

Blended Concessional Finance: The Rise of Returnable Capital Contributions

By Arthur Karlin and Kruskaia Sierra-Escalante

In new and challenging markets, blended concessional finance—the combining of concessional funds with other types of finance, on commercial terms—is increasingly used to mobilize capital and accelerate high-impact private sector investments. However, a relatively new approach for the provision of concessional capital for use by development finance institutions is emerging—the “returnable capital” model. With this new model, principal, interest, and other amounts are repaid to the original provider of funds (usually a government) on a regular basis. Because this can reduce the impact on donor government budgets, more government funds could become available for collaboration with the private sector. This note explores the effects of this new model on incentives, accounting, resource management, and reporting.

Creation of a growing, inclusive, and sustainable private sector is essential if all countries are to meet the United Nations’ Sustainable Development Goals (SDGs). The private sector provides most of the employment, goods, and services needed to achieve such critical SDGs as providing good jobs and growth and ending poverty. *Blended concessional finance*¹ has become increasingly important in this regard. As the world’s remaining areas of poverty and instability are becoming concentrated in high risk environments where the private sector faces additional obstacles, some temporary use of concessional finance is often needed to support pioneering private sector projects and help create markets. Governments have recognized this and, as a result, the allocation of donor and other development money for blended concessional finance is growing. For example, in 2017 development finance institutions (DFIs) utilized over \$1.1 billion in concessional funds to support more than \$8.7 billion of private sector projects in developing countries.²

The Rise of Returnable Capital Contributions

Until recently, the concessional funds used by development finance institutions (DFIs) in blended concessional finance projects came mostly from government grants or long-term contributions to dedicated facilities. These facilities then invested the funds in private sector projects on concessional terms, alongside DFI and other commercial finance. This “grant/long-term contribution model” was the financing modality generally used by the International Finance Corporation (IFC) for donors’ contributions to the climate facilities before fiscal year 2010, as well as for newer facilities that finance small and medium-enterprises (SMEs) and agribusinesses (see Figure 1).³ Starting in FY10, with climate funds from Canada, and continuing in FY18, with new funds from Canada, as well as from Finland, and the IDA-IFC Private Sector Window (PSW), more funding became available to IFC based on a different model—the “returnable capital” model. With this model, there is an explicit up-front agreement that reflows (interest, fees,

About the Authors

Arthur Karlin (akarlin@ifc.org), Consultant, Blended Finance—New Business and Portfolio, Blended Finance, Economics, and Private Sector Development, IFC. Kruskaia Sierra-Escalante (ksierraescalante@ifc.org), Senior Manager, Blended Finance—New Business and Portfolio, Blended Finance, Economics, and Private Sector Development, IFC.

dividends, and repayment of principal) are regularly returned to the original providers of the concessional funds. While IFC used a similar approach with some earlier multilateral donor facilities, the desire of funders to receive periodic reflows has become explicit, and has grown in recent years. IFC expects that this returnable-capital model for funding blended concessional finance will become even more important in the future.

The “returnable capital” model can appeal to governments because they regularly receive the reflows, and can redeploy the funds for other programs or priorities. However, choosing between a “grant/long-term contribution” model and a “returnable capital” model involves some important considerations related to incentives, accounting, resource management, and reporting. Thus, to help DFIs and other providers of blended concessional finance make the best decision when

choosing between the two models, the rest of this note addresses the differences between the two approaches.

Blended Concessional Finance Instruments: The Client Perspective

The choice between the grant/long-term contribution model and the returnable capital model primarily concerns the providers of concessional funds to DFIs, rather than the private sector firms that ultimately receive the funds. However, the decision can affect the instruments as well as the level of concessionality and risk appetite available for use in private sector projects. Thus, these impacts can be important considerations in deciding how to structure blended concessional finance facilities.

In 2017, the DFI Working Group on Blended Concessional Finance surveyed DFIs to gather information on the

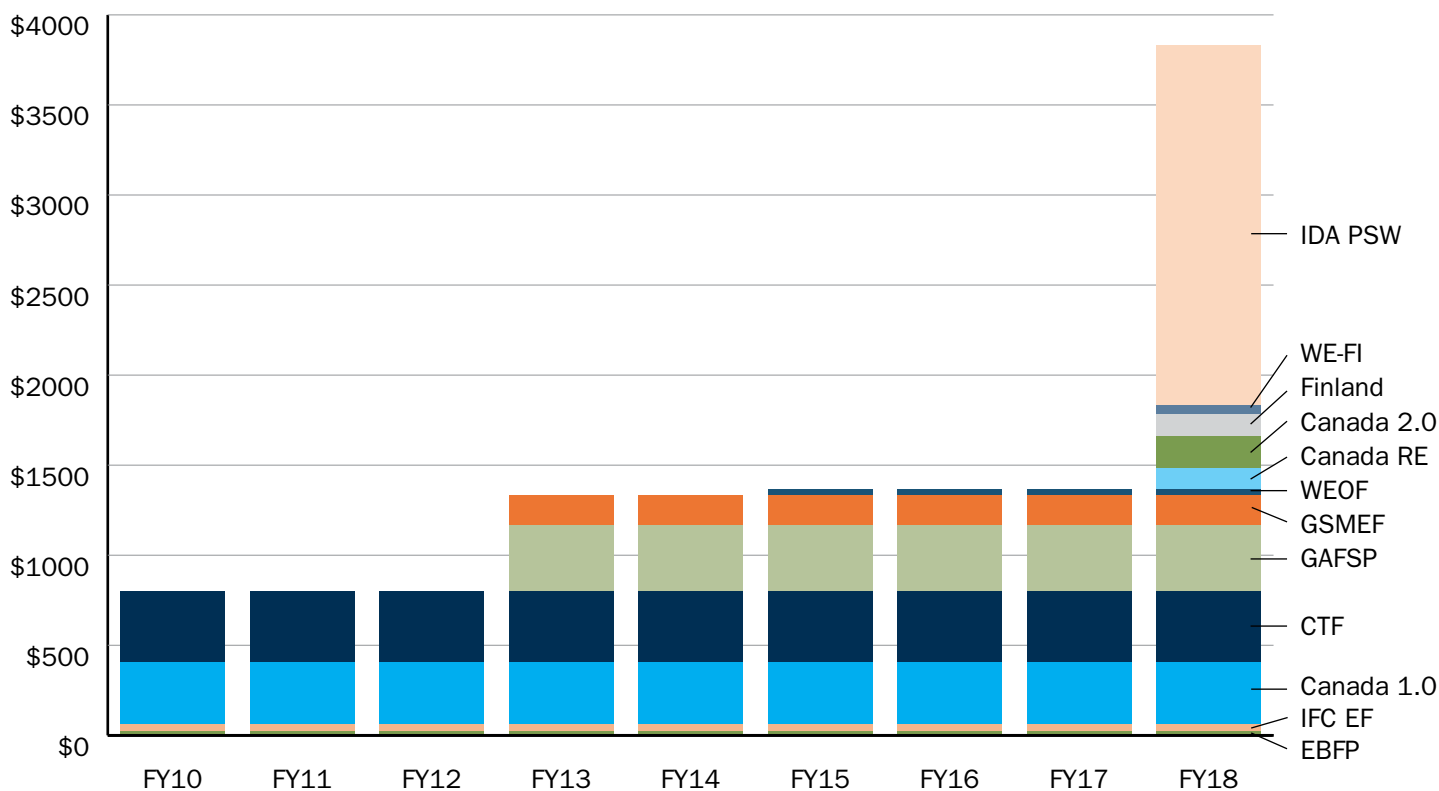


FIGURE 1 FY2010–FY2018 IFC Blending Concessional Funds Under Management, \$ millions

Source: IFC.

Note: IFC EF= IFC-GEF Earth Fund Program; EBFP= IFC-GEF Environmental Business Finance Program; CTF=Clean Technology Fund (Climate Investment Funds); GAFSP=Global Agriculture and Food Security Program; GSMEF=Global SME Finance Facility; WEOF=Women Entrepreneurs Opportunity Facility; WE-FI=Women Entrepreneurs Finance Initiative; IDA PSW=IDA Private Sector Window; Finland=Finland-IFC Blended Finance for Climate Program; Canada 1.0/2.0= Canada-IFC Blended Climate Finance Program [phase 1, phase 2 respectively]; Canada RE= Canada IFC Renewable Energy Program for Africa. A description of, and links to, further information on the various funds can be found on the IFC website under Blended Finance: https://www.ifc.org/wps/wcm/connect/CORP_EXT_Content/IFC_External_Corporate_Site/Solutions/Products+and+Services/Blended-Finance.

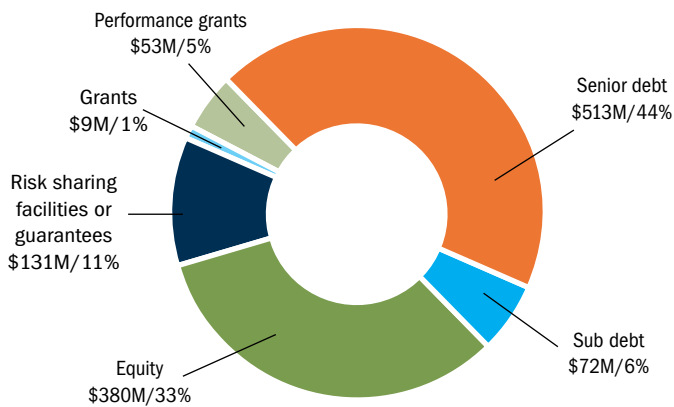


FIGURE 2 DFI 2017 Blended Concessional Finance: Concessional Commitment Volume by Instrument

Source: DFI Working Group on Blended Concessional Finance for Private Sector Projects, Joint Report, October 2018 Update, p. 13.

different instruments they use to provide concessional funds to private sector clients. Figure 2 shows the results, which indicate that DFIs use a wide range of instruments for concessional finance, including various types of debt, equity, guarantees, and grants. Although the reasons for using the different instruments reflect many project variables regarding risk, costs, timing, and investor characteristics, the 2017 review identified some common themes:⁴

- **Senior debt**, when concessional, can address cost issues, e.g. the high start-up costs for pioneering technologies, or the high costs of providing loans to SMEs.
- **Sub debt and equity** mitigates senior debt risk by improving coverage ratios (e.g. the expected cash flows compared to the required senior debt interest payments).
- **Grants** can address high initial capital or start-up costs that occur with new technologies or markets.
- **Performance grants** can provide incentives to encourage project sponsors to meet development goals.
- **Guarantees and risk-sharing facilities**, especially when on-lending through financial intermediaries to riskier segments such as smallholder farmers’ cooperatives or SMEs, can address underlying portfolio risks. Typically, these are used when liquidity is either not a problem, or to indirectly address the cost of local currency funding.

In addition to finance, advisory services (technical assistance) are often provided by the DFIs to help develop projects, create markets, and address supply chain issues. In many cases, the funding comes from the same facilities

(or parallel funding pockets) that are used for blended concessional finance.

Of the two models for providing concessional finance from donors, the grant/long-term contribution approach is the most flexible. Once funds are provided to a facility, depending upon the agreement with donors, the funds can be used for various types of debt, equity, guarantees, and grants, and in many cases, also for advice and/or capacity building. Returnable capital models, however, require a regular reflow of funds, which generally means that providing grants and performance-based incentives to clients and funding advisory services is not feasible, as such instruments “consume” the original capital, with no potential for reflows.

Blended Concessional Finance Instruments: The Donors’ Perspective

From the perspective of the providers of concessional resources (usually governments), the grant/long-term contribution and returnable capital models vary with regard to cash flows, budgets, credits for overseas development assistance (ODA), and the instruments available to the ultimate private sector clients (see Figure 3).

Reflows

As discussed, the most obvious difference between the two models is the difference in reflows. With the grant/long-term contribution model, principal, interest, fees, and dividends from clients regularly flow back to the facility,

Grants/Long-term Contributions to Private Sector Facilities	Returnable Capital
No reflows except, in some cases, at the facility’s close	Regular reflows
On budget	May be off budget
Counts as ODA	ODA count but different timing/amount (“net”)
Allows for grants to private clients	No grants to private clients
Uses existing facility governance and management	May require new partners and vehicles

FIGURE 3 Blended Concessional Finance Instruments: The Donors’ Perspective

Source: IFC.

not the donor. Depending on the facility's agreement, these reflows may be used for advisory services or additional private sector investment. In some cases, there may be provisions for eventually returning any remaining capital to the original donor.

In the returnable capital model, principal, interest, dividends, fees, and other reflows are paid back on a regular basis to the original contributor of the concessional finance. The original contributor can then reinvest the funds in various ways—e.g., back into the same concessional finance facility, into alternative investments, or used for domestic finance.

Budget

Depending on the rules in the country providing the concessional finance, the two concessional finance models can have significantly different impacts on government budgets. Grants or long-term contributions to facilities may be viewed as on-budget expenses. Contributions for returnable capital may be viewed as investments, and thus, for the most part, off budget in terms of government expenditures.⁵ This can be a strong incentive to provide funds to facilities as returnable capital rather than as grants or long-term contributions. Returnable capital can be viewed as an addition to regular ODA, beyond the current budget resources. Also, it can provide new ways of increasing development outcomes through the private sector via investments and leveraging private capital.

The returnable capital model seems consistent with the *Billions to Trillions*⁶ concept of leveraging targeted support from governments to increase private sector engagement in achieving the SDGs. The overall result of the difference in impact on government budgets could be that substantially more resources become available to the private sector under the returnable capital model. Also, if shifting private sector programs from grants to returnable capital takes the private finance off budget, more ODA grant resources could become available for purposes that are not generally suitable for returnable capital financing—for example, most human capital investments.

Overseas Development Assistance

The rules used by the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC) for counting private sector support in ODA are currently under review.⁷ One of the methods being piloted (the “institutional approach”) includes, as ODA, government contributions to a private sector investment facility, net of any reflows of principal from the facility back to the government. This could

discourage governments from using the returnable capital model for concessional finance, as it could lead to a reduction in ODA credits due to the reflows (i.e., if the funds come out of the ODA budget and are not reinvested in other ODA uses). An alternative method being piloted by the OECD for calculating ODA for private projects (the “instrument-specific approach”) would likely not have this issue. In this case, the ODA calculations would be based on net flows (outflows minus reflows) between the facility and the private sector client (rather than from the government to the facility), and, thus, under the returnable capital model, ODA would not change.

Impacts on Private Sector Clients

As discussed above, investment grants, performance grants, and advisory services to support the private sector can be important parts of DFI programs. However, these instrument options would generally not be available with a returnable capital model. Therefore, the providers of concessional finance will need to consider the importance of these different instruments in the context of their development goals.

For example, advisory services are an essential complement in high risk countries to create markets, while performance grants can be important in aligning incentives among various stakeholders and in achieving the development outcomes that otherwise would not be obtained.

One alternative could be to use returnable capital for investments, and use separate facility grant agreements for investment grants, performance incentives, and/or advisory services. Another alternative would be to structure the facility as partially returnable capital—allowing for a percentage to be “consumed” through some of these grant-based instruments.

An additional impact of the returnable capital model on private sector clients could be changes in the allowable risk profile for investments, pricing flexibility, and corresponding levels of concessionality. With returnable capital, the provider of concessional finance is directly affected by the performance of the private sector investments and the price charged for taking such risks. For donors looking for a basic level of return, this might lead them to put greater restrictions on the risk levels of the projects being undertaken, the pricing, or the level of concessionality. For highly risky segments such as smallholder agribusiness, it may be important to be more flexible regarding the minimum return requirements.

The returnable capital model is also limited due to its potential inability to provide support to important development projects that may not have a clear investment return—for example, social programs or disaster recovery programs.

Investment Management

In many cases, the establishment of returnable capital models for providing concessional finance to the private sector will require new partnerships between the providers of concessional finance and the institutions that have the capacity and experience to effectively deploy the finance to private sector projects via non-grant instruments. Providers of concessional finance will have to consider how much management can be undertaken in-house versus delegating investment decisions to a partner. Investment partners should have deep experience in assessing and structuring investments in developing countries, especially with projects in higher risk environments that are more likely to require blending. Investment partners should also have strong governance, fiduciary, and reporting capabilities; high environmental and social standards; an understanding and commitment to development; and the ability to measure different types of investment impact. In addition, alignment of the interests and perspectives on development of both the providers of capital, and the implementing partners, is essential.

Outlook and Recommendations

Based on feedback from the providers of concessional funds, use of the returnable capital model is likely to grow. Providers of concessional funds who are considering the returnable capital model should carefully examine four major issues:

1. The importance of regular reflows for the overall management of development programs
2. The specific impacts on budgets and ODA
3. The impacts on the types of funding instruments available to the private sector, and assessment of the possible trade-offs between development impact and the required return on investments
4. Management of the funds and the selection of partners.

Returnable capital approaches for providing concessional funds to the private sector could have important benefits for the providers of concessional funds, particularly through the availability of reflows, and less impact on the budget. This could mean that far more resources might become available to the private sector. Other impacts may also be important, though, as the reported ODA could potentially become more uneven, and the instruments available to clients, such as grants and advisory services, could become more limited. The specific circumstances for providers of concessional funds with regard to their development goals, country accounting rules, ODA rules, and details of the agreements for funding facilities, will all affect the attractiveness of the two different options.

ACKNOWLEDGEMENTS

The authors would like to thank the following colleagues for their review and suggestions: Martin Spicer, Director, Blended Finance, Economics, and Private Sector Development, IFC; Niraj Shah, Principal Investment Officer, Blended Finance—New Business and Portfolio, Blended Finance, Economics and Private Sector Development, IFC; Morten Lykke Lauridsen, Principal Multilateral Engagement Officer, Development Partnerships and Multilateral Engagements, Partnerships, Communication & Outreach, IFC; Max von Bonsdorff, Director, Unit for Development Finance and Private Sector Cooperation, Ministry of Foreign Affairs, Helsinki, Finland; François Primeau, Senior Analyst, Global Affairs Canada, Ottawa, Canada; and Thomas Rehermann, Senior Economist, Thought Leadership, Economics and Private Sector Development, IFC.

Please see the following additional reports and EM Compass Notes about blended concessional finance:

Blended Concessional Finance: Governance Matters for Impact (Note 66); *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—What Lessons Can be Learned from IFC’s Experience?* (Note 3). For more information please see: ifc.org/BlendedFinance

¹ 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.”

² See “DFI Working Group on Blended Concessional Finance for Private Sector Projects, Joint Report, October 2018 Update,” p. 13.

³ This discussion reflects general trends and does not apply to all donors, e.g. one of the donors to the Global Agriculture Food Security Program has always taken back reflows.

⁴ See “DFI Working Group on Blended Concessional Finance for Private Sector Projects, Report on Phase 2 Activities, October 2017,” pp. 13-14.

⁵ The exact impact on budgets depends on the details of the donor contract, and on the rules of the different governments. For example, if interest rates are fixed, but below government funding costs, a “grant element” may be on budget, but the rest of the contribution counts as an investment.

⁶ World Bank and International Monetary Fund. 2015. “From Billions to Trillions: Transforming Development Finance Post-2015 – Financing for Development: Multilateral Development Finance,” April 2, 2015.

⁷ See OECD. 2018. “Reporting Methods for Private Sector Instruments,” December 12, 2018. [http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC\(2018\)47/FINAL&docLanguage=En](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC(2018)47/FINAL&docLanguage=En)

Additional EM Compass Notes Previously Published by IFC Thought Leadership

SEPTEMBER 2019

Note 71: Artificial Intelligence: Investment Trends and Selected Industry Uses

AUGUST 2019

Note 70: How Insurtech Can Close the Protection Gap in Emerging Markets

JULY 2019

Note 69: The Role of Artificial Intelligence in Supporting Development in Emerging Markets

JUNE 2019

Note 68: Basic Business Models for Banks Providing Digital Financial Services in Africa

APRIL 2019

Note 67: The Case for Responsible Investing in Digital Financial Services

MARCH 2019

Note 66: Blended Concessional Finance: Governance Matters for Impact

Note 65: Natural Gas and the Clean Energy Transition

FEBRUARY 2019

Note 64: Institutional Investing: A New Investor Forum and Growing Interest in Sustainable Emerging Markets Investments

JANUARY 2019

Note 63: Blockchain and Associated Legal Issues for Emerging Markets

Note 62: Service Performance Guarantees for Public Utilities and Beyond—An Innovation with Potential to Attract Investors to Emerging Markets

NOVEMBER 2018

Note 61: Using Blockchain to Enable Cleaner, Modern Energy Systems in Emerging Markets

Note 60: Blended Concessional Finance: Scaling Up Private Investment in Lower-Income Countries

OCTOBER 2018

Note 59: How a Know-Your-Customer Utility Could Increase Access to Financial Services in Emerging Markets

Note 58: Competition Works: Driving Microfinance Institutions to Reach Lower-Income People and the Unbanked in Peru

SEPTEMBER 2018

Note 57: Blockchain Governance and Regulation as an Enabler for Market Creation in Emerging Markets

JULY 2018

Note 56: A Practical Tool to Create Economic Opportunity for Low-Income Communities

JUNE 2018

Note 55: Peru's Works for Taxes Scheme: An Innovative Solution to Accelerate Private Provision of Infrastructure Investment

MAY 2018

Note 54: Modelo Peru: A Mobile Money Platform Offering Interoperability Towards Financial Inclusion

APRIL 2018

Note 53: Crowding-In Capital Attracts Institutional Investors to Emerging Market Infrastructure Through Co-Lending Platforms

Note 52: Crowding-In Capital: How Insurance Companies Can Expand Access to Finance

Note 51: Blended Finance - A Stepping Stone to Creating Markets

JANUARY 2018

Note 48: Increased Regulation and De-risking are Impeding Cross-Border Financing in Emerging Markets

OCTOBER 2017

Note 47: From Farm to Fork: Private Enterprise Can Reduce Food Loss Through Climate-Smart Agriculture

Note 46: Precision Farming Enables Climate-Smart Agribusiness

SEPTEMBER 2017

Note 45: Beyond Fintech: Leveraging Blockchain for More Sustainable and Inclusive Supply Chains

Note 44: Blockchain in Financial Services in Emerging Markets – Part II: Selected Regional Developments

Note 43: Blockchain in Financial Services in Emerging Markets – Part I: Current Trends

AUGUST 2017

Note 42: Digital Financial Services: Challenges and Opportunities for Emerging Market Banks

JULY 2017

Note 41: Blockchain in Development – Part II: How It Can Impact Emerging Markets

Note 40: Blockchain in Development – Part I: A New Mechanism of ‘Trust’?

Note 39: Technology-Enabled Supply Chain Finance for Small and Medium Enterprises is a Major Growth Opportunity for Banks

MAY 2017

Note 38: Can Blockchain Technology Address De-Risking in Emerging Markets?

APRIL 2017

Note 37: Creating Agricultural Markets: How the Ethiopia Commodity Exchange Connects Farmers and Buyers through Partnership and Technology

Note 35: Queen Alia International Airport – The Role of IFC in Facilitating Private Investment in a Large Airport Project

MARCH 2017

Note 34: How Fintech is Reaching the Poor in Africa and Asia: A Start-Up Perspective

Note 33: Creating Markets in Turkey’s Power Sector

FEBRUARY 2017

Note 32: Private Provision of Education: Opportunities for Emerging Markets

Note 31: Improving Emerging Markets Healthcare Through Private Provision

JANUARY 2017

Note 30: Masala Bond Program – Nurturing A Local Currency Bond Market

Note 29: Toward a Framework for Assessing Private vs. Public Investment in Infrastructure

Note 28: The Importance of Local Capital Markets for Financing Development

DECEMBER 2016

Note 27: How Banks Can Seize Opportunities in Climate and Green Investment

NOVEMBER 2016

Note 24: De-Risking by Banks in Emerging Markets – Effects and Responses for Trade

Note 23: Energy Storage – Business Solutions for Emerging Markets

Note 22: Mitigating the Effects of De-Risking in Emerging Markets to Preserve Remittance Flows

SEPTEMBER 2016

Note 20: Mitigating Private Infrastructure Project Risks

Note 19: Creating Mobile Telecom Markets in Africa

Note 18: Seven Sisters: Accelerating Solar Power Investments

Note 16: Congo Call Center – Business Amid Fragility

Note 15: How Emerging Market Leaders Can Spur Technological Gains

Note 14: How to Make Infrastructure Climate Resilient

Note 13: Insurance Options for Addressing Climate Change

Note 12: New Ways for Cities to Tackle Climate Change

Note 11: How Business Can Insure Against Climate Risks

Note 10: How New Data Tools Can Assess Climate Risks

Note 9: Innovative Insurance to Manage Climate Risks

MAY 2016

Note 6: Global Productivity Slowdown and The Role of Technology Adoption in Emerging Markets

APRIL 2016

Note 5: Infrastructure Financing Trends

Note 4: Infrastructure Finance – Columbia and FDN

Note 3: Blending Public and Private Finance

Note 2: Case Study – Bayport Financial Services

Note 1: Supporting Local Bond Market Development



Creating Markets, Creating Opportunities

IFC

2121 Pennsylvania Avenue, N.W.
Washington, D.C. 20433 U.S.A.

ifc.org/ThoughtLeadership