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**Research Report**

# Blended finance and its potential for development cooperation

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21 BRIEFING PAPER

# Blended Finance and its potential for development cooperation.

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# List of Abbreviations

| | |
|---|---|
| AgriFI | Agricultural Financing Initiative |
| AIF | Asia Investment Facility |
| AIP | Africa Investment Platform |
| BMZ | Federal Ministry for Economic Cooperation and Development (Germany) |
| CIF | Caribbean Investment Facility |
| DCI | Development Cooperation Instrument |
| DFID | Department for International Development |
| DFIs | Development Finance Institutions |
| EC | European Commission |
| EDF | European Development Fund |
| EFSD | European Fund for Sustainable Development |
| EIB | European Investment Bank |
| EIP | External Investment Plan |
| ENI | European Neighborhood Instrument |
| EP | European Parliament |
| EU | European Union |
| EUR | Euro |
| FfD | Financing for Development |
| FMO | Netherlands Development Finance Company |
| IFC | International Finance Corporation |
| IFCA | Investment Facility for Central Asia |
| IFIs | International Finance Institutions |
| IFP | Investment Facility for the Pacific |
| IPA | Pre-Accession Assistance |
| KfW | Kreditanstalt für Wiederaufbau |
| LAIF | Latin America Investment Facility |

| | |
|---|---|
| LDCs | least developed countries |
| LICs | low-income countries |
| MDBs | Multilateral Development Banks |
| MIF | Multilateral Investment Fund |
| MMF | Multiannual Financial Framework |
| NDICI | Neighborhood, Development and International Cooperation Instrument |
| NIP | Neighborhood Investment Platform |
| ODA | Official Development Assistance |
| OECD | Organization for Economic Cooperation and Development |
| OECD DAC | OECD Development Assistance Committee |
| OHCHR | Office of the High Commissioner for Human Rights |
| SDGs | Sustainable Development Goals |
| SMEs | Small and Medium-sized Enterprises |
| SSA | Sub-Saharan Africa |
| UN | United Nations |
| UNCTAD | United Nations Conference on Trade and Development |
| USAID | United States Agency for International Development |
| USD | US Dollar |
| WB | World Bank |
| WBIF | Western Balkans Investment Framework |

# Abstract

The implementation of the Agenda 2030 entails massive financing needs. The debate increasingly emphasizes the importance of the private sector and the role of aid to 'leverage' private sector investments for development. In this context, the concept of blended finance is key. This briefing paper traces the current debates about blended finance. It introduces definitions, instruments and main actors, presents existing data and provides a critical assessment of the concept.

***Keywords***: blended finance, SDGs, European Union, development finance

# 1. Introduction: Leveraging SDGs with private finance

The implementation of the Agenda 2030 with its 17 Sustainable Development Goals entails massive financing needs. Additional spending required to deliver on the SDGs in so-called developing countries is estimated at USD 2.5 trillion per year (UNCTAD 2014). Financing needs for infrastructure are estimated at USD 1.5 trillion per year (UN 2015). There is a consensus that these volumes cannot be raised from public sources alone. Hence, the debate increasingly emphasizes the importance of the private sector in helping to fill these financing gaps.

While the promotion of private sector activities in target countries has long been part of development cooperation strategies, there has been a shift in recent years towards defining the private sector as a partner at the national and global level in addressing development challenges. This shift has to be seen in the context of declining Official Development Assistance (ODA) and rapidly increasing (though highly volatile) private capital flows to developing countries since the 1990s (Küblböck/Staritz 2015).

In recent years, the focus has turned to conceptualising aid as a catalyser to 'leverage' private sector investments for development. The associated slogan, to "move from billions to trillions"[1], has become popular in the development discourse. The underlying assumption is that small amounts of aid can be used to overcome barriers to investment and hence mobilise private capital to fill gaps in development finance, particularly related to infrastructure (Küblböck/Staritz 2015; UN 2017).

This assumption is crucial to the concept of blended finance, which has gained momentum in recent development debates and strategies. Discussions at bilateral and multilateral levels, (e.g. about leverage targets of Development Finance Institutions or about including private sector flows ODA statistics) indicate that the volume of blended finance is set to increase in the coming years. The European Union (EU) is a key actor in this field. Current plans about its new financial development architecture suggest that blended finance mechanisms will play a prominent role in the coming decade. This briefing paper traces the current debate about blended finance. After this introduction, the second part discusses definitions, presents existing data about volumes and delineates the rationale for the increased use of blended finance. The third part gives an overview on instruments and actors involved, and identifies main trends. The fourth part is about the European Union as key actor of blended finance. The fifth part provides a critical assessment of the concept. The last part concludes.

[1] The slogan was introduced in a report prepared by the largest Multilateral Development Banks (AfDB et al. 2015) for the Development Committee Meeting 2015.

# 2. Definitions, volumes and rationale for blended finance

Blended finance has found its way into the Financing for Development (FfD) discussion as a promising tool to provide the sustainable development agenda with additional capital. However, as there is no consensus about the exact definition of blended finance, it is difficult to acquire reliable figures of public and private funding dedicated to blending operations. This chapter gives an overview about definitions of blending used by different institutions, about various attempts to quantify volumes of blended finance and about the rationale for the increased use of this approach in development finance.

## 2.1. Definitions and volumes of blended finance

The basic concept of blended finance is the creation of financial mechanisms that use public (or philanthropic) funds to attract additional private finance for projects with a development objective. Hence, the two key elements of blended finance are the additionality of funds – the private investment would not have materialised without the public contribution – and the investment's positive contribution to development.

However, different actors employ different definitions of blended finance. A recent UN-report on blending identified more than 30 definitions (Choritz et al. 2018). Differences relate, amongst others, to the sources of funding (public/private, or public/public), and to the question of whether concessional[2] resources have to be involved. The absence of common definitions and reporting criteria make it difficult to obtain systematic insights and to have an informed discussion about the amount of private resources mobilized, public resources invested, and development effects (Attridge/Engen 2019; Bilal/Große-Puppendahl 2016).

At a multilateral level, a working group was formed in 2017 by Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs), to "help ensure the effective and efficient use of concessional resources in private sector projects, and avoid market distortion or crowding out private capital" (DFI Working Group 2018: 7) and to harmonise blended finance approaches. It formulated common principles[3] and developed a methodology to estimate the volumes of private finance. The working group refers to 'blended concessional finance for the private sector operations of DFIs' and defines it 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 SDGs, and mobilize private resources' (DFI Working Group 2017: 3).*

Based on this definition, data collected by the working group found that DFIs financed a total project value of more than USD 15 billion between 2014 and 2016. Out of this sum, concessional donor finance amounted to USD 1.5 billion, USD 5.2 billion came from DFIs' own account finance and consequently, private investment mobilized was USD 8.3 billion (DFI Working Group 2017: 9). An updated survey reports a total project volume of USD 8.8 billion in 2017, out of which concessional commitments were USD 1.2 billion, DFIs' own account regular pricing investment USD 3.9 billion and private sector investment USD 3.3 billion (DFI Working Group 2018: 12). In both reports, the working group states that the project volume financed by DFIs using blended concessional finance solutions is a relatively small percentage of total DFI private sector projects financed throughout the year.

At a bilateral level, the OECD has taken on a coordinating effort among its members to find a common definition of blended finance and to formulate common principles and criteria (see OECD 2018a). This is particularly relevant, as the currently discussed modernisation of ODA

2 Concessional finance is extended on terms more generous than market conditions. A concessional loan has either interest rates below market rates or grace periods, or a combination of both. See: https://stats.oecd.org/glossary/search.asp
3 Enhanced Blended Concessional Principles for DFI Private Sector Operations

statistics within the OECD DAC will enable donors to report investment in blended-finance approaches to a certain extent as ODA (see more details in Obrovsky/Riegler 2019). As a result of the OECD coordination endeavour, the following definition of blended finance has been adopted:

'*the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries*' (OECD 2018b: 22).

The definition agreed upon by OECD DAC members is much broader than the definition adopted by the DFI working group. In the OECD definition, the term *additional finance* refers to both public and private commercial finance that is not currently deployed to support development outcomes. *Development finance* is defined as external finance including development assistance from donor governments, development finance providers, and philanthropic foundations' private funds (OECD 2018b), and includes both concessional and non-concessional resources.

Based on this definition the most recent OECD survey – covering the years 2012-2015 – concludes that USD 81.1 billion were mobilized from the private sector as a result of official development finance interventions. This amounts to a yearly average of about USD 20.3 billion (Benn et al. 2017), which is considerably higher than the results of the DFI working group (USD 2.8 billion/year). The OECD's numbers rely on answers by 72 bilateral and multilateral development institutions (aid agencies, DFIs, and development banks). The participating institutions reported on amounts mobilized by guarantees, syndicated loans, shares in collective investment vehicles, credit lines, and direct investment in companies. Contrarily to MDBs and DFIs, the OECD identifies the mobilization of private-financing operations by these institutions as blended finance even if they are solely funded from their own account resources (Attridge/Engen 2019).

Finally, the global network Convergence – "an institution that connects, educates, and supports investors to execute blended finance transactions" (Convergence 2017: 2) – aims to expand the evidence-base around the potential of blended finance. It claims to maintain the largest and most detailed database of historical blended finance transactions in the market and defines blended finance as

*"the use of catalytic capital from public or philanthropic sources to increase private sector investment in developing countries and sustainable development" (Convergence n.d.a).*

This definition is narrower than the OECD approach as it focuses only on private capital with regard to *additional finance*. In 2017, Convergence's database included 187 blended finance deals that mobilized USD 51.2 billion towards sustainable development in so-called development countries (Convergence 2017: 4). Currently (May 2019), Convergence's online database comprises over 440 historical blended finance transactions amounting to over USD 126 billion mobilized private capital (Convergence n.d.a). An annual breakdown is not available.

These examples demonstrate the effects of inconsistencies in the definitions of blending between major development actors. Reported volumes substantially differ and are hard to compare. Even if discussions between the OECD and the MDBs have started (OECD 2018c) and Convergence states that it works closely with the OECD and the DFI Working Group to coordinate blended finance activities (Convergence n.d.a), progress on alignment and harmonization has yet to be achieved (Attridge/Engen 2019). However, the collected and presented figures give first insights into trends of blending finance concerning use, potential, sectoral and regional distribution, and actors involved (see section 3.2 in this paper).

## 2.2. Rationale for blending

The principle of blended finance is not new, despite the momentum it has recently gained. The main reason for the increased attention is its perceived potential to raise very large sums of money for development projects from the private sector with comparably small sums of ODA (Bilal/Große-Puppendahl 2016; Tew et al. 2016). According to the European Commission (EC), the main factor that has contributed to the emergence of blending within development finance has been the rising demand for development funding from partner countries to meet the SDGs and to finance capital-intensive projects (EC 2015). Another view is given by Mawsdley (2018), who sees blending as part of a trend to use development finance to create investment opportunities in 'frontier' economies for over-accumulated international capital.

The narrative supporting blending is based on the argument that market failures are especially pronounced in developing countries and thus lead to suboptimal levels of private investment (Attridge/Engen 2019). In other words, the lack of investment in developing countries is not caused by a lack of capital, but by the capital owner's unwillingness to invest due to risk-return considerations – related either to macroeconomic and business risks or regulatory and political risks (OECD 2018b). Eventually, even if investments in developing countries may represent positive project returns, associated risk and uncertainty may deter commercial investors from providing financing (ibid.) The objective of blended finance arrangements is therefore to reduce or compensate for risk (Tew et al. 2016).

The increased use of blending can also be seen as a response of traditional development finance institutions to the emergence of new donor institutions that provide relatively cheap financing on a flexible or no-conditionality basis. This has created competitive pressure within traditional donor countries, in particular related to the Go-Global strategy of China (EC 2015; Tröster et al. 2017).

*Additionality*

Blended finance as a tool to shift the perceived unfavorable risk-return relationship by providing a guarantee to the investor and thereby removing barriers to the investment faces a two-fold task: on the one hand, it has to calibrate finance instruments in order to take account of investor's concerns about risk-return profiles. On the other hand, it has to ensure the delivery of expected development outcomes (OECD 2018b). To adjust this potential tension, the concept of *additionality* plays a crucial role. Since blended finance means to subsidize private investment, the use of ODA can only be regarded as legitimate as long as benefits to society exceed private returns (Carter 2015). Put differently, a blended finance transaction has to deliver an *additional result* that would have not materialized *without* the public money transfer (Bilal/Große-Puppendahl 2016).

The most prominent dimension of additionality is *financial additionality*. Financial additionality is given when the investment would not have materialized without the public contribution (Bilal/Große-Puppendahl 2016; Pereira 2017). Regarding its blended finance definition, the DFI working group underlines the difference between *concessionality* and *additionality* by emphasizing that the former is not the source of the latter. Concessionality rather undermines additionality "if a DFI offers the same financial services in concessional terms as commercial finance institutions are willing to provide on market terms" (DFI Working Group 2017: 5). Also the OECD states that blended finance should only be deployed where financial additionality is clearly demonstrated (see OECD 2018b: 31).

*Developmental additionality* refers to the outcomes of blended finance transactions and projects. It asks whether blended finance leads to better development results compared to results that could not have been achieved without the mobilization of commercial finance (OECD 2018b; Pereira 2017). While some actors in the debate refer to developmental additionality, others prefer to speak about *development impact* (Benn et al. 2017; Convergence 2017; DFI Working Group 2017), which however risks to disregard to what extent a positive effect is linked to the commercial contribution.

Further dimensions are *operational (institutional)* and *systemic* additionality. The former describes the improved quality of an investment due to public finance and its technical, social, environmental, governance standards and practices (Bilal/Große-Puppendahl 2016). The latter represents a broader approach and refers to the potential that successful projects implemented with blended finance might help overcome investor's biased risk perceptions by giving a positive signal to the market (ibid). Although there are hardly any explicit references to these dimensions, the EU's approach, for example, shows that they are taken into account (see section 4 in this paper).

# 3. Instruments, actors and trends

Blended finance can take many different forms, and various actors are involved in blending operations. Even if definitions differ and the collected data lacks comprehensiveness, some trends can be identified to assess the potential of blended finance. This chapter introduces the main instruments and actors involved in blending operations, and sketches trends that can be distinguished across different datasets.

## 3.1. Blending instruments

Various instruments are employed in the endeavor to mobilize additional resources into development projects. Each instrument has characteristics that make it more or less appropriate for a given project, and has different potential impacts, risks and returns for the parties involved (Tew et al. 2016).

The following main instruments can be identified[4] :

- Equity instruments (including junior/subordinate capital/risk capital)
- Debt instruments
- Mezzanine instruments (mix of equity and debt instruments)
- Grants (e.g. investment grants/design or preparation grants) and interest rate subsidies
- Guarantees and risk-insurance mechanisms
- Technical assistance;

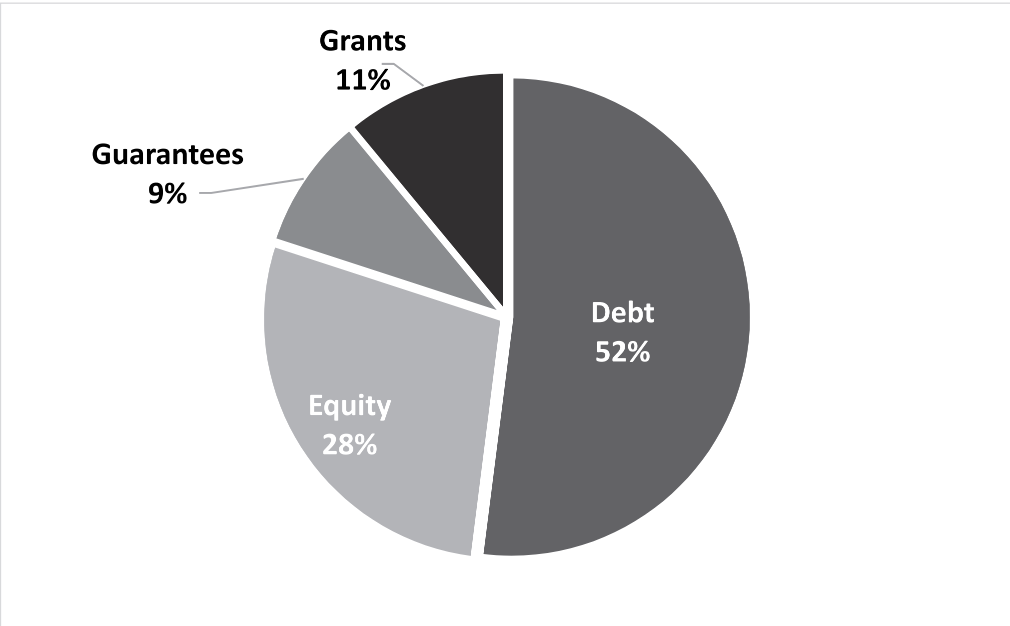
For DFIs, the standard financial instruments are equity and debt instruments, as well as mezzanine finance that combines characteristics of both. DFIs use these instruments to finance projects at both market rates and concessional terms. Grants (and grant like contributions such as interest rate subsidies) are direct, non-reimbursable monetary contributions to a project or fund used in particular in cases of projects with high economic rates of return to society but low financial profitability for investors. Guarantees and insurances refer to arrangements where the public sector agency does not provide immediate funding, but instead enters into an agreement to protect against political or commercial risks by compensating losses (OECD 2018b; Tew et al. 2016). Technical assistance provides support in different phases of the project. It includes for instance feasibility studies and capacity building during the project's preparation or policy advice during implementation. Technical

[4] This compilation is based on different systematizations by different actors: Benn et al. (2017); Convergence (n.d.a); DFI Working Group (2017); EC (2015); OECD (2018b).

assistance is used to boost project design, management, and/or quality (EC 2015; OECD 2018b).

The available databases show diverging decompositions of blended finance activities by type of instruments due to differences in the underlying surveys. According to DFI working group figures, debt instruments accounted for roughly 52 % of DFI's concessional commitments in 2014-2016 (43.0 % senior debt; 9 % sub debt). Commitments using equity instruments accounted for 28 %, risk-sharing facilities or guarantees for 9 % and grants for 11 % (DFI Working Group 2017: 10; Figure 1). In contrast, the OECD reports that bilateral and multilateral development institutions used primarily guarantees (44 %), followed by syndicated loans (19 %), debt instruments (credit lines) (19 %) and equity instruments (18 %) (Benn et al. 2017: 4).The Convergence database presents different categories and numbers with concessional capital (including debt and equity) accounting for 45 %, technical assistance funds for 26 %, guarantees and risk insurance for 20 %, and design-stage grants for 9 % of blending instruments (Convergence n.d.a). Finally, the EU's focus lies on investment grants, grant-like contributions such as interest rate subsidies, and technical assistance. These three instruments together accounted for 90 % of the EU's support to blending projects in the Multiannual Financial Framework (MMF) 2007-2013 (investment grants 48 %; technical assistance 31 %; interest rate subsidies 11 %; guarantees and risk capital 10 % (EC 2015: 9).

***Figure 1: Break down by Type of Instrument used by DFIs***




Source: DFI Working Group (2017: 10)

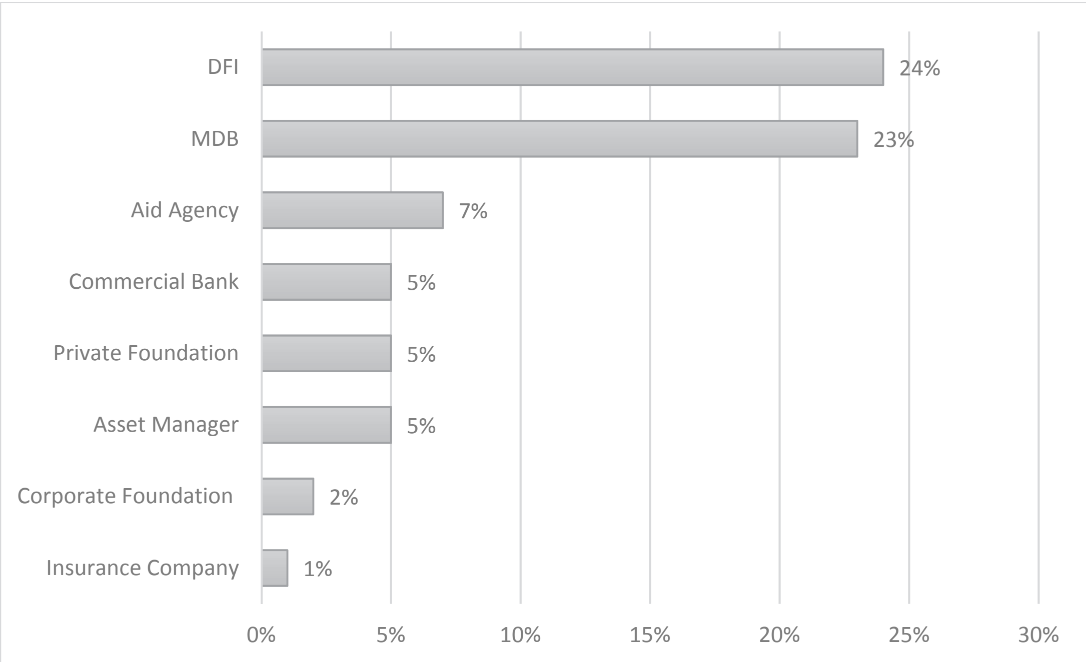
## 3.2. Actors involved in blending operations

As diverse as the instruments are the actors involved in blending finance. In a mapping exercise, Convergence (2017) lists numerous organizations involved in financing, management, research and advocacy of blended finance and divides them into nine categories. These include for instance aid agencies and public donors, multilateral and national development banks, private foundations, commercial banks and investors as well as think tanks and NGOs.

According to Convergence (2018), around 800 organizations have made around 2500 financial commitments to a blended finance structure. While more than 75 % of these actors are private entities (55 % commercial investors, 25 % philanthropic organizations), the public investors are the most active. Among the actors with at least three engagements, more than half of the financial commitments are made by public players. DFIs account for 24 % of these commitments, MDBs for 23 % and aid agencies for 7 % (Figure 2).

Public investors either provide finance or act as intermediaries for blending instruments and structuring mechanisms. In particular, MDBs and DFIs as public investors with a commercial-development mandate are involved in different roles. On the one hand, they act as commercial investors by providing commercially-priced capital for blended finance transactions. On the other hand, they blend donor money with their own commercial capital which allows them to invest on below market terms, to reach companies or projects that they would not be able to support on commercial terms (Merchant 2019). The most active DFIs in blended finance (by number of financial commitments) are the International Finance Corporation (IFC, 156 commitments), Netherlands Development Finance Company (FMO, 134) and European Investment Bank (EIB, 64).

***Figure 2: Type of active investors by number of investments***




Source: Convergence (2018)

The most active donors involved in blending are the United States Agency for International Development (USAID, 66 commitments), the British Department for International Development (DFID, 30), the World Bank (WB, 27), followed by the German Federal Ministry for Economic Cooperation and Development (BMZ, 27) and the Multilateral Investment Fund (MIF, 25), and (Convergence n.d.a).

Despite the dominance in terms of numbers of commitments, Convergence (n.d.a.) reports an average size of investments between USD 10 to 20 million.

Private investors engaged in blended finance cover a large variety of actors. These include private financial actors such as commercial banks, asset managers and insurance companies. These private financial players account for 11 % of financial commitments (see Figure 2). Beyond commercial actors, philanthropic investors provide funds for blended finance transactions responsible for 7 % of all financial commitments. This type of investors comprises private foundations such as the Bill & Melinda Gates Foundation but also corporate foundation such as the Shell foundation. Further, impact investors such as Calvert Impact Capital, Triodos

Bank or Oikocredit as well as some NGOs are engaged in blended finance structures (Convergence 2018). The average investment size varies significantly among private actors. However, current data do not allow a decomposition of blended finance by type of investor and volume of committed funds.

## 3.3. Trends in blended finance

It has already been noted that figures on blended finance significantly differ according to the definition in use, the periods analysed and the actors surveyed (see section 2.1 in this paper). Thus, the collected data lacks comprehensiveness (Benn et al. 2017; Convergence n.d.b). Nevertheless, it can help to identify certain trends and to assess the potential of blended finance. As Convergence (2017) points out, multiple trends can be distinguished across all datasets, amongst others on regional and sectoral allocations (see also Benn et al. 2017; DFI Working Group 2017; Tew/Caio 2016). Three issues appear to be of particular importance:

*Blended finance grows constantly, but may not live up to high expectations*

Convergence's historical data shows that blended finance transactions were growing steadily with an acceleration since 2007-2008 (Convergence 2017: 4). Within Benn et al.'s (2017: 4) observation period, private finance mobilized has risen from USD 15.0 billion in 2012 to USD 26.8 billion in 2015. This represents an increase of about 79 %. The OECD (2018b: 98f.) in general notices an increasing interest in blended finance facilities among development finance providers.

However, extrapolating OECD figures suggests that the amount of capital mobilized from the private sector will fall short in providing the "trillions" needed to fill the SDG funding gap (Tew/Caio 2016). Attridge/Engen (2019: 38) estimate that the leverage of blended finance projects by nine MDBs and DFIs analysed reaches a ratio of 0.75. In other words, 1 US Dollar of public capital mobilized 75 USD cents of private finance. For projects in LDCs, the ratio was even lower with 0.37. In addition, compared to other forms of international resource flows to developing countries, private sector investments resulting from blended finance transactions remain very limited. In 2014 they accounted only for a resource flow share of 0.7 % (Tew/Caio 2016: 7). In this context, the call to lower expectations of the potential of blended finance is repeatedly being voiced (e.g., see Attridge/Engen 2019).

*(Sub-Saharan) Africa receives the most capital, but only a small portion goes to low-income countries (LICs)*

According to Benn et al.'s (2017: 5) estimations, roughly 30 % or USD 24.3 billion of private finance mobilized went to African countries. Convergence (2018: 12) calculates that approximately 42 % of blended finance deals targeted Sub-Saharan Africa (SSA). However, only around 30 % of total global capital mobilized in these structures go to this region due to the low average deal size of around USD 125 million (Convergence 2018). The DFI Working Group data support these findings: In 2017, new concessional commitments of USD 326.0 million went to SSA. By way of comparison, Europe and Central Asia, which rank second, received commitments amounting to USD 223.0 million (DFI Working Group 2018: 16).

However, blended finance is unevenly spread across countries with different income levels. Benn et al. (2017: 5) find that 77 % of the funds mobilized were for projects in upper and lower middle-income countries. Projects in so-called least developed countries (LDCs) and low-income countries (LICs) only received contributions of USD 5.5 million (7 %) and USD 2.2 million (3 %). Convergence's (2017) and the DFI Working Group's (2018) results confirm these findings. Attridge/Engen (2019: 29) point to the potential risks of this development, which will lead to ODA being diverted away from LICs and from investments in health, education, and social protection that are needed to eradicated extreme poverty.

*Financial services, energy, and industry sectors gain most – effects on social infrastructure remain unclear*

Benn et al. (2017: 8) identify the banking sector (33 %), energy generation and supply (25 %), and industry (14 %) sectors as dominant sectors in terms of amounts mobilized. Convergence (2017: 5f.) partly confirms these findings. By applying a different terminology, it states that 26 % of blended finance deals took place in financial services, 23 % in energy and climate, and 14 % in health. When measuring capital mobilized via blending instruments, the relation shifts to 15 % for financial services, 30 % for energy and climate and 30 % for health. The last number comes as a surprise, since in Benn et al.'s (2017) statistics the amounts spent on health are USD 2 billion, representing only 3 % of total capital mobilized.

While there is a broad agreement that the financial services/banking, energy/infrastructure, and industry sectors will remain important targets for blended finance, since they represent clear business cases (OECD 2018b), discussions are ongoing in how far social infrastructure sectors can benefit from blended finance deals. More detailed information by providers of blending is needed to evaluate effects on those sectors, e.g. to which subsectors money is channelled (Tew/Caio 2016).

# 4. The European Union as key actor of blended finance

The European Union (EU) has been at the forefront of promoting blended finance. Since the concept's introduction in the Multiannual Financial Framework (MFF) 2007-2013, blending has become an important tool of EU external cooperation. The EU development cooperation framework "Agenda for Change" (EC 2011) also explicitly mentions blending as innovative way of financing development by encouraging private investment and partnerships in development.

The EU defines blending

"as the strategic use of a limited amount of grants to mobilize financing from partner financial institutions and the private sector to enhance the development impact of investment projects" (EC 2015).

According to the EC (2015), EU-blending comprises the following goals:

- financial leverage: mobilize public and private resources for enhanced development impact;
- non-financial leverage: improve project sustainability, development impact, quality, innovation and enable a faster project start;
- policy leverage: support reforms in line with EU and partner country policies;
- aid effectiveness: improve cooperation between European and non-European aid actors
- visibility: provide more visibility for EU development funding

## 4.1. EU blending facilities

Eight blending facilities have been established since 2007 covering all the geographical regions of EU development cooperation. In 2012, the EU Platform for Blending in External Co-operation was launched to coordinate efforts across all EU blending facilities.

Currently, the following EU blending facilities exist

- Africa Investment Platform (AIP),
- Caribbean Investment Facility (CIF)
- Investment Facility for the Pacific (IFP)

- Neighborhood Investment Platform (NIP)
- Latin America Investment Facility (LAIF)
- Asia Investment Facility (AIF)+
- Investment Facility for Central Asia (IFCA)
- Western Balkans Investment Framework (WBIF)

The AIP, CIF and IFP are currently financed via the European Development Fund (EDF11), the NIP is part of the European Neighborhood Instrument (ENI), the LAIF, AIF and IFCA are financed under the Development Cooperation Instrument (DCI) and the WBIF under the Instrument for Pre-Accession Assistance (IPA). In addition, various thematic initiatives use blended finance, including the Agricultural Financing Initiative (AgriFI) and the Climate Finance Initiative. Within its blending operations the EU uses various instruments including technical assistance, investment grants, interest rate subsidies, risk-sharing instruments, guarantees and risk capital. The EIB is the largest implementer under the different blending facilities (up to 30 % across all facilities) (Latek 2017).

## 4.2. The European Investment Plan as a "new chapter" of EU development policy

In 2017, after the mid-term review of the MFF 2014-2020, the EC launched the European External Investment Plan (EIP), establishing a "new chapter" of EU development policy (Mogherini/Mimica 2016). The EIP shall 'create conditions for Europeans to expand their business and become active in new countries while supporting the economies and societies of the partner countries and the EU's strategic foreign policy objectives – from security to global development'. Reflecting current policy priorities, to tackle the 'root causes of migration' is explicitly included as a key objectives of the EIP[5].

The main financial arm of the EIP is the European Fund for Sustainable Development (EFSD). It combines the blending facilities for the African continent (AIP) and the EU Neighborhood (NIP) with a new guarantee mechanism that is also accessible for actors beyond the EIB, including European and non-European DFIs, and private investors from EU-Member States and partner countries[6]. The EIP also introduces two non-financial components: technical assistance and policy dialogue. While technical assistance focuses on helping local authorities and companies to develop bankable projects, policy dialogue aims at improving the business environment and the investment climate.

Until the end of 2018, the EU had allocated EUR 3.7 billion in EIP funding, out of which EUR 2.2 billion were allocated for blending programs and EUR 1.5 billion for the guarantee mechanism. According the EC, this sum is set to leverage EUR 37 billion in investment (EC n.d.). Until 2020, the EU plans to achieve a leverage effect of EUR 44 billion with a contribution of EUR 4.1 billion.

In June 2018, as part of the planning process for the MFF 2021-2027, the EC proposed to further streamline its financial architecture and instruments, including the incorporation of the activities currently financed by the EDF into the EU-budget. Most of the EU's external financial instruments shall be merged into a single instrument, the so called Neighborhood, Development and International Cooperation Instrument (NDICI), endowed with EUR 89 billion.

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5 More on the discussion if EIP is an adequate tool to tackle migration issues: Sol (2017).

6 Sol (2017) remarks in this respect: "This is perhaps one of the most striking changes proposed in the External Investment Plan: traditionally the European Union allowed only some 'trusted' public entities (like the European Investment Bank) to manage financial instruments based on European budget lines on its behalf, now the private sector would be able to directly benefit from European guarantees. To a certain extent, this can be seen as the concretization of a new vision of the EU development finance, where the private sector would play a central role. Yet, this new orientation raises some legitimate concerns."

The aim of the NDICI is to increase coherence and consistency between instruments, to allow for more flexibility (e.g. in the choice of partner countries), and to simplify processes. One of the key dimensions of this unified financial architecture is to crowd in private sector investment from outside the EU (Bilal 2019). Hence, the EU also intends to significantly increase the funds for blended finance to stimulate investment in developing countries.

The proposed financial arm of the NDICI, called EFSD+, would integrate all existing geographic blending facilities into a single worldwide blending facility. Those facilities shall be supported by a unified External Action Guarantee which would merge existing guarantee instruments and cover both sovereign and private sector risks. This should create a single entry-point for investors. The EC predicts that the new framework will mobilize EUR 500 billion in investment over the implementing period of the MFF (Bilal 2019; EC n.d., 2018; Gavas/Timmis 2019).

Negotiations about the new external financial architecture are ongoing. In March 2019, the European Parliament (EP) adopted a resolution on the NDICI proposal (Immenkamp 2019). Controversial issues relate e.g. to the governance provisions of EIP/EFSD+ that are currently largely unspecified and would give almost exclusive decision power to the EC, to the unclear role that the EIB plays in this new framework, and to the lack of clear development and environmental targets (Bilal 2019; Immenkamp 2019).

# 5. Reflections about blended finance for development purposes

Can blended finance live up to expectations to mobilize large amounts of capital for development purposes and to finance the SDGs? There are reasons to doubt that the enthusiasm for the concept is fully justified. The following section includes some reflections on blending in general and on the EU plans in particular.

## 5.1. Development impact and additionality

The main reason given for using public funds to leverage private investment is to mobilize additional money in difficult investment situations, for example in low-income countries or in fragile and conflict-affected states. However, recent reports point to the fact that only a small portion of blended finance is used for projects in Low Income Countries (Benn et al. 2017; DFI Working Group 2018, Attridge/Engen 2019).

An evaluation of the first seven years of the EU's use of blending as aid delivery mechanism (ADE 2016) concluded that the EU had obtained a strategic advantage, particularly in supporting large infrastructure projects in transitional and middle-income countries. However, it also found that development effects of those projects such as employment generation and poverty reduction were not sufficiently considered. In addition, the evaluators often missed an explicit link between the project objectives and the objectives and priorities of the partner countries.

The results of this evaluation suggest that – if blending tools are to meet development policy objectives (poverty reduction, development impact, additionality, ownership and alignment) – the funding criteria have to be more specific and targeted towards those aims. This would allow them to be more firmly anchored in the conception and design of the funded projects (Küblböck 2018).

These questions particularly apply to the objective of additionality, which serves as a legitimizing indicator for public support of private investment. Currently, to measure additionality is challenging due to the lack of harmonized definitions, approaches and methodologies (Bilal/Große-Puppendahl 2016; OECD 2018b; Pereira 2017). Research shows that donors assume additionality too easily and that they rely on ex-ante assessments based on information provided by the project beneficiary rather than on a systematic application of ex-post evaluations (Pereira 2017).

The current focus on reaching spending targets and volume of funds – as reflected in the Blended Finance Taskforce Action Plan – risks to overlook the quality of the projects in terms of development impact and business case. Investment projects in fragile environments are more complex to realize, and need profound knowledge of local circumstances as well as time. Moreover, many 'bankable' projects are already identified and financed by DFIs (Attridge/Engen 2019; Pereira 2017). As the common feature of blended finance is to take over risk of private sector operations, this inevitably means that when a project fails, the public will eventually have to step in with taxpayer's money.

In this vein, the expectations attached to the EIP to deliver quick results in terms of spending volumes and leverage exert considerable pressure (Bilal/Große-Puppendahl 2016). First appraisals of the functioning of the EIP and its financing arm EFSD suggest that criteria for selecting investment proposals continue to be too vague. This implies the danger of deadweight effects, meaning that DFIs continue with business as usual and use the risk-sharing tools to increase the expected return of investment instead of looking for projects in difficult investment situations (Gavas/Timmis 2019).

## 5.2. Opportunity costs

The above reflections on additionality and development effect raise the question of opportunity costs, in other words, there may be the risk that using ODA to crowd in private investment has the effect of diverting funds away from funding basic social services needed to eradicate extreme poverty. A recent report identified 48 countries that are currently unable to fully fund core poverty eradication expenditure from their own domestic revenues (Manuel et al. 2018).

In the euphoria of transforming "billions into trillions" there is a risk to overlook that only a small portion of the investment needed to achieve the SDGs will yield sufficiently high returns to be of interest to the private sector, especially in the poorest countries. Hence, there is the danger that the push for increased allocation of concessional resources to blended finance diverges ODA from projects in the poorest and most fragile countries to activities in middle-income countries with better return prospects (Manuel et al. 2018).

## 5.3. Debt sustainability

An aspect often neglected in the debate about blended finance is that projects supported through blending frequently involve sovereign loans, often for large-scale infrastructure projects (energy, transport, etc.) (EC 2015). Only if outstanding debt can be serviced by an adequate income stream, either from (affordable) service fees or from government funds via taxation, blended finance projects should be considered. Currently, the rise of loans via new or expanded financing schemes risks to generate a new wave of foreign debt. This gives reason for concern, as – after substantial debt relief initiatives at the beginning of the millennium – recent figures point to the danger of a new debt crisis in many developing countries. External loans to developing country governments more than doubled between 2008 and 2017, due in part to a lending boom driven by low global interest rates. As a consequence, developing country debt payments increased by 85 % between 2010 and 2018 (Jubilee Debt Campaign 2019). Some countries are already under severe payment distress. Therefore the evaluation of a country's debt sustainability and possible effects of each project has to be at the core of blending operations. Currently, objectives such as the above mentioned mobilization targets for MDBs or the expectations attached to the EIP to rapidly deliver on its spending targets lead to considerable pressure to increase spending, which implies the risk of pushing debt sustainability considerations aside.

## 5.4. Demand versus supply

A somewhat controversial discussion concerning the use of blended finance evolves around the question if there is a lack of capital available for development finance or a lack of so called ‘bankable’ projects (i.e. projects that are commercially viable or will become commercially viable with a small subsidy). To be commercially viable, a project has to yield sufficient financial returns in order for a loan to be reimbursed, or for an equity investment to yield profits. In order to boost the number of ‘bankable’ projects, development banks increasingly provide support for project planning and preparation (Carter 2015). However, two main questions arise in this respect: First, what are opportunities and risks of using ODA to enhance investment opportunities in infrastructure? Second, what are conditions for the success of blended finance projects in small and medium-sized enterprises?

### *Privatizing and financializing infrastructure*

First, many debates about the need for blended finance target the “infrastructure gap”. The decisive question is, which part of the infrastructure in poor developing countries can be commercially viable, respectively at whose cost. There is a risk that the public subsidy for investments in infrastructure ends up guaranteeing returns to private investors, while the fees charged for the services provided might not be affordable for citizens. Moreover, financing big infrastructure projects via external debt and with public guarantees must be linked to transparency and accountability vis-a-vis citizens who ultimately have to bear the costs and the risks involved. While in industrialized countries governments have stepped back from private provision of key infrastructure such as water or transport, the ‘billions to trillions’ agenda could result in a further push towards privatization of infrastructure in developing countries, and to ODA used to create investment opportunities for financial investors (Mawdsley 2018). Besides, a recent report by the UN Human Rights Commissioner points out that more attention should be given to ‘environmental and human rights gaps’ related to infrastructure investment (UN/OHCHR/Heinrich Boell Foundation 2018).

### *Financing small and medium-sized enterprises*

Second, another line of the debate refers to the role of blended finance to finance small and medium-sized enterprises (SMEs). The main condition for private funds to be invested productively in the local private sector is the existence of local companies with promising projects that can absorb those investments. Many poor countries lack a formalized small and medium enterprise sector with productive and learning capacities and a potential to successfully integrate into local, regional and global value chains. Experiences show that for successful local economic development, not only a business-enabling but a development-enabling environment is necessary, i.e. a combination of measures at various levels such as macroeconomic policies, infrastructure, education and social policy, a strategic trade, investment and industrial policy including collaboration between the private and public sector, and the integration of these policies in a broad-based development strategy (Küblböck/Staritz 2015). In order to contribute positively to broader economic development, blended finance should therefore be embedded into a country framework in line with industrial policies and local policy processes. This would require to involve stakeholders from developing countries in decision-making about blending (Pereira 2017).

The EU has reacted to the supply-demand dilemma by introducing non-financial components into the EIP (technical assistance and dialogue) that should help to develop bankable projects and create a business-enabling environment. However, there is a risk that such dialogue instruments are too narrowly focused on the business-enabling environment, neglecting broader conditions for economic development and, as a consequence, to productive investment opportunities that contribute to value addition and employment creation.

# 6. Conclusions

This briefing paper has given an overview of current trends and discussions about the role of blended finance for financing SDGs. To conclude, three main themes can be discerned that need further discussion.

First, common definitions and standardized reporting criteria are needed to enable more research and better monitoring of the quantity and quality of blended finance and its development impact. Currently, the picture of how much ODA is used to mobilize which volume of private finance remains opaque, and systematic evidence of impacts is missing. Multilateral and bilateral donors should therefore speed up efforts for harmonising definitions and reporting criteria, and launch independent evaluations of blending operations.

Second, the risk that using ODA as a tool to leverage private finance diverts public resources from sectors that are key for poverty reduction in Low-Income Countries should be addressed. Current trends show that blended finance operations take place mainly in Middle-Income Countries. Moreover, the focus of donors to ‘unlock’ private finance and the pressure to reach volume targets can undermine principles of Aid Effectiveness such as ownership, harmonisation, alignment and mutual accountability agreed upon in Paris (2005) and Accra (2008). These principles also imply that the debate about blending has to be broader and involve in particular local stakeholders in target countries.

Third, blended finance should not be used to push for further privatisation of infrastructure at the expense of citizens. More attention and transparency is needed to avoid an increase in external debt, also via hidden risks of guarantees. In this context the euphoria around blended finance should not distract attention from the importance of raising other funds for infrastructure investment, in particular domestic resources. Issues such as adequate taxation of transnational corporations, closing tax havens and impeding capital flight should be on the forefront of the discussions for SDG-implementation. Concerted efforts of the international community are needed for a substantial advance in this direction.

As long as claims about the positive development impact of blending cannot be tested empirically due to a lack of a representative data base and transparency, there is a risk that strategies for SDG-implementation are increasingly interpreted as a false pretense to exploit rent-seeking. This could lead to the ultimate consequence that development assistance will suffer a further loss of credibility and support amongst the wider public. In this context, Carter (2015) questions the term blended finance itself and suggests using the term “subsidizing” rather than blending to clarify the motives behind the concept. Such a view does not reject blending as a tool, but calls for greater transparency in dealing with the concept, its elements, and the actors involved.

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