

DERIVATIVES LAWS AND REGULATIONS FOR ALTERNATIVE ASSET MANAGERS

BLENDED FINANCE, CREDIT-RISK TRANSFER, AND THE
MISSING MIDDLE: WHY IMPACT INVESTING STILL
STRUGGLES WITH FINANCIAL ENGINEERING



Overview

1. Blended Finance, Credit-Risk Transfer, and the Missing Middle: Why Impact Investing Still Struggles With Financial Engineering	3
2. Blended Finance Today: Effective, Familiar, and Intentionally Simple	4
3. Why CRT and Derivative Overlays Haven't Reached the Frontline	5
4. The Pension-Fund Frontier: Where Risk, Return, Place, Policy and Institutional Enablement Meet	6
5. Crowding In vs Crowding Out: A Misdiagnosed Risk	7
6. Impact Valuation: The Missing Precondition for Impact-Linked Derivatives	8
7. Outcome-Based Finance: A Parallel Experiment With Lessons	9
8. What All This Means: Derivatives Are Useful But They Are Not the Bottleneck	10
9. A Closing Reflection: Innovation Should Serve Impact, Not the Reverse	11
10. Future Outlook and Policy Recommendations	13
11. Conclusion	15
12. Author Biography	16
13. Firm Biography	17

Blended Finance, Credit-Risk Transfer, and the Missing Middle: Why Impact Investing Still Struggles With Financial Engineering

For more than a decade, the promise of blended finance has been straightforward: combine public or philanthropic capital with private investment to unlock projects that would otherwise be too risky or too small to attract institutional money.

Yet as the sustainable-finance world matures, a new question has started to surface: Could financial tools such as credit guarantees or risk-sharing swaps make investors feel safer, and therefore allow blended-finance deals to scale up more easily?

In a wide-ranging discussion hosted by LexHost, Cliff Prior CBE, one of Europe's most seasoned market-builders in social investment, and Jonathan Gilmour, a leading UK derivatives lawyer at Travers Smith, offered a grounded perspective. What emerged was neither a dismissal of innovation nor an endorsement of financial engineering, but a nuanced picture of where the market actually is – and what it still lacks.

Blended Finance Today: Effective, Familiar, and Intentionally Simple

Across the non-profit and social enterprise sectors, blended finance is already commonplace. Foundations, DFIs, and government agencies routinely take first-loss or concessional positions to enable effective participation.

Cliff described it succinctly:

“Blended finance is very, very commonly used, in its simpler forms. Most social enterprises operate far below the scale at which derivatives or CRT would ever make sense.”

This echoes long-standing practice. The UK’s Access Foundation has become a reference point for small-scale blended funds. At a much larger scale, Cliff referenced in detail the landmark fund with the following structure:

- MacArthur Foundation provided a \$25m unfunded guarantee.
- FMO participated through a \$111m junior tranche.
- The senior tranche was organised by Allianz SE, with Skandia and Allianz Insurance Companies.

Total grant and investment capital reached \$1.11bn, a powerful example, but still a rarity.

Yet despite such successes, Cliff cautioned that complex structures have sometimes proven more expensive than effective.

In other words, blended finance works, but scaled simplicity tends to outperform complicated innovation.

Why CRT and Derivative Overlays Haven't Reached the Frontline

While CRT, total-return swaps, and derivative overlays are common tools in mainstream credit markets, both speakers agreed they rarely appear in impact-first transactions.

Scale mismatch

Most impactful projects are simply too small.

Legal documentation under ISDA, specialist counsel, and risk-monitoring requirements can overwhelm a fund of £5–20 million the typical scale of many social projects, even those backed by national intermediaries.

Cliff was frank:

“Introducing derivatives would be too heavy for most projects. The complexity burden is too high relative to the impact.”

Banks prefer to hold the sustainable assets they originate

Jonathan added an underappreciated point: even where banks lend to sustainable or blended-finance projects, they may be uninterested in transferring the risk away, because doing so undermines their own:

- ESG lending volumes
- internal climate-transition commitments
- regulatory or reputational positioning

So the theoretical “market appetite” for CRT in impact is often overstated.

What if derivatives were applied purely at the institutional layer?

This remains possible in principle: asset managers could package diversified sustainable-lending portfolios and use CRT for balance-sheet efficiency.

But the discussion highlighted that the binding constraint is not risk transfer, it is credible deal flow, governance, and impact measurement. Until these foundations improve, the market will struggle to justify a derivative layer.

The Pension-Fund Frontier: Where Risk, Return, Place, Policy and Institutional Enablement Meet

Both speakers highlighted an important development: pension schemes, particularly in the UK, are being encouraged to invest in local social and sustainable projects, including:

- social housing,
- green infrastructure,
- broader “place-based” investments.

The Impact Investing Institute has published “Impact Investing Principles for Pensions,” clarifying how such investments fit within fiduciary duty. One principle allows trustees to consider local economic benefits where aligned with risk-adjusted returns.

Jonathan framed it from the legal perspective:

“System-level risks, climate, economic stability, are financially relevant over pension time horizons. They can’t be separated from fiduciary duty.”

Large schemes may act as “universal owners” capable of steering capital directly.

Smaller schemes, as Cliff Prior observed, are often constrained by their reliance on external asset managers and rigid contractual mandates, limiting their ability to engage in place-based or impact-aligned investments, a challenge that remains unresolved.

CRT and derivatives may one day sit inside institutional portfolios to manage risk on large pools of sustainable assets, but they are not the primary unlock for pension participation. Governance clarity and impact measurement matter far more.

Crowding In vs Crowding Out: A Misdiagnosed Risk

The conversation emphasised that the fear of “crowding out” grants or concessional finance by using CRT is misplaced.

Cliff shared an experience from Zambia, where substantial DFI capital flowed into the financial system – yet:

“The scale was too large for the local market to absorb. The money strengthened local bank balance sheets but didn’t easily reach the real-economy projects it was meant for.”

The lesson is clear:

- The issue is not that CRT displaces grants.
- The issue is that financial plumbing in many markets is too narrow to absorb large tranches of capital efficiently.

Crucially, this constraint was not permanent. The eventual solution involved sustained, multi-year coordination between Zambia’s Central Bank, local banks, and impact-investing experts to expand intermediation capacity, improve risk allocation, and develop bankable pipelines that could translate system-level capital into real-economy investment.

This aligns with research from Convergence, the global blended-finance network, which consistently finds that the binding constraints in emerging markets are local capacity, intermediation, and pipeline development – not the absence of sophisticated financial instruments.

Outcome-Based Finance: A Parallel Experiment With Lessons

On outcome-based finance (SIBs, DIBs, carbon-linked outcomes):

- The structuring burden is high.
- Costs are significant.
- Deals are often idiosyncratic.

Cliff cited a platform named DIOM (Diversified Impact Outcome Marketplace), developed by ImpactScope, which aims to aggregate and scale outcome-based contracts.

Similarly, the Italian-origin outcome bond model has gained traction for carbon projects but again, at scales where transaction costs can be justified.

The core message:

Until intermediaries and documentation are standardised, complexity will remain a ceiling on growth.

This applies as much to impact-linked derivatives as to outcome bonds.

What All This Means: Derivatives Are Useful But They Are Not the Bottleneck

After reconciling both perspectives, the conclusion becomes far clearer.

What's working today

- Blended finance using simple, well-understood risk layers.
- Local and thematic intermediation.
- Pensions exploring place-based and impact-aware strategies.
- Growing momentum behind impact measurement and accounting.

What's not ready yet

- Derivative overlays for small and mid-sized impact projects.
- CRT in contexts where transaction costs overwhelm the investment size.
- Liquid markets for hedging impact-related performance risk.
- Impact valuation frameworks robust enough to anchor pricing.

Where derivatives may eventually matter

They could become important upstream tools for large institutional sustainable-credit portfolios – once:

- impact valuation becomes standardised or at least as a core reference point,
- reporting and governance align globally, and
- there is enough volume to justify liquid secondary markets.

But the present-day constraint is not engineering innovation it is market infrastructure, pipeline depth, and impact measurement.

A Closing Reflection: Innovation Should Serve Impact, Not the Reverse

Cliff closed with a candid observation relevant to all emerging frameworks:

“Every time a valuation or reporting system is introduced, practitioners immediately start bending it in practice. That’s why these frameworks need constant iteration.”

Jonathan added a pragmatic corollary:

“The questions we’re being asked sit across quite disparate topics CRT, impact bonds, parametric insurance, tokenisation. In reality, the markets for these are at very different stages.”

The message is not that innovation should stop.

It is that innovation must be grounded, phased, and honest about what problems it actually solves.

Systemic risk amplification is also a growing concern. The interconnected nature of derivatives markets means that climate shocks affecting a key sector, asset class, or geographic region can quickly cascade through the system. Inadequate collateral practices, concentrated exposures, or insufficient counterparty risk controls can turn localized climate events into market-wide disruptions.

Addressing these gaps will require coordinated efforts from regulators, market participants, and standard-setting bodies. It will also demand continued innovation in financial modeling, data collection, legal structuring, and policy design. The next section will consider the path forward and offer recommendations for enhancing the resilience and responsiveness of derivatives markets to the realities of climate risk.

Future Outlook and Policy Recommendations

Looking ahead, the effective management of climate-related risks in derivatives markets will depend on the alignment of policy frameworks, regulatory oversight, and market innovation. A forward-looking strategy must begin with the enhancement of climate-related disclosures. Comprehensive and standardized reporting requirements will enable more accurate pricing of risk, improve market transparency, and support better-informed decision-making by investors and counterparties.

Promoting standardization of climate-linked derivatives contracts is equally important. This includes not only contractual language and performance metrics but also methodologies for verifying climate outcomes. Clear definitions and benchmarks for key terms such as carbon intensity, emissions reduction targets, and sustainability triggers are needed to ensure that these instruments function as intended and maintain legal robustness.

Encouraging financial innovation in climate hedging tools is another critical area. Market participants should be incentivized to develop instruments that address sector-specific risks and that can be tailored to diverse transition scenarios. New product development should be supported by regulatory flexibility and legal clarity, while being grounded in sound risk management principles.

Supervisory capacity must also evolve. Regulators need the expertise and tools to assess the climate resilience of derivatives portfolios and infrastructure. This may include developing bespoke supervisory stress tests, increasing cross-agency collaboration, and integrating climate risk into routine supervisory reviews.

Finally, the harmonization of regulatory approaches across jurisdictions will be essential to avoid regulatory arbitrage and ensure consistent treatment of climate risk in globally interconnected derivatives markets. International coordination can foster best practices, facilitate information sharing, and create a level playing field for market participants operating in multiple regions.

Both adaptation to climate damages and emissions reductions programmes have public good elements on account of network effects and pervasive market failures. For example, private individuals may not have the incentive to spend adequate amounts on flood defences from which others will benefit, and therefore be inclined to free ride. Investment in energy, transport and urban infrastructure also requires a degree of central coordination and investment. This makes key sectors highly sensitive to policy, planning and regulation. In turn, this enhances the returns to clear, consistent and credible government strategies which help contain, quantify and manage risk, facilitating derivative pricing.

The climate challenge is complex, urgent, and dynamic. It requires a commensurate response from policymakers, regulators, and financial institutions. Derivatives markets, given their scale and intermediation role, have a critical part to play in the transition to a more sustainable global economy. The path forward must be grounded in prudence, innovation, and a shared commitment to financial and environmental resilience.

Conclusion

As climate change reshapes the landscape of financial risk, derivatives markets stand at a critical juncture. These markets are not insulated from environmental pressures; instead, they are deeply interwoven with the systems and institutions that must adapt to a changing climate. The growing salience of climate-related financial risks has revealed both vulnerabilities and opportunities within the derivatives ecosystem. This work has explored how these risks permeate the structure and function of derivatives markets, and how regulators and market participants are beginning to respond.

Throughout this analysis, a central theme has emerged: derivatives markets serve as both a conduit for and a countermeasure to climate risk. They can transmit shocks through leverage, interdependence, and concentrated exposures. Yet they also offer tools for hedging, for redistributing risk, and for channeling capital toward more sustainable outcomes. The challenge ahead lies in ensuring that the balance tilts firmly toward resilience and utility, rather than fragility and opacity.

While regulatory responses are still evolving, the direction of travel is clear. Enhanced disclosure, standardized products, improved data, proactive supervision and coordinated public policy are no longer optional—they are foundational to a derivatives market that can withstand climate shocks and support an orderly transition to a low-carbon economy. The integration of climate considerations into capital, collateral, and conduct frameworks is no longer theoretical; it is a practical imperative.

The road ahead will demand collaboration across public and private sectors, across jurisdictions, and across disciplines. Legal, regulatory, and financial innovation must go hand in hand. Only through sustained effort and alignment of incentives can derivatives markets fulfill their potential as instruments of climate risk mitigation, adaptation, and accountability.

Author Biography



Jonathan Gilmour

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Jonathan Gilmour is a Partner and Head of Derivatives & Structured Products at Travers Smith. He specialises in derivatives and structured products from both a transactional and advisory standpoint. He is widely regarded by peers and clients as one of the leading specialists in his field. He counts among his clients some of the UK's largest and most sophisticated financial institutions, financial markets

infrastructure, digital asset exchanges, investment managers, private capital managers, challenger banks and occupational pension schemes. Jonathan regularly negotiates and advises on ISDA, GMRA and GMSLA documentation as well as the impact of related regulation, including EMIR/UK EMIR and SFTR/UK SFTR. He also advises on the structure and documentation of bespoke transactions to hedge exposure to key market risks, including interest rate, inflation, FX and longevity, and advises on investment management, custody, clearing and collateral management arrangements, as well as pension scheme funding and risk transfer arrangements. Jonathan is rated as a 'Leading Individual' by both Chambers and Legal 500 and is 'Highly Regarded' by the IFLR.



Cliff Prior

GSG Impact

Clifford James Prior CBE is a civil society leader with a strong record of delivering transformational change and strategic development. He has held CEO roles at Better Society Capital and GSG Impact, where he led initiatives to strengthen impact investing and drive solutions to pressing health, social, and environmental challenges. Cliff focuses on building and leading

organisations that empower people, expand opportunities, and support the development of capacity to address systemic challenges. Cliff is currently advising on a suite of companies, working on the interconnection of SME development, health, impact and AI. These include Gifftid.AI for SME support, Impact Licensing Initiative, epigenetics, and how impact can become tradeable - including through developing an impact outcomes marketplace. Cliff is also a board member of the funding committee of City Bridge.

Firm Biography



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GSG Impact

GSG Impact is a global not-for-profit organisation, established under the 2013 UK G8 presidency, with the goal to create the infrastructure and incentives for capital to flow for measurable, positive social and environmental impact. We do this by creating, accrediting and supporting national impact institutions - GSG National Partners. Each National Partner brings together leaders from business, finance, non-profit and government to advance our goal in their own countries. Today we are responsible for over 40 National Partners covering 2/3 of the global population. Over 1/2 of our National Partners are in emerging markets, with many more in development.