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**Research Report**

# Scaling green investment for SMEs in low- and middle-income countries through guarantees and blended finance

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IDOS POLICY BRIEF 20/2026

# Scaling Green Investment for SMEs in Low- and Middle-Income Countries through Guarantees and Blended Finance

Bao-We-Wal Bambe & Phemelo Tamasiga

## Summary

Climate mitigation and adaptation require substantial investment to advance sustainable development. In low- and middle-income countries (LMICs), mobilising such finance is particularly challenging for small and medium-sized enterprises (SMEs) due to persistent market failures, including limited financial disclosure and weak credit-risk information. High upfront costs, uncertain returns and weak regulatory frameworks further constrain adoption of low-carbon technologies. While fiscal constraints and the capital-intensive transition underscore the need for private capital, traditional bank financing is restricted by long project horizons, high risk and macroeconomic instability.

Blended finance and guarantees are key instruments for mobilising private investment in LMICs. Blended finance combines concessional public resources with private or additional public capital to mitigate profitability risks, while guarantees reduce perceived risk by covering partial losses, particularly for non-commercial risks. This policy brief assesses their role in scaling SME climate finance, alongside their limitations and context-specific applicability. Evidence suggests that leverage effects, especially for blended finance, are more modest than often assumed and are context dependent; nonetheless, these instruments remain relevant for de-risking SME finance, contingent on improved design and implementation. The policy brief advances the following recommendations:

- Financial intermediaries should prioritise SMEs facing binding financing constraints that prevent projects with clear socio-economic and environmental benefits. Project selection should integrate financial and climate vulnerability, though assessment remains difficult in low-income countries (LICs). De-risking instruments should target specific constraints, with guarantees mitigating risks and blended finance supporting projects with insufficient risk-adjusted returns to attract private capital. Multilateral development banks (MDBs) and development finance institutions (DFIs) should ensure additionality, minimise concessionality and strengthen monitoring and transparency.
- MDBs and DFIs should better align donor incentives with effective risk-sharing and flexible financing structures. Concessional senior loans dominate blended finance but have limited loss absorption, reducing effectiveness in high-risk environments. A more balanced mix, including subordinated debt, equity and guarantees, can improve risk allocation and crowd in private investors. Greater use of special purpose vehicles and off-balance-sheet structures can further expand financing capacity in fragile contexts.
- MDBs and DFIs should strengthen coordination, standardisation and local engagement. Fragmentation in blended finance and guarantees increases complexity and transaction costs and deters institutional investors. Greater harmonisation across MDBs, DFIs and private investors would improve capital allocation and complementarity, while standardised procedures and contracts would streamline project preparation and scaling in LMICs.
- Governments in LMICs should address structural constraints, with MDBs and DFIs providing complementary de-risking and capacity-building support. Weak investment climates, shallow financial markets, poor project pipelines and weak credit information systems reduce the effectiveness of blended finance and guarantees, particularly in LICs. Governments should strengthen investment climates, deepen financial markets and improve SME capabilities, while MDBs and DFIs support local intermediaries and broader reforms.

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## Introduction

Climate change poses severe and asymmetric challenges to the global economy, with low- and middle-income countries (LMICs) facing disproportionate climate risks and significantly lower adaptive capacity than high-income countries. As these risks intensify, they undermine productivity, employment and long-term growth prospects, particularly in key sectors such as agriculture, energy, water and transport. To respond, businesses in these regions must develop both mitigation and adaptation strategies. Mitigation refers to actions that reduce emissions and environmental impacts, including the expansion of renewable energy, improvements in energy efficiency and reforestation. Adaptation, by contrast, focuses on adjusting to current or expected climate impacts and can take several forms: structural shifts across sectors, spatial relocation or diversification, and sector-specific innovation and technology development.

Small and medium-sized enterprises (SMEs) are present across the economy but are disproportionately concentrated in sectors with high exposure to climate risks. Across LMICs, they account for approximately 60–70 per cent of formal employment and around 40 per cent of gross domestic product (GDP), making them a primary source of jobs and income for large segments of the population (OECD [Organisation for Economic Co-operation and Development], 2025a). Agriculture, largely driven by smallholders and agri-based SMEs, employs over half of Sub-Saharan Africa's workforce and remains highly vulnerable to climate shocks such as droughts, floods and extreme temperatures. SME investment decisions therefore shape emissions, resource efficiency and climate resilience, making green investment in renewable energy, energy efficiency, climate-smart agriculture and resilient infrastructure central to sustainable and inclusive development in LMICs.

Despite their vital economic role, SMEs in LMICs face severe financing constraints due to market failures and institutional weaknesses. These include the lack of certified financial statements and reliable credit information, which exacerbates information asymmetries and tightens credit constraints, amplified by regulatory barriers, macroeconomic instability and weak infrastructure. In addition, the small scale of many SMEs increases their perceived default risk, further discouraging financial institutions from extending credit. Globally, around 40 per cent of formal SMEs in emerging markets are credit-constrained, due to limited collateral, lack of credit histories and high transaction costs. The challenges are further exacerbated for green investments, which involve high upfront costs, long payback periods and perceived climate risks. Consequently, many SMEs cannot invest in mitigation or adaptation and instead respond to climate shocks by reducing output or employment, reinforcing vulnerability and inequality. These constraints are particularly pronounced in low-income countries (LICs) and persist amid a widening climate finance gap, as strained public budgets, declining development aid and risk-averse financial institutions limit funding for long-term investments. Mobilising private capital, particularly for SMEs in climate-sensitive sectors, is therefore essential.

Market failures and institutional constraints in LMICs justify policy interventions such as blended finance and guarantees, promoted by development finance institutions (DFIs), to address the lack of high-impact projects where socio-economic benefits outweigh private returns (Attridge & Engen, 2019). Blended finance combines concessional public resources with private or additional public capital to improve risk-return profiles and attract investment, while guarantees aim to mitigate investment risks by providing partial risk coverage, particularly against non-commercial risks such as political instability, regulatory uncertainty, expropriation or breach of contract (Mirabile et al., 2013; Sial, 2025).

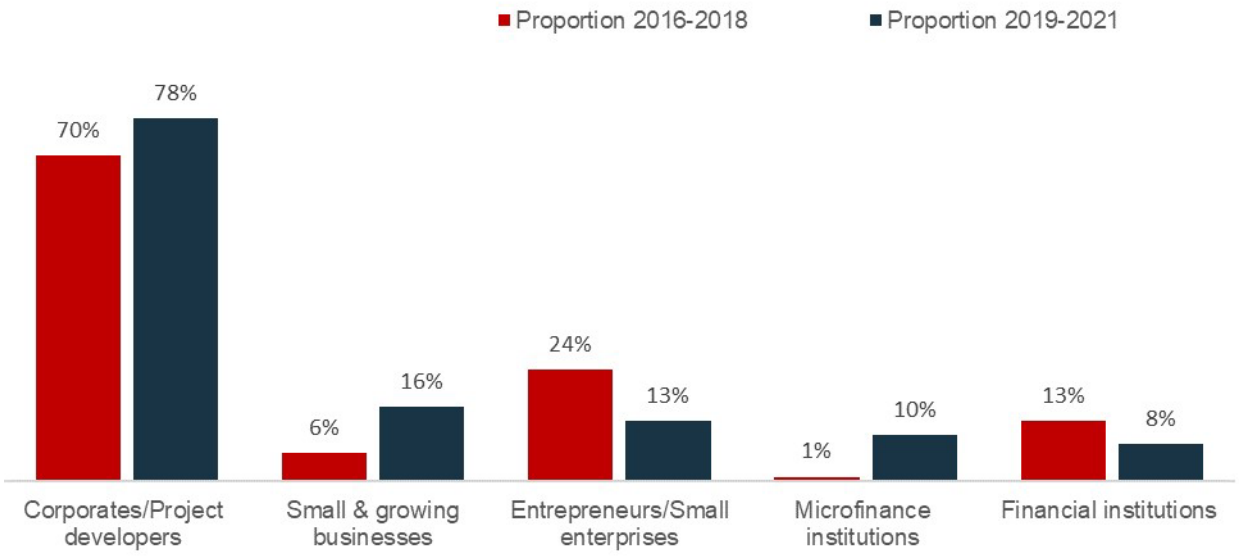
Amid declining external aid flows and widening Sustainable Development Goal (SDG) financing gaps in LMICs, blended finance and guarantees

have gained renewed attention as de-risking instruments to help crowd in private investment for sustainable development and the climate transition. This policy brief contributes to the ongoing debate on these instruments along three dimensions. Firstly, it examines how different financial instruments can complement each other in mobilising capital for SMEs in LMICs, with a focus on green finance, an area that remains significantly underexplored (Sial, 2025; OECD, 2025b). By linking instrument design to the specific market failures they aim to address, it assesses their ability to alleviate barriers to SME green investment while recognising their limitations. Secondly, drawing on Attridge and Engen (2019), it explores why blended finance and guarantee mechanisms have generated limited results in LMICs, particularly in LICs, where financing gaps are most severe, and identifies the institutional and market conditions shaping their performance. Finally, the brief proposes practical recommendations for DFIs and policymakers to improve targeting, strengthen additionality and mobilise greater private investment in climate-resilient SME activities.

## Recent trends in climate finance gaps and constrained SME access in adaptation finance

Following COP15 in 2009, countries in the Global South called for half of international climate finance to support adaptation (Hos et al., 2026). Blended finance for adaptation increased by 72 per cent between 2016–2018 and 2019–2021, with greater investment in agriculture, conservation and the blue economy (Convergence, 2022). However, financing remained concentrated among large businesses and project developers, whose share rose from 70 to 78 per cent, while SMEs consistently received only about 30 per cent (Figure 1). Guarantees also expanded but remained concentrated in emerging middle-income economies (Bambe, 2025). Despite this progress, adaptation accounted for only 14 per cent of blended finance transactions, and climate finance still falls far short of the USD 8.1–9 trillion required annually through to 2030 (CPI, 2023). Agrifood systems, where SMEs play a central role, receive only USD 28.5 billion annually (Chiriac et al., 2023). Closing this gap requires not only greater financial flows but also better-targeted instruments for SMEs.

**Figure 1: Direct recipients of climate blended finance transactions, 2016-2021**




Source: Convergence (2022)

## Key benefits of guarantees and blended finance

Blended finance and guarantees are key instruments promoted by DFIs to mobilise private investment in developing countries. They have gained renewed attention as de-risking tools to support the SDGs amid declining public aid, rising climate risks and widening financing gaps. By combining concessional public resources with private or additional public capital, blended finance seeks to improve the risk-return profile of projects and mobilise private investment. Guarantees can complement these efforts by mitigating non-commercial risks, such as political instability, regulatory uncertainty and expropriation, without directly providing financing. Beyond supporting investment in environmentally sustainable projects, these instruments can also contribute to maintaining access to finance during periods of economic stress. In many LMICs, particularly in Sub-Saharan Africa, improved SME access to finance can accelerate climate-smart agriculture, including efficient irrigation, soil conservation and agroforestry, strengthening long-term sustainability, food security and rural livelihoods.

Evidence suggests that every dollar of World Bank guarantees has leveraged, on average, four dollars of investment project and investment finance (Le Houérou & Lankes, 2023; IEG, 2023). In other words, these guarantees do not involve direct disbursement but instead cover part of the underlying risk, thereby reducing uncertainty for private investors and encouraging their participation. In contrast, blended finance instruments appear to have more limited leverage effects, with each dollar of MDB and DFI resources mobilising on average 1.06 dollars in lower-middle-income countries, 0.65 dollars in upper-middle-income countries and only 0.37 dollars in LICs (Attridge & Engen, 2019). However, these estimates should be interpreted with caution due to persistent measurement challenges, including the lack of publicly available data on grant equivalents and a fundamental counterfactual problem, as it is not possible to observe whether private investment would have occurred in the absence of public intervention – making it difficult to establish causal effects. Despite their growing use in instruments such as the Blended Finance Facility, the African Guarantee Fund, the Africa Agriculture and Trade Investment Fund, and the AfricaGrow Fund of Funds (see Box 1), relatively low observed leverage ratios highlight the persistent challenge of mobilising private capital at scale to close the SDG financing gap. More broadly, achieving long-term climate objectives will require a substantial scaling-up of private investment, with estimates suggesting that each concessional dollar will need to unlock approximately seven dollars of private finance by 2035 to remain aligned with net-zero pathways (IEA, 2024).

## Key challenges

Guarantees and blended finance are not panaceas for addressing the SME climate financing gap. Recent evidence has tempered expectations, particularly regarding the potential of blended finance, showing that its effectiveness is highly context-specific and often constrained by a range of factors. The priority is therefore not only to mobilise more finance, but to direct appropriate instruments to the firms, risks and investment horizons where they are most needed (UNDP & Convergence, 2026; Habbel et al., 2021).

A first challenge is the accurate identification and targeting of market failures. Blended finance and guarantees are justified only when private finance cannot support high-impact projects because of specific distortions. For many vulnerable SMEs in LMICs facing binding financing constraints or high upfront green investment costs, the key policy question is whether these instruments enable investments that would otherwise not occur or improve financing terms. In practice, however, de-risking tools are often directed towards already bankable firms while failing to reach more constrained SMEs or socially valuable but lower-return projects, raising

persistent concerns about additionality. According to the OECD, financial additionality refers to finance unavailable on comparable terms without official support, while development additionality captures outcomes that would not otherwise occur. Without either, concessional resources subsidise investments rather than correcting market failures (Habbel et al., 2021). Demonstrating additionality is particularly difficult in intermediated structures, where funds pass through local financial institutions before reaching beneficiaries, making it hard to determine whether concessional finance expands access to finance, improves financing terms or enables investments that would otherwise not occur (Habbel et al., 2021; Léon, 2025).

**Box 1: Examples of blended finance and guarantee mechanisms in LMICs**

The Blended Finance Facility (BFF), launched in 2017 by the World Bank Group (IEG, 2024), combines International Development Association (IDA) resources, International Finance Corporation (IFC) investments and the Private Sector Window (PSW) to mobilise private capital by de-risking projects in high-risk developing countries. It supports sectors such as SMEs, agribusiness, health, education, housing, infrastructure, and climate mitigation and adaptation. The PSW blends public and private resources to crowd in private investment in LICs through de-risking mechanisms rather than direct financing. In Cambodia, the BFF supported a 50:50 risk-sharing facility for a portfolio up to USD 30 million, contributing to financial sector development and increasing lending to SMEs (ADB [Asian Development Bank], 2019).

The African Guarantee Fund is an initiative that provides partial credit guarantees to financial institutions in order to mitigate lending risks, alongside capacity-building programmes that enhance partners' ability to assess and manage credit risk when financing SMEs. Established in 2011 by the Danish Government through the Danish International Development Agency (DANIDA), the Spanish Government through the Spanish Agency for International Development (AECID), and the African Development Bank, its mandate is to expand SME access to finance so that they can fully act as engines of economic growth across Africa.

The Africa Agriculture and Trade Investment Fund (ATIF) is a blended finance initiative aimed at strengthening agricultural value chains by providing financing to financial institutions, agribusinesses and SMEs. Its goal is to enhance food security, create jobs and increase incomes through the mobilisation of both public and private capital. In 2011, ATIF made its first investment in Agrivision (Zambia) to support the expansion of its agricultural operations, including the installation of irrigation infrastructure.

The AfricaGrow Fund of Funds is a blended finance initiative aimed at supporting around 150 innovative African SMEs and start-ups in reform-oriented countries by addressing financing gaps and strengthening their equity base. Its objective is to foster sustainable economic and social development while creating more than 25,000 jobs by 2030, with a strong emphasis on sustainability and measurable impact. Its main limited partners include Germany's development finance institutions (DEG and KfW, acting on behalf of the German Federal Ministry for Economic Cooperation and Development) and Allianz insurance companies. AfricaGrow primarily invests in market-oriented regional and country funds operating in countries such as Benin, Côte d'Ivoire, Egypt, Ghana, Morocco, Rwanda, Senegal and Tunisia.

A second key challenge lies in the selection and structuring of financing instruments. Blended finance relies on a heterogeneous set of mechanisms (see Table 1). Concessional senior loans remain the most frequently used instrument, accounting for around 42 per cent of total commitments (Sial, 2025), largely because they align with the prudential constraints and risk preferences of MDBs and DFIs. However, their ability to crowd in private capital is often limited, as public actors retain repayment priority rather than absorbing downside risk for private investors (DFI Working Group, 2018). This suggests that blended finance may be more effective when public capital is deployed in junior or other risk-absorbing layers of the capital structure, alongside greater use of upstream concessional instruments that enhance bankability and expand the pipeline of viable projects. These include subordinated debt, equity and explicit risk-sharing mechanisms such as guarantees. In particular, partial credit guarantees are often considered well suited for domestic SMEs as they cover only part of financial obligations, limiting full risk transfer, reducing moral hazard, and encouraging more rigorous credit assessment and monitoring by intermediaries while maintaining borrower exposure to project performance (Arráiz et al., 2014; Humphrey & Prizzon, 2014).

A third challenge concerns the absorptive capacity of banks participating in DFI-supported intermediated lending programmes. In African economies, Léon (2025) finds that these programmes do not increase aggregate credit; instead, participating banks exhibit lower credit growth than non-participating institutions and mainly reallocate lending towards targeted clients. The author suggests that this pattern may reflect the limited absorptive capacity of recipient banks, particularly shortages of human resources, which require them to reallocate lending and monitoring efforts between clients targeted by the programme and ordinary borrowers. The effects of this reallocation remain ambiguous: it may improve credit access for the most constrained firms but also crowd out other vulnerable borrowers.

A fourth challenge is the fragmentation of the investment support environment. Blended finance often remains transaction-focused due to weak upstream conditions, including thin project pipelines, inconsistent standards, limited coordination among public and private actors, and regulatory frameworks that do not sufficiently reduce uncertainty. A similar pattern is observed in the use of guarantees, where instruments provided by MDBs and European Union institutions remain fragmented, complex and difficult to access. These constraints are fundamentally systemic rather than purely transactional, requiring governments to act both as facilitators, through regulation, standard-setting, coordination and information provision, and as direct actors through early-stage support, public risk-taking and project preparation. Without stronger enabling conditions, guarantees and concessional finance facilities are likely to remain bespoke, costly and limited in scale (UNDP & Convergence, 2026; OECD, 2025a).

A final challenge is tailoring instruments to the distinct characteristics of mitigation and adaptation. Mitigation investments, such as energy efficiency and distributed solar, often generate clearer revenue streams and are therefore better suited to blended finance. By contrast, adaptation investments typically yield diffuse, long-term or public good benefits that are difficult to monetise, especially for SMEs in agriculture, water and local services. Yet adaptation finance remains dominated by loans, while the most climate-vulnerable countries receive relatively little funding. As vulnerability increases, grants and other concessional instruments become more appropriate, suggesting that highly vulnerable SMEs may require technical assistance and targeted concessional finance rather than conventional blended finance models (Hos et al., 2026).

**Table 1: Instruments of blended finance and guarantees**

| Instrument | Definition | Key features |
|---|---|---|
| **A. Debt instruments** | Financing provided by DFIs, commercial banks, investment funds, governments or corporates requiring repayment of principal plus interest; includes loans, credit lines and bonds | Loans may be secured by assets such as property, cash, inventory or receivables; credit lines allow flexible borrowing and repayment within a limit; bonds are fixed-income instruments that provide agreed interest payments over a fixed period. |
| Senior debt | Debt that takes priority over other forms of unsecured or subordinated debt and is repaid first in the event of default | Senior debts are typically provided by private commercial banks, institutional investors and investment funds seeking low-risk exposure and stable returns; DFIs and MDBs can play a catalytic role through co-lending or credit enhancement that enables private capital mobilisation. |
| Subordinated (junior) debt | Debt that ranks below senior debt in the capital structure and is repaid only after all senior obligations have been satisfied | Junior debt has lower repayment priority than senior debt and is typically provided by DFIs, MDBs and concessional investors, absorbing higher risk to improve credit quality and enable private senior lending. |
| Syndicated loans | Loans provided by a group of lenders (a syndicate) working together to finance a single borrower; can take the form of a fixed amount, a credit line or a combination of both | Risk is shared across multiple lenders, typically involving lead arrangers and participating lenders; syndicated loans are generally structured and administered by commercial or investment banks acting as lead arrangers, while MDBs may participate as co-arrangers or anchor lenders to mobilise large financing volumes under a single structured agreement. |
| **B. Equity and risk capital instruments** | Ownership/loss-absorbing capital provided to a company or project, entitling investors to residual returns after all creditors are paid | Instruments have a high risk-return profile with a residual claim on assets and may be provided directly or via investment funds. |
| Equity | Ownership stake in a firm or project with residual claim on profits and assets | Residual loss-absorbing capital is provided by DFIs, MDBs, philanthropic actors, impact investors and private investors; equity structures may include senior and junior tranches, with public actors often providing catalytic or first-loss equity to de-risk investments and crowd in private capital. |
| First-loss capital | Capital or support provided by an investor or grant-maker that absorbs losses first in an investment structure, thereby protecting other investors | First-loss capital acts as credit enhancement by absorbing initial losses; it is used to catalyse participation of other investors and can be structured through multiple instruments (equity, grants, guarantees, subordinated debt). |
| Collective investment vehicles (structured funds) | Investment vehicles with a defined legal structure that pool financial resources from different investors in financial or non-financial assets; different asset classes with distinct risk and return profiles combined in structured funds | The vehicles use a waterfall structure with senior, mezzanine and junior tranches; public donors invest in junior tranches, DFIs in mezzanine, and private investors in senior tranches; losses are absorbed in reverse order of seniority, while returns are distributed in order of seniority; they are often combined with grant-funded technical assistance. |
| **C. Risk-sharing and results-based instruments** | Instruments designed to reduce investment risk or link financing to performance outcomes | The instruments reduce financial, political or operational risks, improve bankability and are often contingent or conditional. |
| Guarantees | Risk-mitigation instruments that reduce financial or non-financial risks; losses covered in the event of default or risk events, while insurance transfers risk to a provider for a premium | Guarantees reduce investment risk and improve bankability by mitigating credit, political and other risks; they mobilise private capital in high-risk markets and operate as contingent liabilities, with payments only made if losses occur. |
| Grants | Non-repayable financial contributions used to reduce investment costs and improve project bankability; often critical for early-stage project preparation in high-risk or less mature markets | Grants support feasibility studies, technical assistance or viability gaps, making projects investment-ready and more attractive to financing. |
| Performance-based grants | Conditional payments disbursed upon achievement of predefined, independently verifiable performance targets; also known as results-based or pay-for-performance financing | Performance-based grants incentivise measurable social or environmental outcomes; they strengthen accountability, align incentives with results, and support project bankability and development of viable project pipelines. |
| Development impact bonds | Results-based contracts where private investors finance social programmes implemented by service providers and outcome funders repay principal plus return only if predefined results are achieved | Payments are conditional on independently verified outcomes; the bonds involve private investors, implementing providers (e.g. NGOs) and outcome funders (e.g. public agencies or donors), with returns depending on achievement of results. |

Source: Authors' adaptation from Humphrey and Prizzon (2014), Habbel et al. (2021) and Sial (2025)

## Specific barriers to blended finance in LICs

Blended finance remains predominantly concentrated in middle-income countries (MICs), with limited reach in LICs. Between 2012 and 2015, LICs captured only 3.6 per cent of total private finance mobilised, while lower- and upper-middle-income countries each accounted for around 40 per cent (Benn et al., 2016). A similar pattern emerges in climate-related blended finance, where MICs represented approximately 41 per cent of transactions between 2019 and 2021, compared to just 24 per cent for LICs (Convergence, 2022). These disparities are further reflected in catalytic effects, with each dollar of MDB and DFI resources mobilising more investment in MICs than in LICs (Attridge & Engen, 2019). While blended finance theory suggests that greater concessional support may be warranted in contexts characterised by severe market failures, recent work highlights that the effectiveness of concessional instruments depends critically on the type of market failure and the design of the intervention (Panizza, 2026).

Several factors constrain the effectiveness of blended finance in LICs (Attridge & Engen, 2019), including weak investment climates, limited bankable projects, and underdeveloped institutional and financial systems. Combined with low risk-adjusted returns, these conditions divert private capital towards more creditworthy economies, leaving many LICs with limited access to finance, particularly in Sub-Saharan Africa. The relatively low risk appetite of MDBs and DFIs further reinforces this pattern by limiting the use of concessional resources in high-risk environments. As a result, scaling climate-resilient investment in LICs requires greater use of upstream concessional instruments. Adjusting profitability targets of MDBs and DFIs and expanding special purpose vehicles (SPVs) or off-balance-sheet facilities could increase flexibility and risk tolerance in financing structures (Pereira dos Santos & Kearney, 2018).

## Conclusion and main policy recommendations

Recent evidence has tempered expectations regarding the ability of de-risking instruments, particularly blended finance, to mobilise private investment. However, this does not imply that these instruments are intrinsically ineffective; rather, their impact depends on the context, type of market failure addressed and intervention design (OECD, 2018; World Bank, 2024). Unlocking their potential therefore requires addressing the structural constraints limiting green investment in LMICs. Selected policy recommendations derived from these challenges are set out below:

**1) Financial intermediaries should prioritise high-impact, financially constrained SMEs, while MDBs and DFIs should ensure genuine additionality in the use of public resources.** Financial intermediaries benefiting from blended finance and guarantee mechanisms should prioritise financially constrained SMEs and small-scale projects affected by genuine market failures, particularly in vulnerable sectors. Public support should be directed only to investments that generate high socio-economic and environmental benefits and demonstrate clear additionality. Effective targeting requires combining quantitative and qualitative assessments of financial performance, market conditions and risk to identify economically viable projects while capturing their broader development impacts, although this remains particularly challenging in LICs. In parallel, MDBs and DFIs should ensure that guarantees and blended finance instruments deliver demonstrable additionality while limiting concessionality to the minimum required. This calls for stronger monitoring frameworks, rigorous ex-post evaluations and greater transparency regarding beneficiaries, financing conditions and financial additionality indicators. Concessionality should be calibrated to project-specific risk, expected profitability, market attractiveness and socio-environmental impact (AIIB, 2017) to maximise the efficient use of scarce public resources. However, measuring leverage and additionality

remains difficult because of limited grant-equivalent data, the absence of credible counterfactuals and the still limited empirical evidence on blended finance despite its rapid expansion.

**2) MDBs and DFIs should align donor incentives with effective risk-sharing mechanisms and adopt more flexible financing structures.** Partial credit guarantees, which cover only part of financial obligations, are generally well suited to SMEs as they reduce moral hazard by requiring financial intermediaries to retain part of the risk. By contrast, concessional senior loans, the most widely used blended finance instrument, may be less effective for high-risk projects, particularly in LICs, which require more comprehensive risk-mitigation mechanisms. Combining concessional loans with risk-sharing guarantees can provide a more balanced structure, strengthening donor incentives while expanding SME risk coverage. The limited use of blended finance and guarantees in LICs, despite greater financing needs, also reflects the low risk appetite of MDBs and DFIs, driven by return expectations and prudential requirements. Bilateral DFIs and national development banks should therefore reassess return targets and consider alternative structures to better channel concessional resources towards underserved and high-impact economies. To this end, alternative structures such as SPVs or off-balance-sheet facilities could increase flexibility in managing high-risk capital and expand financing capacity in fragile environments. Finally, adaptation finance requires a distinct approach, relying more heavily on concessional instruments to support less bankable investments in vulnerable countries.

**3) MDBs and DFIs should improve coordination and standardisation across financial institutions while strengthening local engagement.** The ecosystem of de-risking instruments remains fragmented and insufficiently standardised, limiting their effectiveness and discouraging institutional investors. Greater harmonisation of guarantee and blended finance frameworks across DFIs and MDBs would improve complementarity, reduce information asymmetries and facilitate more efficient capital allocation. At the same time, standardised approaches should remain sufficiently flexible to accommodate local market conditions and preserve the role of domestic financial institutions in identifying, screening and monitoring projects. Standardised documentation, contractual arrangements and technical assistance would simplify project structuring and scaling while supporting secondary markets and reducing transaction costs. Initiatives such as Scaling Capital for Sustainable Development (SCALED), launched in 2024, illustrate this approach by promoting standardised blended finance structures that improve coordination among governments, development banks and private investors, thereby facilitating institutional investment in SDG-aligned projects.

**4) Governments in LMICs should lead efforts to address structural constraints, with MDBs and DFIs supporting complementary de-risking and capacity-building.** Leveraging instruments deployed by MDBs and DFIs, including blended finance and guarantees, should be viewed as temporary tools designed to address specific market failures in LMICs rather than as universal solutions. Recent evidence suggests that their capacity to mobilise private capital, particularly through blended finance, remains more limited than previously expected and is even lower in LICs due to persistent structural constraints, including weak investment climates, underdeveloped financial markets, limited pipelines of bankable projects, insufficient standardisation and information gaps that discourage institutional investors. Enhancing their effectiveness therefore requires not only improved financial structuring and simplified implementation frameworks but also broader reforms to strengthen the enabling environment for SME investment. Governments in LMICs should improve financial information systems, expand reliable credit infrastructure and strengthen SME capabilities in areas such as financial management, risk assessment and project preparation. MDBs and DFIs should complement de-risking instruments with targeted technical assistance for

SMEs and financial intermediaries, while addressing capacity constraints among domestic financial institutions and monitoring wider portfolio effects beyond direct beneficiaries. Ultimately, de-risking instruments are most effective when embedded within broader reforms that strengthen institutions, formalise economic activity and improve the overall business environment.

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