which public and private investors can work together."

UK-BASED

Case study 1: Mayor of London's Energy Efficiency Fund

London aims to reach net zero carbon emissions by 2030, but historic financing of its low-carbon infrastructure has been fragmented and at nowhere near the scale required to enable the city to go fossil fuel-free at the speed required. The MEEF aims to address these failures.

The Mayor of London's Energy Efficiency Fund (MEEF) is a £500 million-plus investment fund, established in 2018 by the Greater London Authority (GLA) with funding from the European Commission. The fund is managed by Amber Infrastructure Group.

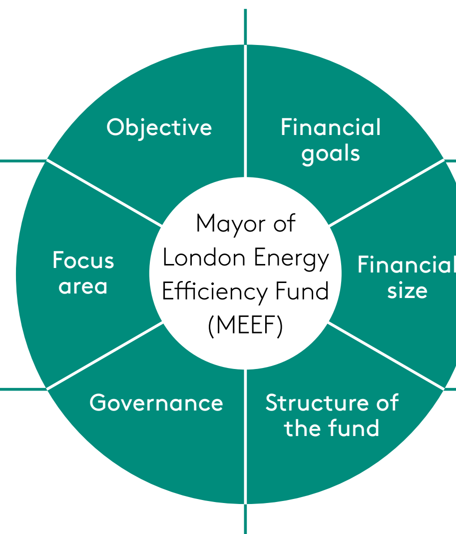
MEEF seeks to address market failures in London's low-carbon sector by providing flexible and competitive finance to enable, accelerate or enhance viable low-carbon projects across the capital. To cater to the different risk appetites of investors, MEEF comprises both senior (low-risk) and junior (high-risk) debt tranches. The public money provided by the GLA/European Regional Development Fund (ERDF) principally funds junior tranches, accepting the potential capital risk of market failure, enabling private investors, including commercial banks, and other fund investors to allocate to the lower-risk senior debt. The GLA has committed £101.4 million, which in turn has enabled Amber Infrastructure Limited to secure £456 million from private investors – close to five times the public funding.

Features of the Mayor of London Energy Efficiency Fund

Thematic objective:
- Support London's transition to low-carbon economy: reduction of CO_2 emissions by 60% until 2025

Investments in:
- Energy efficiency measures and retrofitting
- Renewables and decentralised energy

Governance:
- Established by GLA
- Governance bodies: Advisory Committee, Internal Monitoring Committee, Investment Committee, Independent Fund Manager



Committed goals:
- Attraction of private capital (at least £260m)
- Leverage effect of the ERDF funds: 10x

Financial size:
- GLA funds: £101.4m
- Private capital: £456m

Financial products:
- Debt (90%)
- Equity (10%)

Source: Updated from European Investment Bank (2018) and MEEF

MEEF has invested in small and medium-sized enterprises (SMEs), and NHS and Local Authority projects across London. These include innovative projects such as electric vehicle charging infrastructure combined with energy storage, a retrofit of a district heat network with water source heat pumps, and an energy performance contract with guaranteed savings for the NHS. The MEEF investment policy was extended in 2020 to cover zero emission mobility to align with the Mayor of London's air quality targets. Between its launch in July 2018 and September 2023, MEEF mobilised over £390 million and reduced London's CO_2 emissions by more than 30,250 tonnes, equivalent to taking 27,500 cars off the road.[3]

3. Source: https://www.amberinfrastructure.com/our-funds/the-mayor-of-londons-energy-efficiency-fund/

UK-BASED

Case study 2: Growth Impact Fund

The economic and social impact of Covid-19 and the subsequent cost-of-living crisis have highlighted existing structural inequalities across the UK. Large-scale funding is needed to increase access to opportunity and address the exclusionary barriers marginalised communities face; the Growth Impact Fund has been established to do this.

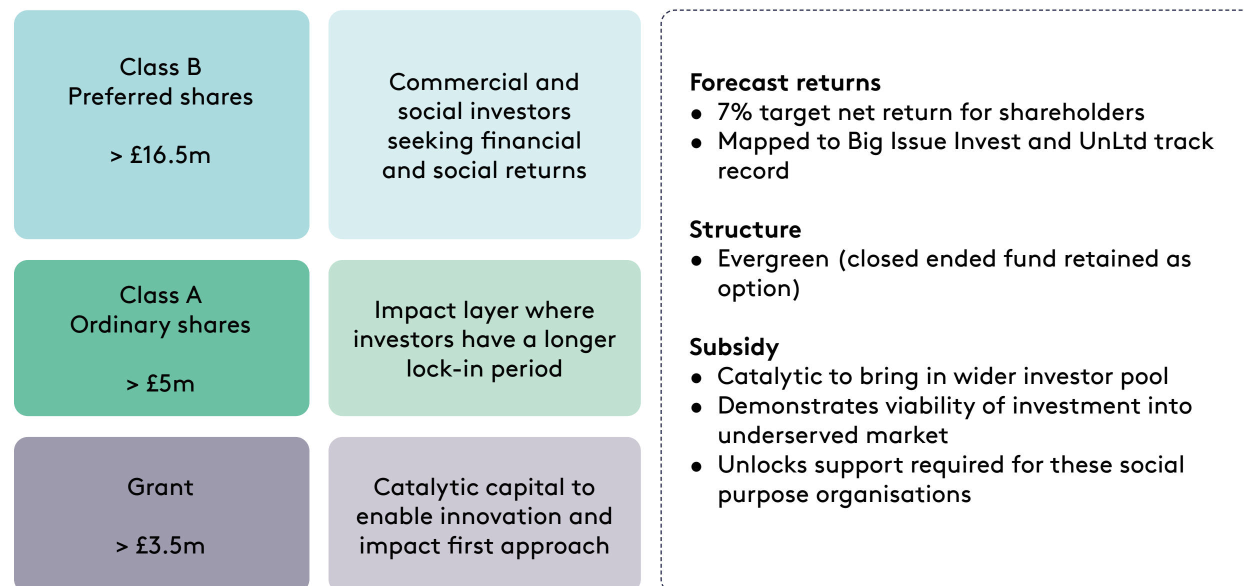
The Growth Impact Fund is a blended capital fund, launched in 2022 by social investment specialists Big Issue Invest (BII), UnLtd and Shift, to tackle inequality in the UK. It has a target size of £25 million, and an initial five-year investment period, providing patient and flexible capital to social purpose organisations (SPOs) that combine sustainable business models, job creation and a focus on social justice.

At least 50% of the fund's investments are to be made to SPOs with leaders from diverse backgrounds, with other investees supported to improve their equity, diversity and inclusion. The fund is accompanied by a bespoke £3 million technical assistance facility (TAF) to provide technical support to investee SPOs. Seventy per cent of the fund's capital will be deployed into equity or quasi-equity investment products, and the other 30% will provide patient and affordable debt products.

The fund is made possible by offering competitive returns and significant impact to investors, through a three-tiered structure: a grant layer, a social/impact investment tranche, and a social and commercial investor layer. Both investment layers have a target 7% net return, but the social investment tranche has a longer lock-up period. These returns are supported by the £3.5 million grant layer, which subsidises upside returns and provides downside protection for investors.

Grant funding is provided by Access, the foundation for social investment, and Bank of America Foundation. Philanthropic funders can also participate through grants in the catalytic capital layer and in the TAF.

Grant/share structure of the Growth Impact Fund



Source: UnLtd

Revenue participation agreements

SPOs are given the flexibility to repay the fund at a point when their revenue affords them the liquidity to do so. These agreements may also be structured, depending on the investees' needs, in ways that allow an SPO to retain more cash to reinvest at an early stage (for example, starting with low revenue participation rates and increasing as the SPOs grow). Grace periods and return caps can also be used to provide more flexibility.

UK-BASED

Case study 3: Arts & Culture Impact Fund LLP

The UK's strengths as a services exporter stretch across a broad range of high-value tradable services, including cultural ones. However, the arts and culture sector is in financial crisis in the aftermath of Covid-19, and with government funding for the arts down 46% in real terms since 2005.[4] The Arts and Culture Impact Fund was set up as one form of support to the sector.

A growing scarcity of grants from all sources means that arts and culture social enterprises increasingly need to look at repayable finance to fund their activities, but these enterprises find it difficult to access affordable lending.

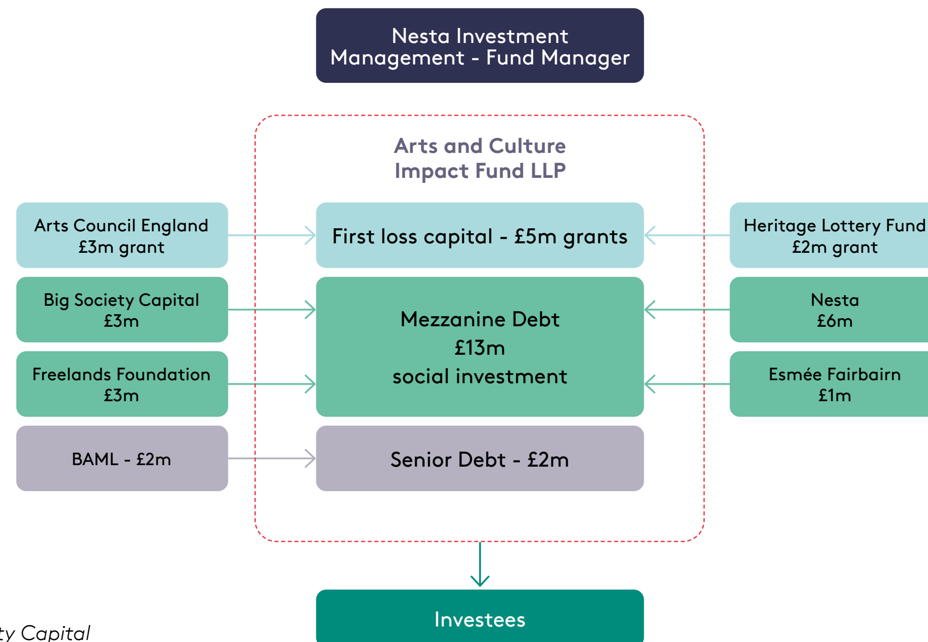
Arts & Culture Finance, a division of innovation foundation Nesta, launched the Arts & Culture Impact Fund in March 2020 to provide arts, culture and heritage organisations with affordable (3–8.5% interest rates, with a base-rate floor), flexible (£150,000 –1 million) and unsecured loans, repayable by May 2030. The fund's investors include public, private and philanthropic funders such as Arts Council England, the National Lottery Heritage Fund, Big Society Capital, Bank of America, the Esmée Fairbairn Foundation, Freelands Foundation and Nesta. At launch, it was believed to be the world's biggest impact investment fund for the cultural and creative sector.

To encourage investors to support unsecured lending to this largely untested sector, the £20 million fund has a three-tranche structure to tailor levels of reward and risk: a concessional, first-loss tranche of £5 million in repayable grants; a mezzanine layer of £13 million provided by social investors, which pays a return to reflect its risk profile; and a senior debt layer of £2 million, which is marketed to private investors – its lower rate of return reflects its low credit risk, making it attractive to risk-sensitive debt investors.

The blended finance structure has enabled substantial levels of financing to be catalysed for arts, culture and heritage organisations. By scaling up the availability and affordability of repayable finance, it is hoped arts organisations with social aims can improve their prospects for sustainable growth, supported by both grants and return-seeking investment.

Photo: Nesta

Tranched structure of the Arts & Culture Impact Fund



Source: Big Society Capital

4. Musicians' Union (2023)

UK-BASED

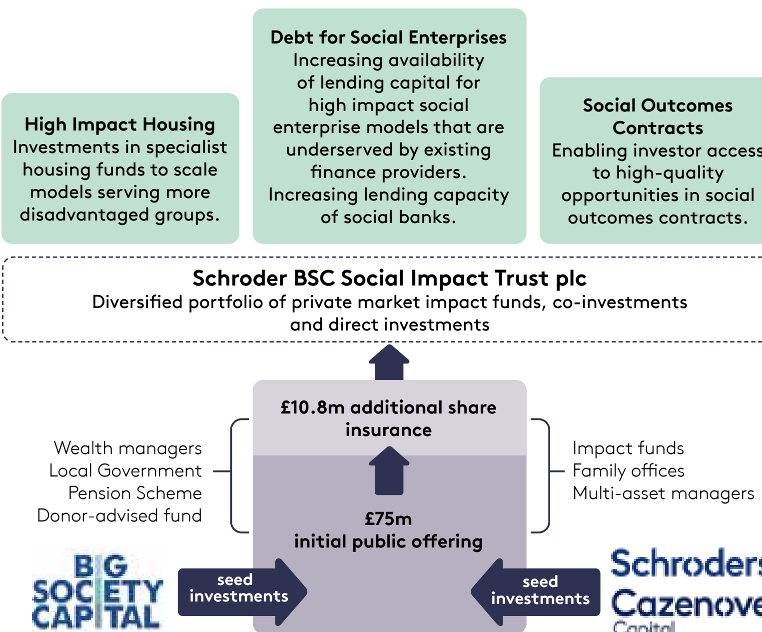
Case study 4: Schroder BSC Social Impact Trust

Research by the Financial Conduct Authority (2022) has shown that 81% of adults would like their investments to do some good as well as provide a financial return. However, accessing private markets, where social or environmental impact is often most effectively delivered, can be difficult for retail investors, given high minimum investment requirements, long ramp-up periods, concentration risk and limited expertise. The Schroder BSC Social Impact Trust (SBSI) is designed to provide a liquid vehicle for wealth managers, advisers and their clients to participate in private impact markets.

SBSI, listed in December 2020, invests in a diversified portfolio of private market impact funds, co-investments and direct investments, focusing primarily on supporting social enterprises, high-impact housing and social outcomes contracts across the UK. The fund's publicly-traded structure ensures daily liquidity for investors.

To catalyse SBSI's initial public offering (IPO), social investor Big Society Capital (BSC) provided a seed portfolio of investments alongside investment from Schroders and its wealth management arm, Cazenove Capital. This enabled the trust to raise £75 million from its IPO in December 2020. In November 2021, it raised a further £10.8 million through a share issuance to investors. In exchange for providing the seed portfolio of proven and well-performing investments, BSC retained an equity stake in SBSI and also received cash payment, enabling it to redeploy some of its capital into other impact investments.

Funding structure of the Schroder BSC Social Impact Trust



Source: *Shamash et al. (2023)*

The Schroder BSC Social Impact Trust aims to deliver measurable positive social impact across the UK[5] as well as long-term growth and income, and to have low correlation to traditional public markets. Since its launch, through funds and co-investments, it has committed £35 million to housing, £41 million in debt and equity to social lending and £8.3 million to social outcomes contracts. It has also supported 168 frontline organisations and reached 276,000 people, 94% of whom are disadvantaged, vulnerable or underserved (Shamash et al., 2023). In August 2023, the fund was trading at a discount of 11% to its net asset value, in line with current valuations in the investment trust sector.

The fund's publicly-traded structure ensures daily liquidity for investors concerned about the long-term nature of private market investments.

5. Using the Impact Management Project Framework for assessing impact at the fund and investee company level.

UK-BASED

Case study 5: Resonance Homelessness Property Funds

As property rents and mortgage interest rates have risen, so too has the need for affordable housing, to provide safe and decent homes for people across the UK. Resonance has two homelessness property funds to provide affordable homes.

Resonance is one of the UK's leading social impact investment companies and currently manages about £350 million of investors' capital across 11 operational funds, including two National Homelessness Property Funds.

Resonance invests in properties which it refurbishes and then leases to expert housing partners to provide safe, affordable homes, with rents usually linked to the Local Housing Allowance (LHA). Tenants are also supported by the housing partner in areas such as training and employment to help prepare them for independent living in the private rented housing sector in the future.

National Homelessness Property Fund 1 (NHPF1) was launched in 2015 and raised £43.6 million from socially motivated investors to buy a portfolio of 229 homes across Bristol, Oxford and Milton Keynes. The second fund (NHPF2) was launched in December 2020, with a six-fold target fund size of £300 million to purchase 1,500 homes across UK regions.[6]

Both funds blend private capital with public funding from local government programmes. Investors include institutional and certified sophisticated investors, local authorities and pension funds, in particular local government pension schemes like the Greater Manchester Pension Fund. NHPF2 has a target net Internal Rate of Return of 6%.

As place-based social impact investments, Resonance Homelessness Property Funds are providing an opportunity for local authorities and local government pension funds to invest in affordable housing in their own geographical area, enabling them to address local housing crises directly. To date, more than 3,000 people have been housed through the funds, and the aim is for this total to surpass 16,000 over the lifetime of NHPF2.

6. See Resonance National Homelessness Property Fund and Resonance National Homelessness Property Fund 2

Tenants are supported to help prepare them for independent living in the private rented sector. Photo: Resonance

UK-BASED

Case study 6: Bridges Outcomes Partnerships

Social challenges can be difficult to solve with standardised solutions. Bridges Outcomes Partnerships works to offer a more personalised approach by facilitating the devolution of decision-making to local areas and communities, and designing investment vehicles in response.

Bridges Outcomes Partnerships is a not-for-profit subsidiary of Bridges Fund Management. Social investors supporting its work include the Office for Civil Society, the Esmée Fairbairn Foundation, Development Bank of Japan, European Investment Fund, Merseyside Pension Fund, Greater Manchester Pension Fund, and many others. Since 2012, Bridges Outcomes Partnerships, via four funds, have supported over 70 innovative projects to improve the lives of underserved children and adults in the UK and globally.

Often, a more personalised and holistic approach is needed to address complex, interconnected social challenges such as homelessness, childhood deprivation or young people moving out of care – one that looks at the 'whole' person and empowers them to help themselves and create sustainable change in their lives. Social challenges are not being addressed effectively using traditional design and contracting methods and there are many local public services across the UK that are significantly underperforming. Difficulties can arise when individuals have to interact with many different state services (like homelessness prevention, support for people with long-term conditions, and services helping families stay together), exacerbated by the fact that coordination between services tends to be poor.

An outcomes partnership creates the conditions for decision-making to be devolved to local areas, and to those closest to the problem, and simultaneously improves data and learning as well as accountability that can be supplied to central government. It also delays payment by government as social investors provide upfront risk and working capital to mobilise the delivery and are repaid only when progress milestones and improvements in people's lives are achieved. This has been shown to deliver significantly better outcomes and better value for money than previous methods, as evidenced by recent research published by Big Society Capital (2022).

Projects include:

- **Greater Manchester Homes Partnership**: a project to address long-term homelessness across the city-region, which reduced homelessness by over 60% over three years at a cost 70% lower than comparable services.
- **Thrive North East Lincolnshire**: a community-led service creating sustained lifestyle changes for people with long-term health conditions. Over five years the service has helped 1,500 people to have 35% lower hospital costs than the control group, while reducing GP usage by 11% (Big Society Capital, 2023).
- **Refugee Better Outcomes Partnership**: supports refugees with housing, employment and community integration (see box, next page).

Outcomes partnerships differ from traditional state-funded programmes in three key ways:

- They take a more collaborative approach to project design, drawing on the expertise of frontline teams and those who use the service.
- They take a more flexible approach to delivery, giving frontline teams the freedom to tailor the service to each individual's circumstances, with a focus on continuous improvement.
- Finally, there is much clearer accountability for the results the project delivers – since government pays only for clear, verified outcomes.

To date, more than 70 projects and 48,800 people have been supported by Bridges' funds, which have received over £129 million of successful outcomes payments from the Government. A recent report by Big Society Capital suggested that every £1 spent on outcomes payments is worth over £10 to the state (Big Society Capital, 2022).

UK-BASED

Case study 6: *Bridges Outcomes Partnerships continued*

Project example: Refugee Better Outcomes Partnership

Refugees face multiple barriers to self-sufficiency in the UK. Prior to Covid-19, refugee employment levels were 20% lower overall than for the wider population, and 30% lower for refugee women compared with UK-born women. Refugees also face challenges in relation to housing, dealing with poor mental health, English language skills and making social connections.

The Refugee Transitions Outcomes Fund is a £14 million initiative commissioned by the Home Office, Department for Digital, Culture, Media and Sport and Department for Work and Pensions (via the Treasury Shared Outcomes Fund). It aims to support refugees who have come through the asylum process, in areas with high asylum seeker dispersal rates.

As part of this initiative, Bridges created the Refugee Better Outcomes Partnership (RBOP) and teamed up with local partners to secure funding for two new refugee support partnerships, one in Plymouth and one in the north-east of England.

On receiving a positive decision from the Home Office on their refugee status, a refugee has 28 days before being evicted from asylum accommodation. Starting from the point of a positive decision, RBOP provides housing, employment and integration support to a refugee, supporting their transition into the community.

RBOP launched in late 2021. As of March 2023, over 1,150 refugees had started the programme, 964 of whom had completed integration plans; 451 refugees had secured accommodation and 172 had entered into employment. The team continues to work with these refugees to move them into safe housing, secure employment, and integrate with their local community. The programme is expected to run until March 2024.

Above: An ‘Amazing Woman’ workshop for female clients to build confidence and self-esteem at ‘Somewhere Else’ in Stockton.

Above: Lili and Mayensi who have started their own El Salvadorian food business catering the NE RISE Anniversary celebration event.
Left: Notash after passing her driving test. Notash now works in the accounts team at RISE. All photos: Bridges Outcomes Partnerships.

UK-BASED

Case study 7: Care & Wellbeing Fund

The UK's healthcare system is struggling with capacity issues and is further hindered by an annual budgeting process that prioritises emergency care over preventive measures – and limits opportunities for innovation. The Care and Wellbeing Fund has successfully tested whether social investment can support sustainable innovation and transformation in the sector.

End-of-life care is an important example of a part of the system that is struggling to meet people's needs. Hospital end-of-life care costs an average of £4,500 per person compared with £1,000 if people die in their home or community. Despite 79% of individuals expressing a preference for dying at home, only half are able to do so, primarily due to inadequate community-based services, inconsistent service provision, and lack of integration between hospitals, community care and private care.

Social Finance is a non-profit organisation that helps to design, fund and scale-up better solutions to complex social problems. In 2015 it launched the Care and Wellbeing Fund (CWF), in partnership with Big Society Capital and Macmillan, a proof-of-concept fund to test whether social investment could support sustainable innovation and transformation in health and social care. The fund is also a relatively rare example of using charitable funds for social investment rather than as grants to deliver impact. Social Finance collaborated in its development with organisations including the Department of Health and Social Care and the NHS Confederation.

CWF was established as a funding vehicle, supported by a £750,000 development grant from the Health Foundation and Macmillan. CWF was able to attract £12 million from Macmillan and Big Society Capital, and the fund succeeded in incorporating innovative social outcome contracts to support the funding of end-of-life care services that agreed to pay financial returns contingent on specified 'care' outcomes being achieved.

The CWF model empowers charities or other philanthropic/state entities to invest for the long term rather than simply granting one-off resources. At a minimum, there is the expectation of recovering those funds, but also the potential to make a return on the investment, to be reinvested or recycled back into the care system.

CWF comprised 14 outcome-focused investments, seven of which were involved in end-of-life care. Top-up funding to finance the cost of successful outcomes for CWF's investments was provided by central government, through the Commissioning Better Outcomes Fund and the Life Chances Fund.

"Social investment for transformation has significant value... when you are managing substantial system pressures, at risk investment allows systems to test new models of care..."
CFO, NHS Foundation Trust

To date, nearly 200,000 people have benefited from CWF'S 14 investments in health and social care; £8.5 million has been invested in end-of-life care projects by CWF and £4.7 million in community care, and £12.6m in outcomes payments have been received (£8.5m in end-of-life care and £4.1m in community care).

Photo: Andresr, istock

INTERNATIONAL

Case study 8: AfricaGrow

Africa is a growth market with enormous potential, and is home to six of the world's 10 fastest-growing economies. For small and medium-sized enterprises (SMEs) in particular, the continent provides tremendous opportunities for trade and investment but more finance is needed, which fund-of-funds AfricaGrow is designed to provide.

There is a major financing gap to fund young enterprise across Africa – created by a lack of traditional bank funding, lack of knowledge among enterprises over how to access financing, and investor perceptions of risk surrounding SME investment. AfricaGrow is a fund-of-funds, managed and structured by Allianz Global Investors, domiciled in Germany and set up in 2019, to promote SMEs and start-ups primarily in African countries associated with the G20 Compact with Africa (CwA). The design and structure of the fund – a blend of public and private finance – is targeted at closing existing financing gaps and building a solid equity base for African SMEs.

AfricaGrow aims to support 150 SMEs and start-ups by investing in regional and country-specific private equity (PE) and venture capital (VC) funds with proven track records and capacity. It is currently invested in about half a dozen funds. The fund has a five-year investment period; it will invest €5–15 million in VC funds, and €10–20 million in growth equity funds. Although the fund's performance data are not public, it has so far achieved both the impact and financial return goals set for investors.

The fund applies sustainability objectives to its investments, using an index-based Development Effectiveness Rating guided by the UN Sustainable Development Goals. The objectives include: long-term change by job creation, local income ignition, market development, environmental responsibility and community benefits.

The fund seeks to have a catalytic effect on the African SME and start-up ecosystem, and thus contribute to the promotion of jobs and income, as well as strengthening sustainable economic growth.

Of the fund's €200 million in assets, €100 million comes from Germany's Federal Ministry for Economic Cooperation and Development (BMZ), €30 million from a subsidiary of Germany's development bank, KfW, the German Investment Corporation (DEG), and €70 million from Allianz companies. An additional €15 million is provided by BMZ to fund a technical assistance facility (TAF).

AfricaGrow hopes to catalyse the emerging private equity and venture capital market across Africa via the TAF. This will support not only AfricaGrow's target funds, and their company portfolios, but also the development of the overall African PE/VC market.

The fund's investment approach aims to address the ecosystemic efforts required to improve skills in the African PE and VC sector, and meet the needs of investors for long-term cash flows and returns while generating a measurable social impact.

Project example: AfricaGrow and Aerobotics – using artificial intelligence in agriculture

The South African company Aerobotics has developed a machine-learning technology that optimises agricultural processes and conserves resources. High-resolution and multi-dimensional images taken by mobile devices, drones and satellites are used to supply tree-level data on plant stocks, size, health, pest infestation and chlorophyll values. The company also uses this data to provide farmers with bespoke insurance products, tailored to farms' requirements.

Farmers can use this information in a targeted manner to improve their efficiency, reduce resource wastage in irrigation and fertiliser use and avoid harvest losses. Thanks to venture capital funding from the Cathay AfricInvest Innovation Fund (CAIF), in which AfricaGrow invests, Aerobotics is now advancing its machine-learning algorithms and widening its product portfolio.

Aerobotics has over 50 employees, more than 90% of whom work at the headquarters in Cape Town.

Drone monitoring of crops. Photo: Aerobotics

INTERNATIONAL

Case study 9: ILX Fund 1

Private sector loans can present a direct and targeted means to fund essential projects in developing economies, from infrastructure to economic resilience, food security, climate change action and mitigation. ILX Fund 1 directly targets sustainable development and climate finance projects.

The scale of capital now required for essential infrastructure projects globally goes beyond what taxpayer-funded development finance can provide. New solutions are required that enable Development Finance Institutions (DFIs) to leverage institutional pools of capital at scale.

ILX Fund 1 is an emerging-market-focused private credit fund, managed by Amsterdam-based manager ILX. The fund gives institutional investors access to investment opportunities in development finance assets, by investing in private sector loans arranged by Multilateral Development Banks (MDBs) and DFIs, targeting sustainable development and climate finance. Its investment strategy benefits from the DFIs' experience of investing in emerging markets, while its strategy of selectively co-investing with a broad range of leading DFIs provides investors with both diversification and scale.

By co-investing with DFIs, ILX directly contributes to the climate change mitigation and adaptation objectives of the Paris Agreement, aiming to limit global warming to 1.5°C.

ILX's managers believe that traditional blended finance, which incorporates subsidy elements, risks actively discouraging the creation of sustainable and thriving markets unless carefully targeted at frontier situations. ILX Fund 1 therefore invests in syndicated loans originated and structured by leading MDB/DFIs, co-investing *pari passu* with these organisations in private sector loans in emerging markets.

Syndicated DFI-loan participations are familiar to investors from their 30-year history in the market. These loan participations provide medium- and long-term finance to projects and companies across core sectors in emerging markets, focusing on four themes:

- **Energy access and clean energy:** includes projects that provide access to electricity, renewable energy, and efficient use of energy resources
- **Sustainable industry and infrastructure:** includes projects that contribute to sustainable industry and social infrastructure that drive employment, economic efficiency and competitiveness
- **Inclusive finance:** includes projects that contribute to increasing access to finance for small and medium-sized enterprises, women entrepreneurs and green projects
- **Food security:** includes projects that contribute to increasing food security and nutrition.

Donors that have supported the development and incubation phase of the fund include the Federal Ministry for Economic Cooperation and Development on behalf of the German Ministry for Development Cooperation (BMZ), the Netherlands' Ministry of Foreign Affairs, and the UK Foreign, Commonwealth and Development Office (FCDO).

ILX Fund I launched in January 2022 with a $750 million commitment from the Dutch pension provider APG on behalf of pension funds ABP and bpfBOUW. In June 2022, the fund reached its target fund size of $1 billion, with a commitment from Achmea Investment Management on behalf of Pensioenfonds Vervoer bringing the total to $1.05 billion. Pensioenfonds Vervoer and APG are among the largest pension fund investors in the Netherlands (and the EU) and among the first institutional investors to target sustainability actively as part of their investment mandate.

Next steps

- In 2023, the European Bank for Reconstruction and Development (EBRD), the EU and ILX Management announced a partnership to boost private sector finance in eastern Europe, the Caucasus, the western Balkans, Turkey, the southern and eastern Mediterranean and central Asia.
- The partnership is expected to facilitate co-financing by Dutch and other European pension funds of up to €300 million over the next three years.
- The investments will be supported by EU guarantees through the European Fund for Sustainable Development Plus (EFSD+) Guarantee Programme. The EFSD+ guarantee structure will enable ILX to co-invest with the EBRD at the same risk-return profile.

INTERNATIONAL

Case study 10: IFC's Managed Co-Lending Portfolio Program

Infrastructure investment plays a crucial role in fostering economic growth and has been proven to promote other development priorities such as improved economic opportunities and life outcomes for marginalised groups. The International Finance Corporation (IFC) is encouraging such development through a syndications process.

Institutional investors have been active participants in infrastructure financing in advanced economies. But when it comes to emerging markets, a lack of investment-grade assets, regulatory uncertainty and limited data about asset performance can deter large-scale institutional investment.

The IFC, a member of the World Bank Group, works to encourage private sector development in developing countries. Its Managed Co-Lending Portfolio Program (MCPP) is key to this work: the programme enables outside investors to participate in the IFC's senior loan portfolio via a syndications process.

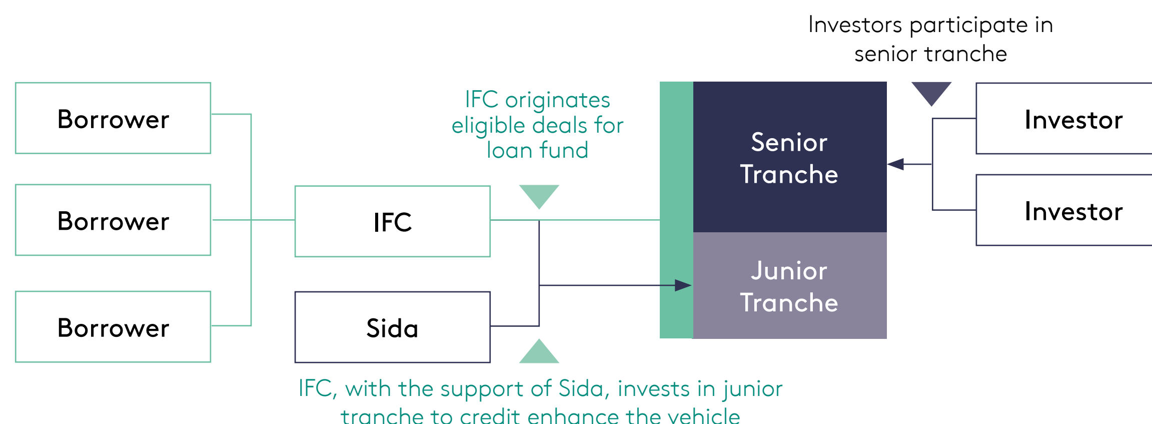
The MCPP Infrastructure initiative was launched in 2016 to attract institutional investors seeking to increase their exposure to emerging market infrastructure debt – in this case, providing financing for power, transport, water and telecoms projects. It is built around a diversified loan portfolio mimicking IFC's own portfolio of infrastructure investments (similar to an index fund) and thus enables investors to benefit from IFC's diversification and expertise across countries and sectors.

One of the major barriers to institutions allocating more assets to infrastructure is their preference for lower-risk debt assets. MCPP Infrastructure addresses this by providing a first-loss tranche of up to 10% of each investor's portfolio, which has the effect of enhancing the vehicle's credit profile to investment grade. A guarantee from the Swedish International Development Cooperation Agency (Sida) is provided on a portion of IFC's first-loss position in exchange for a guarantee premium. By significantly reducing IFC's capital requirement for the first-loss tranche, the Sida guarantee frees up capital that can then be used to replicate and scale up the model.

It has been estimated that the innovative structure of MCPP Infrastructure potentially allows $10 of institutional financing to be leveraged for every $1 invested in the first-loss tranche.

This first-loss tranche-with-guarantee model has focused on attracting institutional investment into higher-risk emerging markets, but could be deployed for many UK funding needs where credit enhancement is required to attract institutional investment.

MCPP Infrastructure – creating an investment-grade emerging market infrastructure opportunity



Source: International Finance Corporation, IFC Project Information and Data Portal, MCCP Infrastructure

INTERNATIONAL

Case study 11: Emerging Africa Infrastructure Fund

The Emerging Africa Infrastructure Fund finances infrastructure in Africa's youngest markets, often in fragile states recovering from disease, armed conflict or natural disaster. Private involvement in these countries is low and mainstream financial institutions often do not lend in such high-risk places – although the need for basic infrastructure across these young economies is extensive.

A vehicle was required that could attract large-scale investment for infrastructure development by leveraging concessional donor funding to mobilise private-sector investment. The Emerging Africa Infrastructure Fund (EAIF) was launched in 2001 to raise and deploy public and private debt capital to deliver transformative infrastructure projects across sub-Saharan Africa. It is managed by Ninety One, one of the largest third-party investors in credit, private equity, public equity and sovereign debt across Africa.

EAIF was the first company within the Private Infrastructure Development Group (PIDG) – a multi-donor organisation that mobilises private investment in infrastructure in the frontier markets of sub-Saharan Africa, south and south-east Asia. PIDG is funded by government donors in the UK, Switzerland, Australia, Norway, Sweden, Netherlands, Germany and the World Bank Group. EAIF provides long-term, flexible, commercial debt capital to infrastructure projects developed by the private sector, and to businesses operating in eligible sectors and countries in Africa. Project and corporate finance is available to be structured in a range of different ways – see table.

EAIF infrastructure funding instruments	
• Diverse debt instruments • Senior debt • Subordinated and/or mezzanine debt • Loans in $ or € for periods of up to 20 years • Local currency loans possible in certain circumstances • Anchor or cornerstone investor in bond issues • Bridging finance	• Underwriting capacity • Structuring and arranging • Sole lender or within a syndicate • Lead or joint arranger with other financial institutions • Viability, technical and environmental grant support to qualifying projects • Introducing clients to other PIDG businesses where appropriate

EAIF's anchor shareholders are the UK, Dutch, Swedish and Swiss governments. It also periodically raises debt capital from private investors including Allianz, Standard Chartered Bank, Standard Bank, and DFIs including the African Development Bank, FMO in the Netherlands, and KfW in Germany.

To attract private debt financing, the fund features:

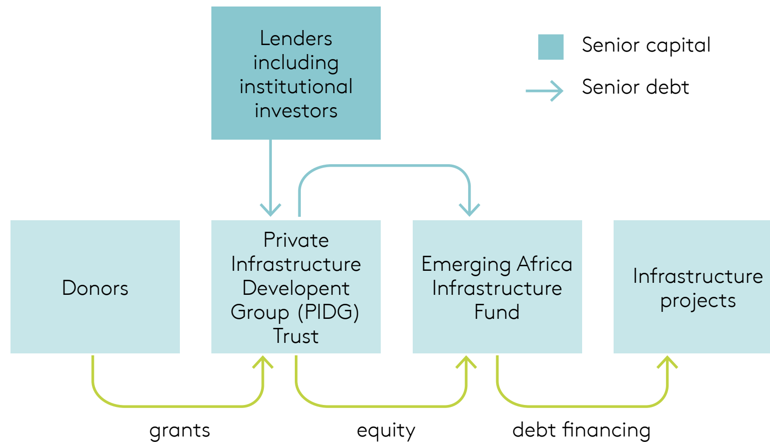
- **$491 million in first-loss equity** made up of contributions by PIDG members on sub-commercial terms (no dividend distribution, profits retained) and retained earnings. As in a normal company capital structure, losses would initially be absorbed by this equity to reduce the risk to senior debt holders.
- **$627 million in senior debt** provided by commercial banks, institutional investors including insurance companies, MDBs and DFIs on commercial terms.

An institutional investor perspective

In 2018, Allianz committed to providing debt financing of €75 million and $25 million, both over 12 years, to EAIF, arguing that EAIF fitted well into its international investment strategy. Claus Fintzen, chief investment officer for infrastructure debt at Allianz Global Investors, said that the deal structure meant its loans were "risk remote" as they were backed by collateral in more than 40 projects. He added that Allianz's fiduciary responsibility was satisfied given the interest rate was "more attractive than listed emerging market debt available on the market" (Impact Investing Institute, n.d.).

Case study 11: *Emerging Africa Infrastructure Fund continued*

Funding structure of the Emerging Africa Infrastructure Fund



Source: Impact Investing Institute, Emerging Africa Infrastructure Fund

EAIF has a diversified portfolio of infrastructure projects in Africa. It operates in nine sectors in 48 countries and lends between $10 million and $65 million (including in euros), typically over 15 to 20 years. EAIF has committed in excess of $2 billion to over 100 transactions since 2002. The portfolio has returned a secured overnight financing rate[7] of +5% in US dollars, with a loss rate (including current provisions) of 0.17% per annum. This has demonstrated the ability of private investors to develop, execute and fund infrastructure in low-income and fragile countries. The concessional capital provided by donors, notably the UK government, has been critical to achieving this significant mobilisation of capital.

7. A 'secured overnight financing rate' (SOFR) is a broad measure of the cost of borrowing cash overnight, collateralised by US treasury securities.

Project example: Nachtigal Hydro Power Company, Cameroon

In 2018, EAIF announced a €50 million loan over 18 years to Nachtigal Hydro Power Company to build a run-of-the-river hydropower station on the Sanaga River in Cameroon. The €1.26 billion plant will have an installed capacity of 420MW and supply Cameroon's Southern Interconnected Grid, adding 30% to Cameroon's baseload electricity supply.

Nachtigal includes a 1,455m-long and 13.6m-high concrete dam, a reservoir containing approximately 28 million m^3 of water, seven 60MW turbines, approximately 50km of transmission lines, and a permanent 6.5km road. The project directly employed over 3,700 people during construction and it is estimated that around 150 new permanent jobs will be created directly when the Nachtigal station becomes operational, with many other indirect jobs.

Photo: Nachtigal Hydro Power Company

INTERNATIONAL

Case study 12: InsuResilience Investment Fund

The InsuResilience initiative was launched in 2015 with a mission to improve access to insurance for poor and vulnerable households, along with micro, small and medium enterprises in developing countries to reduce their vulnerability to climate change. This fund is the only one under the G7 InsuResilience Global Partnership to both raise private capital and invest in the private sector.

The InsuResilience Investment Fund is a joint initiative between BlueOrchard, a global impact investment manager and member of the Schroders Group, and BMZ, the German Federal Ministry of Economic Cooperation and Development.

The InsuResilience strategy is made up of four elements – two investment sub-funds and two grant facilities. The sub-funds have public capital from BMZ which acts as first-loss capital, meaning that, in the event of portfolio losses, private investors are only indirectly impacted. These investment funds are accompanied by a technical assistance facility (TAF) and a premium support facility (PSF), which are both funded entirely by BMZ.

Debt Sub-Fund: One of the biggest challenges to providing climate insurance in developing countries is reaching small-scale farmers and micro and small business owners. They often live in remote locations and have limited or no experience with climate insurance products. This is where aggregators, such as microfinance institutions and cooperatives, play a vital role in connecting insurers with those who need insurance most. The Debt Sub-Fund invests in aggregators who already offer micro-insurance or intend to introduce such products. It provides senior and subordinated debt, with a typical loan size of between $5 million and $10 million, and a tenor of between two and five years.

Equity Sub-Fund: This sub-fund invests in companies along the entire insurance value chain – from insurers to brokers to data and software providers, including agritech or fintech companies that offer climate insurance products or related services. Only companies that have (or aim to have) low-income and vulnerable households and small businesses as part of their customer base are eligible for investment. Through this vehicle, the team acquires significant minority stakes in investees and takes a board seat. The typical investment size is $5–10 million. As with the Debt Sub-Fund, the Equity Sub-Fund includes public capital, which provides partial downside protection to private investors.

Technical assistance facility (TAF): Each of the investees can also benefit from focused capacity-building support, which is organised and funded by the TAF. The TAF is funded separately by BMZ and has a commitment of €11 million ($13 million). It helps to launch and boost investees' climate insurance by offering international expertise in conducting feasibility studies, sourcing data, insurance product design and operations support, and advises on how to market and distribute products. The TAF also supports accessibility and market growth by educating investees, their clients, and other relevant stakeholders in climate insurance. By June 2023, 39 technical assistance projects had been delivered.

Premium support facility (PSF): The PSF is a €6.2 million ($7.3 million) facility also funded by BMZ. It provides temporary subsidies to reduce insurance premiums that are paid by the clients of selected investees. For example, premium subsidies help make climate insurance policies more affordable in the introductory phase, when pricing uncertainty and transaction costs drive premiums up. They also help overcome initial information asymmetries between the insurance company and its clients on the value of insurance products. The PSF aims to increase demand for climate insurance products so that they reach a critical mass to make the products financially sustainable.

By June 2023, 11 PSF projects had been delivered. The strategy expects to reach between 70 and 110 million beneficiaries by 2025.

Photo: Jonathan Erasmus, istock

INTERNATIONAL

Case study 13: The Rhino Bond

Black rhinos are a critically endangered species and extremely vulnerable to extinction in the wild, mainly due to poaching and habitat loss. Their numbers have declined from 65,000 in 1970 to just 5,500 today. Combatting rhino poaching and protecting rhino habitats involves constant monitoring that requires significant, long-term funding, which is not always available from conservation donors. The Rhino Bond is the world's first wildlife conservation bond.

Private investment in this area is clearly needed, but until recently, there has been no mechanism to funnel private capital into rhino conservation, or a rigorous means of measuring the outcome.

In 2016, the Zoological Society of London (ZSL) started the Rhino Impact Investment Project to develop the world's first bond structure to tie returns on upfront investment directly into supporting rhino population growth. This work was undertaken through United for Wildlife, a partnership with six other wildlife charities and The Royal Foundation of the Duke and Duchess of Cambridge, and resulted in the launch in March 2022 of the Rhino Bond, the world's first wildlife conservation bond.[8]

The bond has a number of features to appeal to risk-sensitive institutional investors:

- It is issued by the International Bank for Reconstruction and Development (part of the World Bank), a triple-A-rated entity that has been issuing sustainable development bonds in international capital markets for over 70 years.
- Redemption is at par in March 2027, so risk of loss of principal is low.

The use of grant funding to finance conservation success payments to investors – rather than the cost of the conservation work itself – presents substantial capital multiplier opportunities to donors.

The $150m Rhino Bond is structured as a five-year, outcomes-based bond. Instead of a traditional coupon paid directly to bondholders, $10 million is paid to black rhino conservation programmes in South Africa. In tandem, bondholders can collectively receive up to $13.76 million in 'conservation success payments' contingent on net rhino population growth (which is independently verified) in targeted areas:

- If the net rhino population declines, bondholders will receive no success payment.
- Between 0% and 2% net rhino growth, bondholders will be paid $36.69 per $1,000 invested.
- Between 2% and 4%, bondholders will be paid $73.38 per $1,000 invested.
- Over 4%, bondholders will be paid $91.73 per $1,000 invested.

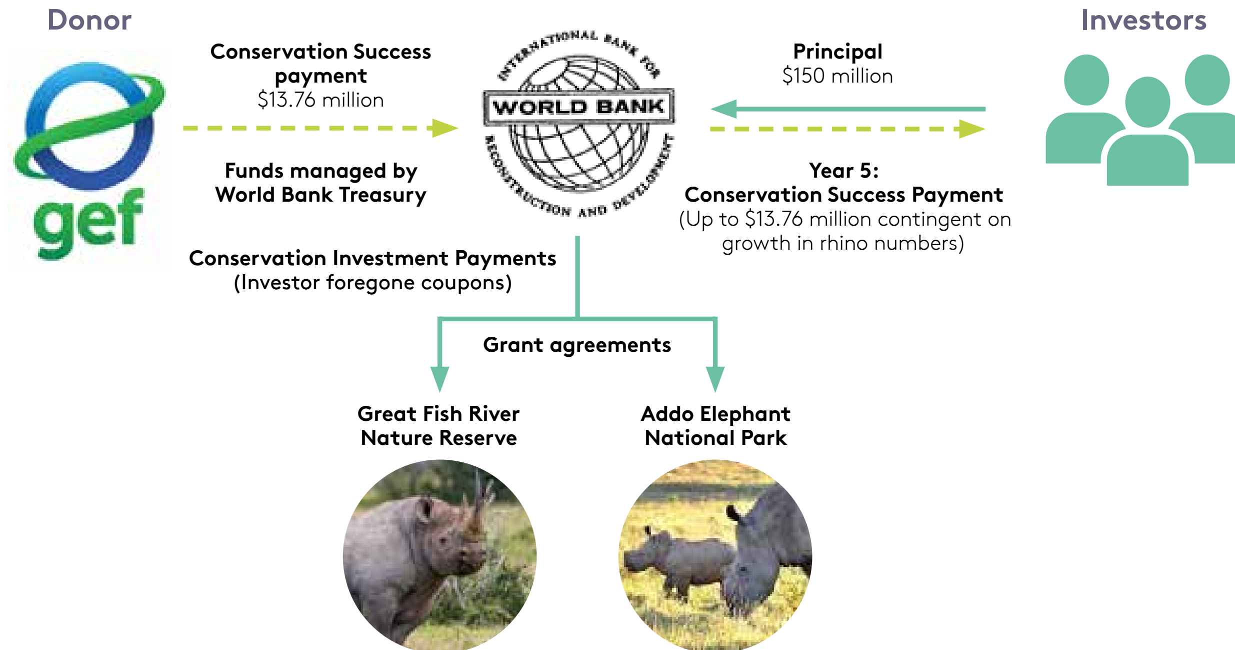
Black Rhinoceros. Photo: Gemsbokvlakte

Success payments to investors have been funded with a performance-based grant from the Global Environment Facility (GEF). Credit Suisse was the sole structurer and joint bookrunner of the bond along with CitiBank.

The Rhino Bond represents a new blended finance approach that maximises the impact of grant funding by channelling it towards conservation outcomes, rather than long-term investments.

8. See https://www.greenfinanceinstitute.co.uk/gfihive/case-studies/the-wildlife-conservation-bond-the-rhino-bond /.

Case study 13: *The Rhino Bond continued*



Source: Green Finance Institute, HIVE, The Rhino Bond

Next steps

- The partners behind the Rhino Impact Investment Project plan to replicate this model with other rhino populations, similar species under threat and in protected areas.
- The development of a robust, verifiable system of measuring conservation impact may make it easier to attract private funding for different conservation landscapes, through a variety of financial instruments.
- ZSL is also exploring financial instruments to channel the total investment proceeds, not just coupon payments, into conservation, e.g. using biodiversity credits.

> *"The Rhino Bond represents a new approach that maximises the impact of grant funding."*

Case studies – lessons for policymakers

These 13 case studies highlight some important guidance for policymakers or institutions seeking to replicate blended finance vehicles at greater scale:

- They all demonstrate that, deployed well, blended finance enables budget-constrained organisations to crowd in multiples of private investment to address pressing economic, environmental and social challenges.
- They show the importance of different investors, with different priorities and desired outcomes, working together from the outset to identify the most appropriate investment funding structure and design.
- This collaborative approach is not just critical to designing the optimal funding vehicle, but also increases each partner's understanding of other stakeholders' priorities and approaches. Collaboration has positive knock-on effects for future projects and, potentially, improves ways of working by each partner as a result of sharing best practice and alternative methods of addressing a given policy challenge.
- Investment vehicles should be tailored to the different financial return and impact expectations of these investors – whether government, grant providers, social investors or investors seeking a commercial return.
- Their track record, as well as conversations with the investors in each product, demonstrate that the design of the investment vehicle is most effective when driven by clear identification and accountability for the desired outcomes at the initial stages.
- Outcomes contracts, with payment for successful achievement of outcomes, are one of the best ways for government to ensure value for money from blended finance structures.
- A proven record of consistently delivering outcomes at a cost that offers a return on investment establishes credibility for future rounds of fundraising.

Blended finance deals require thoughtful structuring and trust between partners, and current capacity in the UK to intermediate them is scarce. Skill-building at government departments and local authorities, as well as at mainstream financial institutions unfamiliar with this approach, is required to roll out blended finance solutions at scale across the UK. This is addressed in the recommendations in the next section.

"Skill-building at government departments and local authorities, as well as at mainstream financial institutions unfamiliar with this approach, is required to roll out blended finance solutions at scale across the UK."

4. Enablers

Six enablers for a significantly more ambitious deployment of private investment towards public policy priorities

There is a significant opportunity for government-backed institutions, such as the British Business Bank, the UK Infrastructure Bank and, in the sphere of development finance, British International Investment, to deploy the instruments described in the case studies above – grants, tranched investment vehicles with varying return expectations, and other blended finance instruments such as guarantees – to crowd in private capital at far greater scale than is currently happening.

Key points

- Blended finance approaches have already been widely tested and proven. Now, policy and regulatory intervention is needed for them to be adopted across the UK at scale.
- Two proposed 'superfunds' could drive large-scale investment into public policy priority areas, especially if certain incentives are provided and specific investment barriers are lowered.
- A new HM Treasury oversight and expertise unit would ensure efficient coordination and necessary skill-building.

This section argues that rolling out these solutions at scale would be greatly facilitated by adopting six regulatory or policy 'enablers'. These measures have been formulated following extensive discussion with policymakers, regulators, social investors and financial services industry representatives, with the aim of creating structures and approaches that are attractive to all stakeholders.

Although each enabler could be implemented in isolation, complementarities between measures mean that the benefits from implementing them together are likely to be greater than the sum of their parts. These six actions would provide a set of policy and regulatory tools to achieve a significantly more ambitious deployment of private investment towards public policy priorities.

Enabler 1: UK Growth Fund

The 2017 Patient Capital Review led by HM Treasury showed that a lack of longer-term investment was holding back business growth in the UK (UK Government, 2017). This prevents high-growth potential firms from scaling up, and means that some enterprises are sold to trade buyers before they grow to maturity. At the same time, institutional investors lack co-investment vehicles designed to encourage them to invest for public policy outcomes over the long term.

A new UK Growth Fund, managed by the British Business Bank or UK Infrastructure Bank and overseen by HM Treasury and an appropriately constituted Investment Committee, would seek to attract long-term capital from major institutional investors such as pension funds. This fund-of-funds would provide the umbrella for sector-specific funds to attract start-up and scale-up investors. It would increase flows of private capital to key growth sectors, and increase listings of UK private companies, (the portfolio companies in the sector-specific funds) on the London Stock Exchange.

Pension assets in the UK total £2.5 trillion, with a further £2.1 trillion on insurers' balance sheets. Our calculations suggest the UK Growth Fund could have an investment target of £5 billion at launch, rising to at least £50 billion over five to 10 years.[9]

This proposal builds on the range of recent proposals and initiatives for some type of economic growth-focused 'super-fund', mobilising pension savings pools in particular.[10] Previously, the Labour Party set out proposals to unlock institutional patient capital investment, including setting up a National Wealth Fund; the Lord Mayor of London proposed a private sector-led Future Growth Fund to provide new investment in the UK's technology industry (City of London Corporation, 2023); and the Economy 2030 Inquiry proposed a pensions 'super-fund' managed by the Pension Protection Fund (Brandily et al., 2023), a proposal then built on by the

9. In its Levelling Up white paper, the Government set out its ambition for Local Government Pension Scheme (LGPS) funds to invest up to 5% of their assets in projects that support local areas (UK Government, 2022). This would direct £18.45 billion into UK-based productive investment opportunities. The Government is now consulting on these proposals with the LGPS and the pensions industry. Building on these proposals, conservative calculations for initial investment into the UK Growth Fund assume at least a 0.1% asset allocation from the existing £4.6 trillion in UK pensions and insurance assets, which includes the LGPS, building to over 1% over 5–10 years.
10. Recommendations in the Economy 2030 Inquiry seek to enable consolidation across the pensions landscape, allowing more investment in productive assets including unlisted firms, as well as more engaged ownership (as blockholders) in UK listed firms. The Chancellor's Mansion House Reforms announced in July 2023 seek to channel pension savings into unlisted firms with a number of initiatives. See Brandily et al. (2023).

Tony Blair Institute for Global Change (Kakkad et al., 2023). The Institute for Public Policy Research (IPPR) has proposed a UK National Investment Fund to finance the net zero transition (Gasperin and Dibb, 2023), and forthcoming proposals from the Capital Markets Industry Taskforce are expected to address the need to consolidate defined contribution (DC) and defined benefit (DB) pensions into pools with greater investment clout.

Meanwhile, the Chancellor's Mansion House reforms also propose consolidation of DC and DB pension pools, with a commitment by the nine largest DC pension providers in the UK to allocate 5% of their default funds' assets to unlisted equities by 2030. The Chancellor has also asked the British Business Bank to explore the case for government to play a greater role in establishing investment vehicles (Hunt, 2023). See Appendix 2 for further details.

The UK Growth Fund builds on these suggestions to propose a structure that would appeal to a broad range of private investors. As well as providing a vehicle for long-term investment in the UK, the Fund would address other challenges to the country's future prosperity, such as: the large number of innovative UK companies that are sold to non-UK buyers, with future value creation shifting overseas as a result; the declining number of private companies seeking a public listing in the UK;[11] and inadequate or non-existent markets in key sectors for the UK's economy, particularly in climate solutions.

"The UK Growth Fund builds on existing suggestions to propose a structure that would appeal to a broad range of private investors."

11. Since 2000, the share of the UK stock market owned by UK pensions and insurance companies has fallen from 39% to 4%, and just 1% of these assets is invested in unlisted UK companies (see Wright, 2023).

The UK Growth Fund would comprise two elements to address these challenges.

First, an 'umbrella' fund-of-funds would provide a diversified superstructure to attract venture capital investment from mainstream investors such as pension funds. Second, the fund-of-funds would sit on top of a set of sector-specific blended finance funds, which would each be designed to address a market failure or funding gap within a specific sector. These sector-specific funds would be designed for investors into start-up and scale-up private companies. Meanwhile, investors in the umbrella fund-of-funds would receive a diversified portfolio of shares/units in each of those sector-specific funds.

Sector-specific funds would be designed to meet identified market needs – e.g. EV charging infrastructure, SME housebuilders, carbon capture, utilisation and storage, early years education – and would address the lack of scale-up finance for young fast-growing companies in the UK (Brandily et al., 2023). Collectively, these sector-specific funds could potentially attract £10 billion of venture capital financing in addition to the investment in the umbrella fund-of-funds, catalysed by government seed funding.[12]

The blend of public and private capital within these funds could vary depending on sector, with government selecting from catalytic capital options such as guarantees, first-loss capital, or *pari passu* co-investment, according to need. The UK Infrastructure Bank (UKIB) and the British Business Bank (BBB) have the potential to provide this type of support, which would be identified during the design phase of each fund (UKIB, 2022).[13] The sector-specific funds would be managed by individual asset managers, selected through a tender process and based on their expertise/track record.

12. Recent funding rounds of private market vehicles in the UK demonstrate that there is huge demand from non-UK as well as UK investors for these types of opportunities, particularly in climate technologies. This estimate is based on confidential discussions with private market investors about the scale of appetite for potential vehicles of this kind. The size and structure of each sector-specific fund will vary depending on need and investor appetite, but assuming that each fund aims for £500 million investment at launch, rising to £1 billion between years one and five, 10 such funds would attract £10 billion of VC funding.

A well-designed route to exit would encourage constituent private companies either to be sold to trade buyers or to go public on a UK stock exchange. Exit routes would include public listing in the UK, sale to a UK trade buyer, or sale to a non-UK trade buyer. In the event that investee companies were sold to a non-UK buyer, an 'exit penalty' to HM Treasury would be payable. Sector-specific funds could also potentially cease to exist once a sustainable market had been established.

Sector-specific funds could be modelled on the Green Finance Institute's Battery Investment Facility (see below) (Green Finance Institute, 2022). This provides a replicable model for the process of designing an optimal funding structure through consultation with government, commercial investors and potential investee companies.

To ensure effective outcomes, the fund-of-funds would also need to be designed through a process of collaboration between investors and government. It is important to note that mandating private investment, e.g. DC pension funds, into a government-controlled vehicle would discourage private investors from engaging positively with the initiative at both the design and investment stages, and doom it to failure.

13. Both UKIB and the BBB have an explicit mandate to crowd in private capital. UKIB aims to deploy up to £3 billion of debt and equity and £2.5 billion of guarantees a year, committing £22 billion over the next five to eight years, subject to the pipeline of investable projects in each year. It can provide both corporate and project finance and invest across the capital structure, including senior debt, mezzanine, guarantees and equity. (See UKIB, 2022.)

Sector-specific fund model: the Green Finance Institute's Battery Investment Facility

The Green Finance Institute has been working to bridge the financing gap that exists in the nascent UK electric vehicle (EV) battery sector. The sector presents a significant growth opportunity, with the UK automotive supply chain for EV technologies forecast by GFI to be worth about £24 billion a year by 2025.

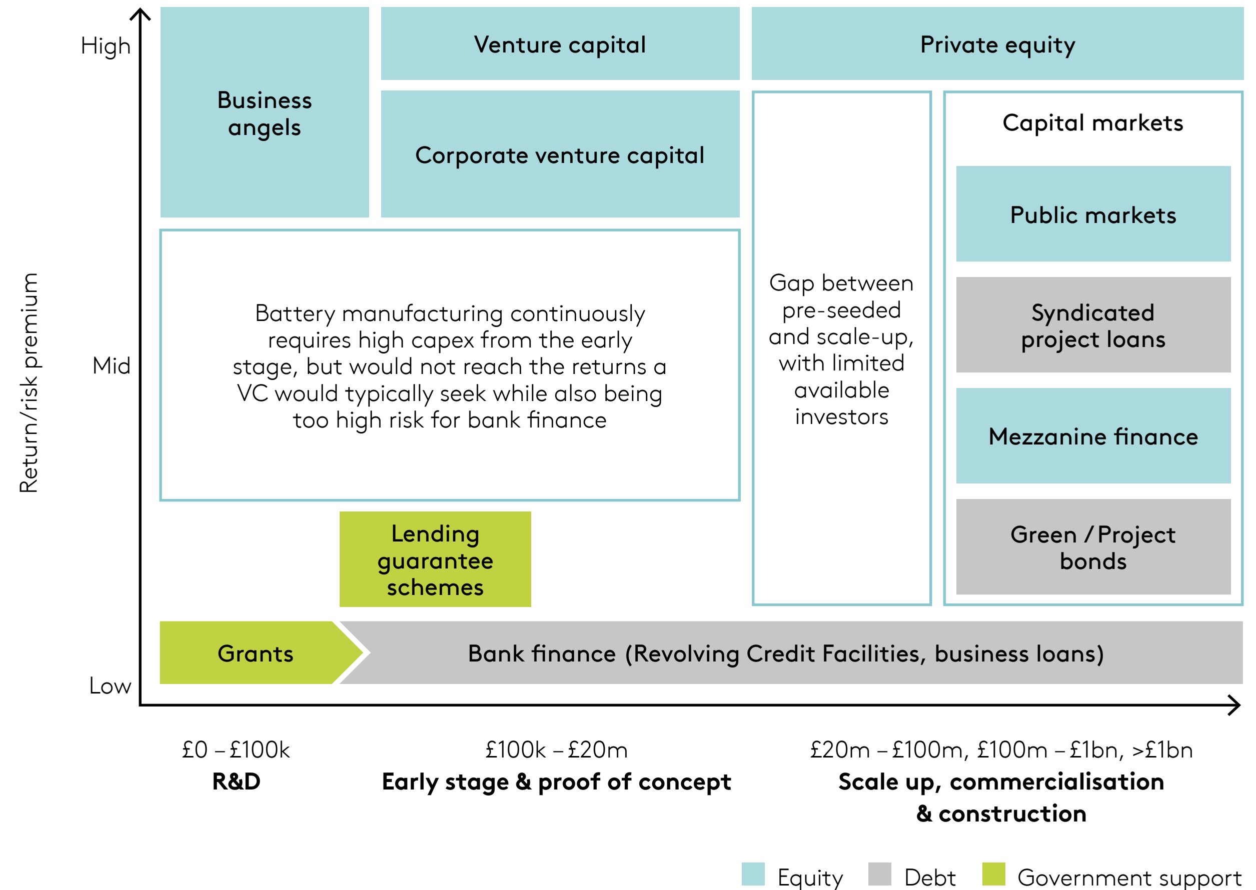
When exiting their initial grant funding, UK companies in the sector can struggle to access private finance to help scale up their growth. In response, the GFI has designed a blended finance de-risking facility – a Battery Investment Facility – that has potential to crowd in private capital, support these companies and widen the pool of investors in the sector. The facility has been developed through engagement with finance, industry, government and current grant providers to the sector.

Background

In the UK's battery sector, grants have successfully driven investment to date and helped to develop key foundational players for the supply chain. However, the grants are limited in scale and reach. To ensure continued investment in the sector, private finance needs to be involved.

Grants are essential at the early stage of company development but, once they end, companies struggle to attract finance before they are seen as sufficiently de-risked to access the capital they need to scale up. The GFI identified the need for a de-risking mechanism to fully unlock the private finance needed to bridge this gap.

The scaling gap in financing the UK battery sector



Source: Green Finance Institute: https://www.greenfinanceinstitute.co.uk/programmes/cdrt/battery-investment-facility/

To assess appetite for a potential blended finance de-risking mechanism, the GFI and its Coalition for the Decarbonisation of Road Transport consulted with representatives from the private investment sector, representing about £1.8 trillion in assets under management. These included global infrastructure funds, asset managers and retail and commercial banks, several with a specific decarbonisation focus. There was strong support from the private sector for investing in and managing an equity and debt blended finance de-risking facility to bridge the financing gap. The consultation also found that an independent fund manager would ensure efficient and speedy deployment of funds, and identified a pipeline of investment-ready projects waiting for finance.

Structuring the Battery Investment Facility

The solution: A facility established as a separate arm's length entity and operated by an independent fund manager

Benefits	Drawbacks
• Private sector engaged in investment deliberation • More likely to have private sector 'buy-in' • Reduced administrative burden on public sector officials • Flexible and agile in market development responses • Increased speed of deployment of capital • Shielded from day-to-day political interference	• Reduced operational and directional control for Government • Success reliant on staff appointments • Establishing and running a subsidiary entity requires time and funding

Source: Green Finance Institute

Enabler 2: UK Community Growth Fund

The UK Growth Fund proposed above would direct increased funding to new and fast-growing areas of the UK economy. But a separate vehicle is also needed to take advantage of the opportunities to finance businesses and communities that struggle to access mainstream finance, primarily through Community Development Finance Institutions (CDFIs). Blended finance vehicles have already successfully increased the flow of capital, both public and private, to CDFIs in the UK. Mobilising more private capital would deliver a step-change in their capacity and capability to lend to marginalised communities.[14]

There are currently 35 enterprise-lending CDFIs across the UK, which collectively lent £248 million in 2022 (Responsible Finance, 2023). Their lending disproportionately goes to the UK's most deprived areas, and to enterprises led by women and people from ethnic minority backgrounds.

The sector has yet to receive major investment by large commercial players – but the interest is there, as is the appetite to take the finance on from CDFIs themselves. This is evidenced by the Community Investment Enterprise Facility (CIEF), launched in 2018 (see box), and the planned launch of an expanded version of CIEF in autumn 2023, involving private and public investors.

The Impact Investing Institute and Social Finance are working on a blended finance CDFI investment vehicle prototype, using the example of CIEF, to attract and combine commercial and non-commercial capital at greater scale. This could provide a model for a government-led UK Community Growth Fund, which could target £100 million of commercial and social investment over three to five years, growing in size as additional investors take part.

The US provides useful lessons for a UK Community Growth Fund, through its legislative and financial support for CDFIs, and its Community Development Financial Institutions Fund, established in 1994 as a bipartisan initiative to promote economic revitalisation and community development through investment in and assistance to CDFIs (Impact Investing Institute and Metro Dynamics, 2021). For more details on US community growth initiatives, see Appendix 3.

Community Investment Enterprise Facility (CIEF)

CIEF is a £60 million investment facility, seeded by £30 million from Big Society Capital (Prat, 2022) with £30 million in matched funding from Triodos Bank and Unity Trust Bank, and managed by Social Investment Scotland. It aims to meet some of the capital needs of Community Development Finance Institutions (CDFIs), to build a better understanding of the financial and social impact of CDFI lending, and to test models of funding for CDFIs to attract other mission-driven investors.

CIEF has invested in four CDFIs across the UK since 2018 to help meet the needs of underserved micro, small and medium-sized enterprises and the disadvantaged communities where they operate. CIEF also played a critical role in delivering the Government's Coronavirus Business Interruption Loan Scheme (CBILS), and later the Recovery Loan Scheme (RLS) (Dayson and Damm, 2022).

14. It is worth noting that a separate consultation was concluded on 19 October 2023 by the Department for Digital, Culture, Media and Sport and the Department for Levelling Up, Housing and Communities on the creation of a Community Wealth Fund for social enterprises and charities. See https://www.gov.uk/government/consultations/technical-consultation-on-a-community-wealth-fund-in-england

Enabler 3: Government blended finance unit

To fully realise the potential to increase the flows of private investment into public policy priorities, coordinated oversight and expertise are needed within central government. To drive this forward requires both a commitment by senior political leadership to this goal, and the establishment of a new function or unit within HM Treasury, also involving other relevant government departments.

The new unit would have five responsibilities:

1. Coordinate and drive efforts to mobilise more private sector capital at scale within central budgetary processes and across government departments, including the Cabinet Office, involving those with responsibilities for business, education, energy, health, housing, levelling up and communities, transport, and work and pensions.

2. Provide a centre of expertise and knowledge-building on blended finance, with a focus on skill-building across government and local authorities.

3. Host regular meetings of a stakeholder advisory group, made up of senior civil servants and financial services representatives, both mainstream and specialist, to ensure effective collaboration across the investment spectrum.

4. Oversee the UK Growth Fund and the UK Community Growth Fund, in coordination with the UK institutions selected for their management.

5. Be responsible for evaluating the impact of blended finance initiatives across government, including the UK Growth Fund and the UK Community Growth Fund, ensuring that such evaluation focused not just on the 'value for money' of these initiatives, but also on the '*impact* for money' achieved.

Enabler 4: New guidance on fiduciary duty

Current guidance on and interpretations of fiduciary duty discourage pension fund trustees and other fiduciaries from allocating funds to investments that deliver a positive economic, environmental or social outcome as well as a financial return. To unlock more significant flows of private investment into public policy priorities, new guidance on fiduciary duty is required from the Department for Work and Pensions and, in the case of the Local Government Pension Scheme, the Department for Levelling Up, Housing and Communities. At a minimum, this guidance should reassure trustees that they are within their duties when taking economic, environmental or social considerations into account in their investment choices, in the context of an overall investment strategy which aims to deliver market-adjusted returns.

While protecting savers' investments, this would increase flows of private sector capital into the UK Growth Fund and other UK growth opportunities. Model guidance could draw on work by the Impact Investing Institute on pensions, the 2022 High Court judgment that ruled on charity trustees' legal duties (Association of Charitable Foundations, 2022), and ongoing work by the Financial Markets Law Committee (2022).

Enabler 5: Investment incentives and penalties

The proposed UK Growth Fund and its underlying sector-specific funds would be designed to be attractive to all types of institutional investor, ranging from mainstream pension funds to specialist angel investors. Additional incentives should not be necessary, therefore. However, government might choose to consider a set of investment incentives, to overcome investors' initial unfamiliarity with the new Fund, and thus uncertainty about allocating to it. These incentives could be reviewed at the end of three or five years.

The Economy 2030 Inquiry proposes "rewiring" the Treasury's incentives around investment by, for example, setting fiscal objectives that explicitly treat investment spending differently from current spending and building in more headroom against these targets (Odamtten and Smith, 2023). Earlier work by the Inquiry has also noted that investment allowances in the UK have historically been among the least generous in the OECD, and the UK tax system favours debt over equity financing (Brandily et al., 2023).

As touched on in Section 2, the UK's response to the US Inflation Reduction Act (IRA), as well as being targeted and employing a range of policy levers, should consider where there is scope for further enhancing tax incentives for net zero investments in fixed capital or innovation (ibid.). There are examples in the UK already: for example, electric vehicles and charging points are eligible for full expensing in the year of purchase. Incentives for investment in specific technologies in specific places – as envisaged in the IRA – would encourage investors with a place-based focus, such as Local Government Pension Scheme funds, and enable government or local authorities to target investment into areas of specific economic need.

> ***"Incentives for investment in specific technologies in specific places would encourage investors with a place-based focus, such as Local Government Pension Scheme funds, and enable government or local authorities to target investment into areas of specific economic need."***

The IRA's tax incentives are specifically designed to create good quality jobs in places that need them and can provide lessons for UK policymakers seeking to maximise the extent to which the net zero transition provides 'good jobs' across the country. Such incentives would complement the proposed new guidance on trustees' fiduciary duty, providing a compelling basis for a range of institutional investors to allocate to the UK Growth Fund. Venture capital and other private equity investors into the sector-specific funds should be offered an incentive modelled on the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS).

Portfolio companies that are sold or which list outside the UK would reimburse the taxpayer incentives from which they have benefited. If companies instead exited via purchase by a UK trade buyer or by listing on the UK stock exchange for a specified minimum time period, this penalty would not apply.

As well as supporting the growth agenda of the UK Growth Fund, and, in turn, of government, therefore, investment incentives and penalties would also help to retain the intellectual property, jobs and skills of the investee companies in the UK, and encourage a greater flow of public listings on UK exchanges.

Enabler 6: Institutional mandates and incentives

The responsibility for managing the proposed UK Growth Fund, its sector-specific funds, and the UK Community Growth Fund should lie with a UK institution backed by government. Effective management, however, requires the mandates and incentives at these institutions to be strengthened around mobilising private sector capital.

Government-backed institutions including the British Business Bank, the UK Infrastructure Bank, Homes England and, in the overseas development finance sphere, British International Investment can and do play a key role in mobilising private capital at scale. This role is already mandated in the framework documents governing their operation and set by government.

However, too often this role is deprioritised against other objectives, whether formally set or as part of the institution's internal culture, such as delivering a targeted return on investment, growing the institution's own balance sheet, or 'shifting product'. As a result, there are currently many missed opportunities for designing government-backed investment vehicles that crowd in private capital. A recent example is the launch by the British Business Bank of the £200 million South West Investment Fund, which provides loans from £25,000 to £2 million and equity investment up to £5 million, but has no focus on mobilising private investment alongside its own commitments.

To enable the UK's economic development institutions to fulfil their potential for crowding in private investment (both return-seeking and philanthropic), the incentives and rewards around it need to be clearer and more powerful. In particular, capital mobilisation should be made an objective of equal weight as balance sheet investment, with that goal reflected in the remuneration of key executives at these institutions.

"To enable the UK's economic development institutions to fulfil their potential for crowding in private investment, the incentives and rewards around it need to be clearer and more powerful."

Cycling club setting off from the International Community Centre, Middlesbrough. Photo: Bridges

5. Conclusion

Conclusion

This report has proposed a set of collaborative actions that could transform the way private and public investors work together to deliver stronger economic growth, reduced inequality, and greater environmental sustainability.

Replicating successful examples of blended finance investment vehicles in education, energy, health, housing and other economic sectors where public or concessional capital can be deployed would mobilise far greater flows of private capital; establishing two national funds would deliver increased and more effective investment into priority sectors and communities across the UK; and implementing the set of enablers recommended here would allow private investors to work more effectively with government for public policy priorities.

Such collaboration requires recognition of the strengths and limitations of each actor in the investment chain, be that government, pension funds, asset managers, philanthropic funders, or the people and communities in which they invest. Only by acknowledging these differences can solutions be delivered that support every participant.

Blended finance investments are most effective when driven by clear identification at the initial stages of the desired outcomes for all parties. Measurement of and accountability for these outcomes is as critical as financial performance in delivering the required policy goals. This is one of the many lessons from past experiments with public–private partnerships, which the Government would want to build into future initiatives.

The good news – as this report has shown – is that multiple successful examples of such public–private collaboration already exist within and outside the UK. Blended finance provides a powerful tool for this collaboration, and can be deployed at far greater scale and for far greater benefits than has been the case to date. To demonstrate a new ambition to deploy blended finance to deliver far greater amounts of investment in the issues and places that matter most to the UK population, political parties should consider making a 2024 election manifesto commitment to mobilising at least £50 billion of private capital for public policy priorities by 2030.

There is huge potential waiting to be seized by policymakers to work more effectively with private investors. Doing so effectively will require a change in mindset as well as ways of working, as this report has set out. Given the huge challenges we face as a country and as a planet, government, the civil service and private investors now need to demonstrate the courage and commitment to these changes, to deliver transformative and positive opportunities for the UK.

"To demonstrate a new ambition to deploy blended finance to deliver far greater amounts of investment in the issues and places that matter most to the UK population, political parties should consider making a 2024 election manifesto commitment to mobilising at least £50 billion of private capital for public policy priorities by 2030."

Appendices

Appendix 1. Blended finance initiatives in the US and EU

The US Inflation Reduction Act

Signed into law in August 2022, the Inflation Reduction Act contains $500 billion in new spending and tax breaks that aim to boost clean energy and reduce carbon emissions, reduce healthcare costs, increase tax revenues and improve taxpayer compliance (McKinsey & Company, 2022).

The act aims to catalyse investments in domestic manufacturing capacity, encourage procurement of critical supplies domestically or from free-trade partners, and jump-start R&D and commercialisation of leading-edge technologies such as carbon capture and storage and clean hydrogen. It also allocates money directly to environmental justice priorities and requires recipients of many funding streams to demonstrate equity impacts.

This is the third piece of legislation passed since late-2021 that seeks to improve US economic competitiveness, innovation and industrial productivity. The Bipartisan Infrastructure Law (BIL), the CHIPS & Science Act, and IRA have partially overlapping priorities and together introduce $2 trillion in new federal spending over the next 10 years.

There are major provisions of the new act that are relevant for efforts in the UK to increase private investment into public policy priorities, particularly addressing climate change:

- **Significant federal funding for climate efforts:** The IRA directs nearly $400 billion in federal funding to clean energy (REPEAT Project, 2022). The funds will be delivered through a mix of tax incentives, grants and loan guarantees. Clean electricity and transmission command the biggest slice, followed by clean transport, including electric vehicle (EV) incentives.

- **Upgrade, repurpose or replace energy infrastructure:** The US Department of Energy's Loan Program Office will receive roughly $12 billion to expand its existing loan authority by tenfold and create a new loan programme capped at $250 billion to upgrade, repurpose or replace energy infrastructure.

- **Provide incentives for private investment:** The majority of the $369 billion in energy and climate funding is in the form of tax credits. Corporations are the biggest recipient with an estimated $216 billion worth of tax credits. These are designed to catalyse private investment in clean energy, transport and manufacturing. Many of the tax incentives in the bill are direct pay, meaning that an entity can claim the full amount even if its tax liability is less than the credit. This allows tax-exempt entities like pension funds to participate in the tax credit, i.e. it is available not just when an entity's tax liability is low, but when it is zero (Solomon, 2023).

- **Consumer incentives:** Some $43 billion in IRA tax credits aim to lower emissions by making EVs, energy-efficient appliances, rooftop solar panels, geothermal heating, and home batteries more affordable. Starting in 2023, qualifying EVs will be eligible for a tax credit of up to $7,500 and $4,000 for new and used vehicles, respectively. Qualifying home improvements will be eligible for a tax credit of up to 30% of the total cost, capped at $1,200 per year. For heat pumps, the credit is capped at $2,000 per year.

- Manufacturing facilities are only eligible for full IRA tax credits if they meet prevailing wage and apprenticeship requirements. Many IRA tax incentives also contain requirements to scale up domestic production or procurement. For example, to unlock the full EV consumer credit, an increasing percentage of critical minerals in the battery must have been recycled in North America or been extracted or processed in a country that has a free-trade agreement with the US. The battery must have also been manufactured or assembled in North America.

- The IRA's clean-energy tax credits and product credits could catalyse and potentially amplify the $70 billion in clean-energy technology and demonstration projects funded under the BIL. The two acts together amount to an estimated $370 billion in federal funding over the next five to 10 years to facilitate the clean-energy transition.

Analysts have predicted that the 'multiplier' effect of the IRA's incentives could be substantial. For example, Goldman Sachs has estimated that the act will spur $3 trillion of investment in renewable energy technology (Goldman Sachs, 2023).

Appendix 1. *Blended finance initiatives in the US and EU continued*

The European Union's InvestEU Programme

The InvestEU Programme supports sustainable investment, innovation and job creation in the EU. Launched in 2021, the InvestEU Fund combines 13 centrally-managed EU financial instruments and the European Fund for Strategic Investments (EFSI) into one instrument.

The InvestEU Fund aims to crowd in private investment through a range of guarantees and targets a multiplier effect of 1:11.4, a more conservative number than that of its predecessor, the EFSI, which targeted 1:15. For every public euro that is mobilised through the fund, it is hoped to generate €11.4 of total investment that would not have happened otherwise.

The €10.5 billion budget earmarked for the InvestEU Fund enables the EU budget to provide guarantees of €26.2 billion: €9.9 billion for sustainable infrastructure; €6.9 billion for SMEs; €6.6 billion for research, innovation and digitisation; and €2.8 billion for social investment and skills.

The guarantee scheme is implemented in partnership with selected financial partners. The major partner is the EIB Group (the European Investment Bank and the European Investment Fund), which is responsible for implementing 75% of the EU Guarantee. Other implementing partners include the European Investment Fund, Council of Europe Development Bank, European Bank for Reconstruction and Development, and national investment banks.

Each financial partner will be expected to contribute some resources to ensure that their interests are aligned, adding an estimated total of €6.55 billion, so the total guarantee will be around €32.75 billion. This in turn will be leveraged by each financial partner. Finally, each InvestEU-backed project is intended to attract other private and public investors.

InvestEU projects must:

- Address market failures or investment gaps and be economically viable
- Have EU backing
- Achieve a multiplier effect and where possible crowd in private investment
- Help meet EU policy objectives

The InvestEU Fund can be combined with grants or financial instruments (or both), funded by the centrally managed EU budget or by the EU Emissions Trading System (ETS) Innovation Fund.

InvestEU Fund instruments seek to attract commercial financing to a wide range of operations and beneficiaries and are intended to only support projects where financing could not be obtained at all or not at the required terms without InvestEU Fund support. The Fund will also target higher-risk projects in specific areas.

By July 2023, €12.4 billion of guarantees had been approved, involving 103 investment operations and 11 implementing partners (European Union, 2023).

European Investment Bank HQ. Photo: Palauenc05

Appendix 2. Proposals for a UK growth 'superfund'

There are a number of existing proposals for a new growth fund in the UK, many centred on reform of the country's pensions regime, on which this report's proposals seek to build in practical ways. All suggest that there is growing momentum for large-scale and radical action.

An earlier recommendation by the Economy 2030 Inquiry proposes that Government should legislate to expand the remit of the Pension Protection Fund to allow it to act as a state consolidation option for solvent pension schemes, giving trustees who want the certainty associated with buy-outs an alternative route. These reforms would create several large defined benefit (DB) funds with both the incentives and capabilities to invest actively in UK equities (Brandily et al., 2023). It also proposes the pooling of Local Government Pension Scheme (LGPS) funds into one consolidated fund.

The Inquiry recommends that the British Business Bank (BBB) should be allowed to borrow capital through the issuance of government-guaranteed bonds in the same way that Germany's national development bank, KfW, is able to, and that the BBB offer a co-investment fund that would allow pension funds to invest as a limited partner alongside it, piggybacking on its expertise.

Elements of this proposal have subsequently been recommended by the Tony Blair Institute for Global Change (Kakkad et al., 2023).

The Institute for Public Policy Research (IPPR) proposes establishing a national investment fund to provide equity and equity-like (convertible loans) financing to companies willing to expand production in green manufacturing activities and to decarbonise heavy industry processes (Gasperin and Dibb, 2023). The fund would be a "holding organisation" with minority stakes in a broad range of companies. Aligned with the Economy 2030 recommendations, IPPR proposes transferring the 4,500 smallest DB funds into a pensions "superfund" managed by the Pension Protection Fund. It recommends establishing in tandem a series of regional, return-generating, not-for-profit entities that would progressively absorb the UK's 27,000 defined contribution funds, the LGPS, the remaining DB funds and, potentially, other non-LGPS public-sector pension schemes, which in most cases are not funded. The end goal would be to establish about six £300–400 billion long-time-horizon diversified funds, which, it argues, would generate better, and more secure returns for pensions than the 5,200 existing DB funds.

Forthcoming proposals from the Capital Markets Industry Taskforce are expected to address the need to consolidate both defined-contribution and defined-benefit pensions into pools with greater investment clout, and the current Lord Mayor has published a proposal to establish a growth fund specifically for consolidated DC pension capital and led by the private sector to invest in UK tech companies (City of London Corporation, 2023).

Meanwhile, political parties have separate proposals around the same theme.

The Labour Party has proposed providing catalytic public investment through a Green Prosperity Plan, to crowd in private-sector investment to the industries of the future. It would reform the British Business Bank, unlocking institutional investment so that more patient capital is available to new and growing businesses (The Labour Party, 2023), and would establish a National Wealth Fund.

The current Chancellor's Mansion House speech announced an agreement between nine of the UK's largest defined contribution pension providers, committing them to the objective of allocating 5% of the assets in their default funds to unlisted equities by 2030. These providers represent over £400 billion in assets and the majority of the UK's defined contribution workplace pensions market. The Government argues that this could unlock up to £50 billion of investment in high-growth companies by 2030 if all UK DC pension schemes followed suit. The Chancellor has also asked the British Business Bank to explore the case for government to play a greater role in establishing investment vehicles. The speech proposed consolidation of both DC and DB pension pools, with a target for LGPS funds of a minimum fund size of £50 billion in assets and a target of investing 10% of their assets in private equity (Hunt, 2023).

The UK Growth Fund proposed in this report builds on many of these innovative ideas, particularly IPPR's proposal for a national investment fund, but it differs in a few key features and, critically, its structure is designed to appeal to a broad range of private investors with different mandates, investment approaches and risk tolerance. Mainstream institutional investors such as pension funds will be encouraged to invest in the highly-diversified fund-of-funds 'umbrella', while venture capital investors will invest directly in the underlying sector-specific funds.

The UK Growth Fund is designed to work within the UK government's existing processes and institutions. It does not mandate investors, including pension funds, to shift their assets or strategies as this would discourage private investors from cooperating in the establishment of any such fund and is in direct contradiction to best practice in designing blended finance vehicles.

The approach advocated in this report is for collaboration between public and private investors, and for any blended finance fund to be co-created and designed from the outset in a collaborative process. This is one of the most important lessons learnt from successful blended finance initiatives in the UK and elsewhere. The UK Growth Fund is designed to take advantage of the respective expertise of different actors in the investment chain. Most existing proposals recommend the creation of a large 'super-fund', yet this would be an unworkable vehicle to invest in the new, small but fast-growing areas of the UK economy that will drive future sustainable economic growth. In addition, the public sector has no background in managing financial assets of this size.

The UK Growth Fund's structure seeks to take advantage of the existing expertise in the public and private investment sector. Its fund-of-funds would be overseen by the most appropriate government-backed finance institution, with the UK Infrastructure Bank already mandated to use the blended finance instruments and approaches described in this report to crowd in private-sector capital. The underlying investments in the sector-specific funds would be managed by private asset managers.

The need for a very substantial boost to investment in the UK is not in doubt. It is immensely positive that so many different organisations across the political spectrum are convinced of the need and are proposing possible mechanisms for private investors to meet this need. Some are more practical than others, some risk alienating partners in either the public or private sector. The proposal for a UK Growth Fund in this report seeks to address these concerns to create an implementable and successful structure for channelling private savings into the UK's sustainable economic future.

The UK Growth Fund is designed to take advantage of the respective expertise of different actors in the investment chain.

Photo: Philip Halling

Appendix 3. US models of effective community development support

The US provides a model for a UK Community Growth Fund, through its legislative and financial support for CDFIs, and its Community Development Financial Institutions Fund established in 1994 as a bipartisan initiative to promote economic revitalisation and community development through investment in and assistance to CDFIs.

In the US, private capital is much more active in driving inclusive growth and building prosperity in underserved and marginalised areas than is currently the case in the UK.[15] This is driven both by major legislation and regulatory requirements – such as the Community Reinvestment Act (CRA) – and by increased knowledge, and therefore use of blended finance models within a market-based development framework. These models use public subsidy, whether that is direct investment or tax incentives, to effectively catalyse private investment in projects aligned with community need. The CRA was originally enacted in 1977 to ensure that banks invested in the communities in which they raised deposits. Investments are CRA-eligible if they invest in low- and moderate-income regions, or in disaster areas or rural middle-income areas designated as distressed or underserved (Grover, 2007).

The appetite for place-based impact investing (PBII) in the US, has developed over decades. The maturity of this market demonstrates that there is an enormous amount to be gained from closer partnership between mainstream financial institutions and places, both in terms of outcomes for those places and financial return.

15. This section draws heavily on Impact Investing Institute and Metro Dynamics (2021).

The strength of place-based investing in the US is largely due to the presence of more than 1,000 CDFIs, including development banks, community loan funds, credit unions and venture funds, which vary by target market. CDFIs assemble deals, develop early-stage assets and create customer pipelines. The work they do – which includes providing debt and equity to small businesses alongside business support services – is specialised and usually requires subsidy. Public policy support and subsidy, trade associations and rating systems have been critical to the success of CDFIs in the US. They now operate at the leading edge of 'market development' – the US take on financial markets-informed regeneration.

In the US, CDFIs and mainstream banks have developed partnerships. Banks not only invest in CDFIs themselves but also act as co-investors. The US also has a set of tax incentives and regulations that have enabled PBII, particularly with regard to blended finance vehicles.

The key attributes of the US system include:

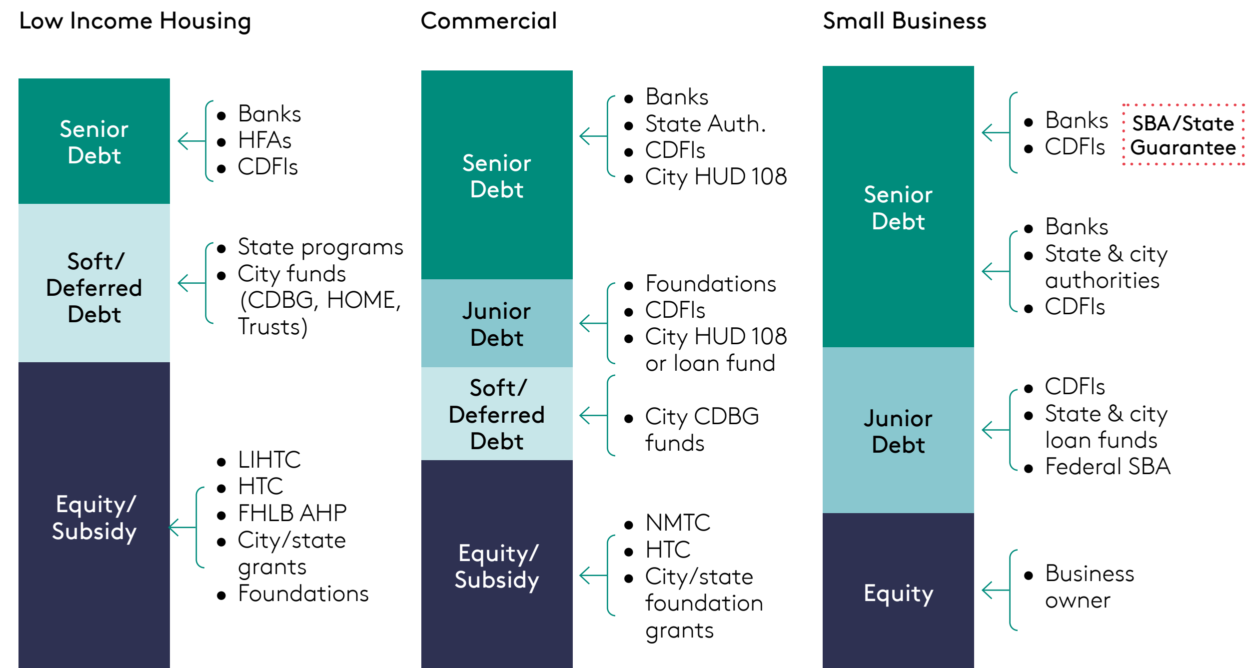
- **A market-based development model:** The approach to local economic growth led by financial institutions in the US is rooted in a community and its existing assets, rather than built from a transaction.
- **Well-rounded and embedded priorities:** US financial institutions are often highly specific in terms of geographical targeting and intended outcomes. They then bring the weight of their whole organisation to bear on these priorities to achieve them, mobilising corporate social responsibility (CSR) initiatives and philanthropic spending alongside new and existing business activities.
- **Collaborative working:** Mainstream financial institutions work extensively with and through delivery intermediaries such as CDFIs and social enterprises, recognising that in some circumstances and/or localities, they do not have the required expertise or reach.
- **Stakeholder diversity:** Successful place-based interventions in the US have brought together a broad coalition of voices and actors, beyond just bilateral relationships between a financial institution and local government.
- **Public-sector capacity and capability:** Local government in the US is more accustomed to attracting private capital to projects. There are experienced public sector practitioners working on commercially viable business plans, which results in increased flow of viable, investable deals.[16]
- **Use of public subsidy:** US financial institutions rely heavily on public subsidy in various forms to deliver their place-based impact investments.

16. Lack of capacity and experience at local authority level is a significant barrier to working with private investors in the UK. The Impact Investing Institute and The Good Economy are working to build relationships to address this between local authorities and private asset managers. 'Enabler 3', the creation of an expertise and oversight unit in central government, as outlined in this report, is also directed at this need.

Tailoring public subsidy for place-based investment in the US

The chart to the right outlines how various kinds of public subsidy can be present and play different roles in a capital stack, illustrating how blended vehicles work in practice across three different sectors and asset classes. In each case, the finance is structured differently, with varying proportions of the project or programme funding covered by different kinds of investment (senior or junior debt and equity). The public subsidy (through direct grants, deferred or no-interest loans, tax credits and/or guarantees) also plays a different role in each example, including both equity and mezzanine debt in the case of low-income housing, for instance. The chart shows that the role of the public subsidy can be tailored to the nature of the investment.

Sample US blended finance structures



Source: Impact Investing Institute and Metro Dynamics (2021)

Notes: HFA = Housing Finance Agency; CDBG = Community Development Block Grant programs; HOME = HOME Investment Partnerships Program; LIHTC = low-income housing tax credit; FHLB AHP = Federal Home Loan Bank Affordable Housing Program; City HUD = City Department of Housing and Urban Development; NMTC = New Markets Tax Credits; HTC = Historic Tax Credit; SBA = US Small Business Administration

US government support for CDFIs

In the US, the government has also played an active role in using guarantees to build the CDFI sector. The US CDFI programme launched in 2010 to provide federal backing for the sector through credit enhancement. The programme allows eligible CDFIs to raise bonds of $100 million or more with a 100% federal guarantee. Over $1.6 billion has been channelled into the CDFI sector as patient, cheap capital using this tool.

By effectively acting as a collateral substitute, loan guarantees from state and federal programmes allow banks to make loans targeted to small businesses that might otherwise not obtain funding on reasonable terms because they are unable to offer sufficient collateral. The most sophisticated CDFIs in the US also employ guarantees in a strategic manner themselves to drive economic growth for their local communities. For instance, Hope Enterprise – a $283 million loan fund – established a credit union affiliate with which to partner, and uses its own capital to guarantee the loans of the credit union, enabling the latter to take more risk than traditional depository institutions.

Guarantees are also actively provided by the US foundation sector, with foundations often deploying them to leverage private sector finance. The successful raising of capital in the US CDFI sector, which is worth c.$2 trillion in total, is arguably also a result of the Community Reinvestment Act (Board of Governors of the Federal Reserve System, 2022), federal legislation that requires banks to lend to all communities, including distressed and disadvantaged ones. It is worth noting that much of CDFI lending occurs in the area of affordable housing.

Providing a model for a UK CDFI fund

A model for a UK CDFI fund is provided by the Community Development Financial Institutions Fund, established in the US in 1994 as a bipartisan initiative to promote economic revitalisation and community development through investment in and assistance to CDFIs.

The US CDFI Fund promotes access to capital and local economic growth through the following initiatives:

- **Community Development Financial Institutions Program:** Directly investing in, supporting and training CDFIs that provide loans, investments, financial services and technical assistance to underserved populations and communities
- **New Markets Tax Credit Program:** Provides an allocation of tax credits to investors in eligible Community Development Entities, which enable them to attract investment from the private sector and reinvest these amounts in low-income communities
- **Bank Enterprise Award Program:** Provides an incentive to banks to invest in their communities and in other CDFIs
- **Native Initiatives:** Provide financial assistance, technical assistance, and training to Native CDFIs and other Native entities proposing to become or create Native CDFIs
- **CDFI Bond Guarantee Program:** Issues bonds to support CDFIs that make investments for eligible community or economic development purposes
- **Capital Magnet Fund:** Offers competitively awarded grants to finance affordable housing solutions for low-income people and low-income communities nationwide.

Since its creation, the CDFI Fund has awarded more than $5.2 billion to CDFIs, community development organisations, and financial institutions through: the Bank Enterprise Award Program; the Capital Magnet Fund; the CDFI Rapid Response Program; the Community Development Financial Institutions Program, including the Healthy Food Financing Initiative; the Economic Mobility Corps; the Financial Education and Counseling Pilot Program; the Native American CDFI Assistance Program; and the Small Dollar Loan Program. In addition, the CDFI Fund has allocated $66 billion in tax credit allocation authority to Community Development Entities through the New Markets Tax Credit Program, and closed guaranteed bonds for more than $1.8 billion through the CDFI Bond Guarantee Program.

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Acknowledgements

The report and its recommendations are the sole responsibility of its author and may not represent the individual views of those listed below, nor the official positions of the organisations they represent. The author gratefully acknowledges the contributions of all those named on this page:

Schroders and the Harriet Collington Foundation for their support for this work.

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Dr Anna Valero, Distinguished Policy Fellow, Centre for Economic Performance, London School of Economics and Political Science, who co-authored a shorter UK-focused version of this report, which appeared as a paper for the Economy 2030 Inquiry.

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Designer: Lynda Durrant, Full Circle Design and Illustration

The following individuals provided input and challenge to this report, and supported the research:

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