

# Blended Concessional Finance: Governance Matters for Impact

By Kruskaia Sierra-Escalante, Arthur Karlin & Morten Lykke Lauridsen

Blended concessional finance, the combination of concessional funds with other types of finance on commercial terms, has great potential to mobilize capital and accelerate high-impact private sector investments in new and challenging markets. Yet full development of these efforts requires strong governance. IFC has been working for some time to develop a robust governance system for blended concessional finance, guided by the Development Finance Institutions Enhanced Principles, a set of principles that employ special operating procedures and checks and balances when using blended concessional finance for private sector projects. While no universal approach will fit all implementers of blended concessional finance, good governance is a common challenge. These institutions need to learn from each other to ensure good governance, as the sharing of experiences is crucial to building global trust in the use of concessional funds. And to work well, governance structures need to be transparent and focus on solving potential conflicts of interest.

The combination of concessional funds and other types of finance on commercial terms is called *blended concessional finance*.<sup>1</sup> It can play a central role in creating and reinforcing markets in developing countries and can help these countries reach their development goals. This type of finance has great potential for development impact through the provision of finance to private firms where access to commercial finance is limited. Along with advisory services and policy reforms, it can be part of a comprehensive solution to overcome constraints that prevent private sector led growth.

The focus of IFC and World Bank Group efforts in private sector development is increasingly moving toward high-risk environments and lower-income countries where needs are greatest. In these difficult environments there may be a need for temporary use of some concessional funds to help

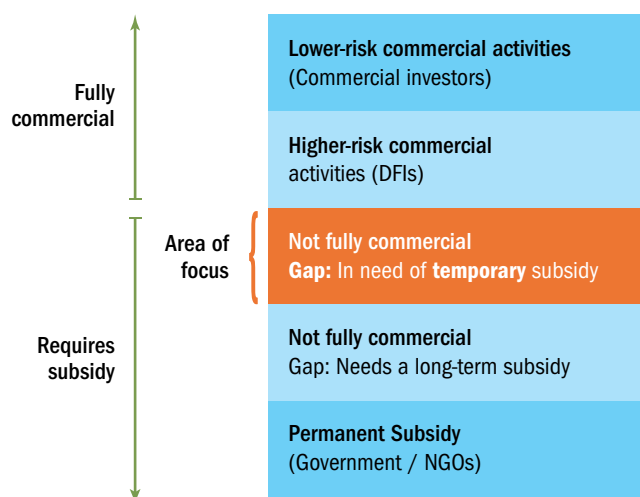
launch important private projects and crowd in sources of commercial finance. These first demonstration projects can help unlock new markets.

Commercial finance and development finance institution (DFI) finance at commercial terms can address the financing needs of many projects (Figure 1). Blended concessional finance is used where impactful and transformative development projects cannot be implemented on fully commercial terms and need a *temporary* push to move forward.

With the increasing focus on providing development finance to high-risk and lower-income countries, blended concessional finance is becoming more and more important, and strong rules are therefore needed to avoid misuse or ineffective use of such funds.<sup>2</sup>

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**FIGURE 1** When Blended Concessional Funds Make Sense

Source: IFC

### Operating Principles for Blended Concessional Finance

While blended concessional finance can help achieve high development impact by creating markets where normal DFI or commercial finance is not sufficient, use of concessional finance by definition cannot apply the “market test” that disciplines commercial finance by requiring that projects provide adequate returns on investment. Without this test, special analyses and processes are needed to determine if a project is worthy of support and if the right amount of concessionalism is being used. The required analytical processes must also guard against potential negative outcomes from the use of concessional resources, including unnecessary allocation of subsidies to DFIs or other investors, or the creation of barriers to entry for commercial institutions, which can undermine market development.

Development finance institutions that invest in the private sector have agreed to a strong set of operational principles (the DFI Enhanced Principles) that specifically address these issues.

#### DFI Enhanced Principles for Blended Concessional Finance in Private Sector Operations

- Economic Rationale for Using Blended Concessional Finance
- Crowding-in and Minimum Concessionalism
- Commercial Sustainability
- Reinforcing Markets
- Promoting High Standards

These principles include:

- **Economic Rationale for Using Blended Concessional Finance.** Concessional finance should be used for projects that contribute significantly to market development. This generally means that the financing will help overcome a market failure and provide returns to society beyond the investors’ returns. By facilitating and pioneering private sector projects, significant improvements can be achieved in the enabling environment, and private markets can then become open to additional companies that can operate without concessional support.
- **Crowding-in and Minimum Concessionalism.** Since concessional funds are scarce, they should be used to the minimum extent possible to make projects viable and attract as much private commercial finance as possible.
- **Commercial Sustainability.** Projects and sectors need to become commercially sustainable over time to contribute to market development. Investments should thus have a clear path to sustainability, with a plan for how concessionalism in the sector can be phased out over time.
- **Reinforcing Markets.** Concessional funds should create and reinforce markets. Markets started with concessional funds can become dependent on subsidies, preventing commercial players from engaging. To avoid this, attention should be given to all aspects of the market that are preventing the viability of commercial projects, such as issues with respect to regulations, suppliers, and skills. Supplementary advisory services and capacity building interventions may be required to address these issues.
- **Promoting High Standards.** All development projects should have high standards for environmental, social, and other issues, but those with concessional finance have a particularly high burden because of the direct public contributions. The use of concessional finance also requires strong governance processes to ensure that all the above principles are implemented.

Overall, in deploying blended concessional finance based on the DFI Enhanced Principles, it is essential to apply analytical rigor and transparency in assessing market failures, determine the size of temporary subsidies that may be needed, and evaluate the potential for market creation and development impact from providing concessional support.

### Key Role of Governance for Blended Concessional Finance

The presence of concessional funds can affect the profitability and risk profile of an investment project and the expected returns and risks for other investors in the project. There can thus be a conflict of interest between the providers of concessional funds and DFIs or other suppliers of funds on commercial terms. Without strong

IFC Management/ Decision Structures	IFC Processes	Analytics	Project Structures
<ul style="list-style-type: none"> <li>• Separate concessional fund teams</li> <li>• Independent decision making through Blended Finance Committee or the Blended Finance Department Director</li> </ul>	<ul style="list-style-type: none"> <li>• Blended concessional finance principle addressed throughout project cycle</li> <li>• Same policies as IFC</li> <li>• Presentations to Blended Finance and Investment Committees</li> <li>• Training/Guidelines</li> <li>• Transparency—Donors, Board, Public</li> </ul>	<ul style="list-style-type: none"> <li>• Concessional element</li> <li>• Analysis of Expected Rate of Returns</li> <li>• IFC's strategy processes</li> </ul>	<ul style="list-style-type: none"> <li>• IFC investment with donor</li> <li>• Sponsor investment in the project</li> <li>• Performance incentives</li> </ul>

**FIGURE 2** Elements of IFC Governance for Blended Concessional Finance

Source: IFC

discipline, development finance institutions may seek to employ concessional financing beyond what is required to make projects viable in an attempt to improve their own financial returns or to improve the financial returns of project sponsors or other investors beyond what is necessary to allow a project to proceed. As financial institutions, DFIs may also have volume targets in certain sectors that lead them to focus on getting deals done even when there is not a clear path to commercial sustainability. Governance structures are therefore needed to manage these potential conflicts and ensure maximum impact of scarce concessional funds.

Implementing the DFI Enhanced Principles also introduces important requirements for analysis outside of the normal governance processes of DFI operations, such as identifying the economic rationale for concessional finance, assessing minimum concessionality, and considering whether it will be feasible to phase out concessional finance over time. It requires clear processes and experience to make these assessments, although care should be taken to ensure these added processes do not unnecessarily slow down project execution.

Demand for special governance arrangements where there are potential conflicts of interest is by no means new in the financial sector or among DFIs, and methods for dealing with the requirements for blended concessional finance has been sought from similar situations. For example, within DFIs, a common issue is the potential for conflicts between providing advice to governments and investing directly in projects affected by that advice. Managing these situations usually involves the separation of investment and advisory teams, clear rules about what data can be shared between teams, and disclosure to all parties involved about the potential for conflicts of interest and the processes employed to manage those conflicts.

Conflict-of-interest issues are also common in the financial industry. For example, in private equity funds there can be different interests between general partners who receive fees and manage several funds, and limited partners who invest in the funds. These conflicts are managed through agreed decision rules regarding different investment situations, and in many cases the use of limited partner investment advisory committees that review transactions where there is a potential conflict. Another example is in commercial banking, where there may be a need to ensure that loan officers with volume targets maintain high credit standards. To provide the needed checks on investment departments, a separate, independent credit department can be employed to approve all loan decisions.

Thus, although approaches to managing conflicts of interest vary greatly depending upon the situation, approaches can include transparency of decision making, independent decision reviews or separate decision-making bodies, restrictions on certain information sharing, and detailed processes to ensure rules are observed and appropriate analyses are done. These lessons should be deployed for finding the best possible solutions for handling potential conflicts of interest in DFIs and others engaging in their use of blended concessional finance.

## IFC's Governance for Blended Concessional Finance

Drawing on some of the experiences and ideas highlighted above and the DFI Enhanced Principles, IFC has been developing, in accordance with its policies and procedures, structures and processes to ensure strong governance when using blended concessional finance. The major structures and processes are highlighted in Figure 2 and are discussed below.

### Team Structures

IFC has established a dedicated team to handle concessional finance investments, separate from the

investment teams that manage IFC's own funds. Although separately staffed and managed (reporting to different management up to the vice president level), the teams share information on the project and work in partnership. However, the concessional finance team represents the interests and monitors the engagement requirements of the concessional finance providers in the transaction, both at the investment stage and during portfolio supervision. This ensures that donor financial interests and development requirements are strongly represented, and that concessional finance principles are observed. The blended finance team may be supported by sector economists in the identification and analysis of the economic rationale for providing concessionality.

### ***Decision Processes***

IFC also uses a senior level, independent decision-making process for blended concessional finance, either through the Blended Finance Department Director, who reports to a vice president outside of operations, or, for more complex or non-routine projects, through a special committee called the Blended Finance Committee. This committee is chaired by an IFC vice president outside of operations and is comprised of directors who are not involved in the project and do not oversee IFC's own account investment. If any potential conflicts of interest are identified, the committee's members may recuse themselves from the decision. The committee or the Blended Finance Director reviews and approves the use, structure, and terms of concessional donor funds at both project concept and approval stages and is also involved in important decisions with respect to any significant portfolio events, including restructurings. The team managing the concessional funds leads the presentation of each project to the Blended Finance Director or the committee, and most donors delegate full decision-making for use of their concessional funds to IFC.

### ***Embedding Concessional Finance Principles and Analytics***

IFC teams managing concessional funds participate throughout the project cycle and are responsible for applying IFC's principles with respect to concessional finance, drawing from the DFI Enhanced Principles. IFC policies require teams to use the same standard of care for donor funds as they would with IFC's own funds. This includes the use of qualified staff and the application of relevant policies and procedures, including environmental and social performance standards and integrity due diligence with respect to lead investors and project managers. Specific discussion of concessional finance principles is required at early endorsement and final approval stages of projects and in project Board documents.

Special analyses are often required to ensure adherence to concessional finance principles. For example, to help assess and justify minimum use of concessional funds, a quantification of the concessional element in a project is required, including, when relevant, a comparison to the

level of concessionality in similar projects.<sup>3</sup> Minimum concessionality may also be determined by examining expected returns on the project, with a comparison to appropriate benchmarks.

Blended concessional finance projects also go through the normal IFC decision processes which, under IFC's *Creating Markets* strategy, provide a holistic focus on all elements, public and private, that are necessary to create and reinforce markets. This includes extensive diagnostics of key private sector constraints with the World Bank, a private sector development strategy in each country, the *Maximizing Finance for Development and Cascade* approach<sup>4</sup> to ensure public and private actions are used in an appropriate mix to open markets, and application of technical assistance to help open markets where needed. In addition, staff managing blended concessional finance projects must articulate how the projects are reinforcing markets, presenting this information to the Blended Finance Director or the Committee and in Board documents.

### ***Staff Guidelines, Training, Internal Promotion***

IFC offers internal training programs for investment officers on adherence to concessional finance principles. Joint sessions have also been held between blended finance investment staff and IFC sector economists to refine the techniques for understanding and articulating the economic rationale for blended finance. Approval templates and Board and Blended Finance Director/Committee documentation includes discussions on adherence to concessional finance principles. Training on blended finance and concessional finance principles is included for all new staff at the induction course for IFC.

### ***Reporting, Monitoring, and Transparency***

IFC strives to have donors and Board members fully informed about the important aspects of blended concessional financial transactions. Reports to donors generally include projects funded, expected impact, and rationale for blended concessional finance, as well as details on the concessional co-investment. Board reports for each project include a section discussing the economic rationale for blended finance and other blended concessional finance principles and how they apply to the project. Board reports also include the project structure and the role and amounts of concessional finance, including the level of concessionality as a percent of total project cost. For measuring impact, all IFC projects are evaluated using the "Anticipated Impact Measurement and Monitoring" (AIMM) framework that measures project contributions to market creation along the dimensions of competitiveness, integration, resilience, inclusion, and sustainability.<sup>5</sup> On average, blended finance projects tend to have higher AIMM scores than IFC's projects not supported by donor funds. This provides another element of comfort that concessionality is delivering additional impact.



Public documents regarding IFC's blended concessional finance projects include pre-board disclosure that blended concessional finance will be used and, when possible, the instruments employed and financing amount, and may include the rationale for use of concessional finance. If requested by donors, public donor reports are prepared showing projects funded and expected impact. Also, overall levels of blended concessional finance used by IFC, and the total cost of the projects financed, are released in public documents including the annual report. Since 2017, the DFI Working Group on Blended Concessional Finance has also been reporting on blended finance activities across 23 institutions, including leverage, breakdowns of volumes by instrument and, more recently, volumes by country income level.

### ***Project Structures***

IFC generally requires certain structural features for investments to provide appropriate incentives for all parties involved to strive to achieve commercial sustainability. For example, IFC's approach to blended finance requires an own-account investment in all blended concessional finance projects and requires that sponsors are directly invested in the project. These are important elements to align interests across relevant stakeholders. For financial institution projects targeting small and medium-sized enterprises, concessional funds are often provided in the form of performance-based grants, to incentivize the achievement of development targets.

### ***IFC Blended Finance Governance Systems in Action***

An example can illustrate how the IFC Blended Concessional Governance structures can improve projects.

IFC was considering financing the construction of one of the first solar power plants in a lower middle-income country in Latin America, which would demonstrate the feasibility of utility scale solar projects in the country and region. Due to country risks, first mover challenges with the new technology, and limited financing from international and local banks, the project was not bankable on commercial terms.

To make this project viable required a combination of concessional and DFI senior loans to improve the cash flow, and concessional subordinated debt to improve the risk profile for senior lenders. Initially the project was structured with donor, IFC, and commercial senior loans and a donor subordinated loan.

However, lessons from previous investments indicated that sometimes subordination of donor investments to senior lenders can be difficult to manage, as conflicts regarding losses and payments can arise between IFC and other senior lenders and the sub-lenders when there are financial issues. The IFC Blended Finance Committee therefore conditioned the larger donor sub loan on IFC investing a small amount in the form of a sub loan (in that case priced

commercially), to align interests between IFC and the donor. Thus, in case of a restructuring, IFC would have a similar interest to the donor in negotiating the possible levels of compensation for holders of the subordinated debt. While this is not always possible, in particular in the context of low-income countries and fragile situations where there are no markets, strong governance structures can help assess when this alignment of interest is desirable or possible.

## **Different Approaches to Handle Conflicts of Interest**

In addition to IFC, many DFIs have been making significant progress in implementing concessional finance principles, including strengthening their decision-making and governance processes and internal capabilities.<sup>6</sup> Many institutions have made a priority of having strong operating guidelines that specifically draw on the Enhanced Principles, as well as transparency regarding concessional funds use. DFIs are also putting in place various types of checks and balances on the use of concessional funds. Although there are many variations of these checks and balances, some of the main approaches include:

- **Team structures** range from: 1) use of regular operational staff for structuring both the concessional finance and any DFI own-account finance, but with special detailed policies and guidelines for use of the concessional funds, and with independent internal reviews; 2) use of dedicated and independent concessional finance staff, working with regular investment units, representing blended concessional finance issues in approval committees; and 3) independent concessional finance teams reporting to management outside of the investment departments.
- **Decision committees** also vary. Some DFIs have a separate blended concessional finance committee, while others use the regular approval committees, but rely on the specialized and independent concessional finance staff or teams to represent the donor viewpoints. A third approach is to use the regular approval committees for decision-making, but with the advice and review of an independent technical level committee, which can be composed of in-house experts not connected with operations and may include outside experts and peers.

The type of structures for checks and balances used by DFIs are driven by several factors:

- **Level of interaction with donors.** Some donors approve each project, providing a strong level of oversight that reduces the need for checks and balances within the DFI. Other donors delegate decision-making on individual projects to the DFI, placing a stronger requirement for independent decision structures within the institution.

- **Volume of blended concessional finance operations.** Separate concessional finance units and decision-making committees require a large volume of activity to support overhead costs but may be justified over time. For example, at IFC, the governance structures evolved in stages as blended concessional finance grew over almost two decades.
- **The need for processing speed.** Separate decision committees introduce an additional decision layer in investment processing and can slow processing down. One way some DFIs address this issue is to use blended concessional finance committees on an exception basis, that is, only in cases with special issues, and delegate decision-making for other projects to lower levels.

## Going Forward—Key Issues

Effective management of concessional funds requires different operating processes and decision-making structures to implement appropriate principles and to address potential conflicts of interest. As demonstrated in this paper, there are a range of structures and processes that can be employed to achieve effective governance, depending on each DFI or other blended finance implementer's specific circumstances.

To scale up the use of blended concessional finance, strong governance is required that ensures impact, the crowding in of private investments, and trust for the donors that provide concessional funds. Going forward, three issues are key for progress:

First, DFIs need to continue to share experiences with different governance approaches in order to make improvements that ensure that concessional funds are used effectively and efficiently, with maximum impact on market creation. Governance models should evolve based on their effectiveness, with a joint vision of learning from each other.

Second, the incentives of the different actors involved in blended finance transactions need to be understood from the start of any transaction, as the motives of a financial intermediary might be different from those of donors. The governance structures should focus on managing potential conflicts of interest and on implementing strong principles for the use of concessional finance, based on the DFI Enhanced Principles. This is even more crucial as concessional finance is entrusted to private sector actors that may not have experience in managing public resources or providing concessionality to private sector operations.

Third, any governance solution for the use of blended concessional finance should be based on transparency, both for private and public actors involved in investments. Disclosure of information on concessionality is essential to providing the required trust among all actors and should be a key element of DFI cooperation. DFIs should also share evaluations and monitoring of results from the use of concessional funds.

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**Please see the following additional EM Compass Notes about blended finance in emerging markets:** *Blended Concessional Finance: Scaling Up Private Investment in Lower-Income Countries* (Note 60); *Blended Finance – A Stepping Stone to Creating Markets* (Note 51); *Blending Public and Private Finance* (Note 3).

<sup>1</sup> The DFI Blended Concessional Finance Working Group defines blended concessional finance as *Combining concessional finance from donors or third parties alongside DFIs' normal own account finance and/or commercial finance from other investors, to develop private sector markets, address the Sustainable Development Goals (SDGs), and mobilize private resources.*

<sup>2</sup> For a discussion of DFI use of blended concessional finance in lower-income countries, see Sierra-Escalante, Kruskaia, Arthur Karlin and Morten Lykke Lauridsen. 2018. "Blended Concessional Finance: Scaling Up Private Investment in Lower-Income Countries." *EM Compass Note No. 60*, November 2018.

<sup>3</sup> The "concessional element" is the grant equivalent of any concessional finance instrument. For instance, the "concessional element" of a grant is 100 percent, while the concessional element of a low interest rate loan might range from 5 to 25+ percent.

<sup>4</sup> Under the World Bank Group's *Maximizing Finance for Development* approach, private sector solutions to development are prioritized first so that scarce public resources are devoted to those areas where they are most needed. Where private sector solutions are not yet possible, advice is provided to governments to improve the investment climate so that private sector solutions can become viable. Where full commercial private sector investments are still not viable, concessional funds may be used along with commercial finance to help launch important private sector projects. See World Bank Group. 2017. "Maximizing Finance for Development: Leveraging the Private Sector for Growth and Sustainable Development." Report prepared by the World Bank Group for the Development Committee, September 17, 2017, pp. 1–2.

<sup>5</sup> For more information on IFC's AIMM framework see: [https://www.ifc.org/wps/wcm/connect/topics\\_ext\\_content/ifc\\_external\\_corporate\\_site/development+impact/areas+of+work/sa\\_aimm](https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/development+impact/areas+of+work/sa_aimm)

<sup>6</sup> "DFI Working Group on Blended Concessional Finance for Private Sector Projects, Joint Report." 2018. [https://www.ifc.org/wps/wcm/connect/9ae7c66a-d269-4707-9f4d-0fb79947ede8/201810\\_DFI-Blended-Finance-Report.pdf?MOD=AJPERES](https://www.ifc.org/wps/wcm/connect/9ae7c66a-d269-4707-9f4d-0fb79947ede8/201810_DFI-Blended-Finance-Report.pdf?MOD=AJPERES)

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