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Strengthening the Local Dimension of Blended Finance

A review of the local approaches and instruments employed by Development Finance Organizations (DFOs)

Knowledge Brief for G20 CwA Peer Learning Event
September 12, 2019

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Introduction

The African Center for Economic Transformation (ACET) is supporting the Group of 20 (G20) Compact with Africa (CwA) through a series of peer-to-peer learning engagements. The primary theme of this year's peer learning is blended finance and a number of events are planned to share and learn from good regional and global practice. This note has been prepared as a background knowledge document to inform the peer-to-peer learning events in collaboration with the Organization for Economic Cooperation and Development (OECD), after which it may be published as a research report or technical briefing and will be used for further CwA-related activities.

In the development finance community, blended finance has emerged as a tool to more effectively mobilize commercial capital towards achieving the sustainable development goals (SDGs). This can stimulate impactful investment, quality jobs creation and inclusive economic growth. With a view to promote better practices, the OECD DAC has endorsed key blended finance principles for unlocking commercial finance for the SDGs. One of the five OECD/DAC Principles for Blended Finance (OECD 2018c) relates to the need to anchor blended finance for development to local contexts. In particular, this principle indicates that development finance should be deployed to ensure that blended finance supports local development needs, priorities and capacities, in a way that is consistent with, and where possible, contributes to local financial market development. In particular, blended finance should support local development priorities; ensure consistency of blended finance with the aim of local financial markets development and should be used alongside efforts to promote a sound enabling environment. If these principles are used to guide development finance organizations' (DFO) engagement in client countries there is a greater likelihood of significant additionality and development impact.

The primary research question addressed herein is how development finance organizations are adapting to country conditions. The paper provides recommendations for enhanced local approaches, which would in turn, lead to expanded financing opportunities. Many blended finance projects have strong local ownership, responding directly to local demands, resulting from broad consultations, and entailing explicit positive spill-overs at the local level. These provide opportunities to learn from good practice. The analysis also reveals that while all blended finance projects stem from local development considerations, they may be generated from external institutions or follow a standardized approach, and with insufficient considerations for local context and dynamics. They may also be client-driven, but with little consultation with local stakeholders.

1. What is Blended Finance?

Blended finance is the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries (OECD 2018). It serves to reduce perceived risks and/or improve returns, while responding to the increasing importance of working with the private sector to achieve sustainable development. Generally, it aims to mobilize additional finance primarily from commercial sources in order to increase the total volume of finance available for sustainable development, including poverty reduction, reduced inequalities, and climate action.

Commercial financial actors, including banks and institutional investors, such as pension funds, insurance companies or sovereign wealth funds, have large volumes of assets under management (AUM) seeking market-rate returns. At the same time, they are constrained in making higher risk (or perceived higher risk) investments, in part due to their mandates. As a result, commercial finance is not yet invested at a sufficiently large scale in developing countries due to the perceived unfavorable risk associated with some investments, particularly in Africa.

Blended finance can be a tool to address the massive needs for additional investment in developing countries by crowding in commercial finance. To that end, the strategic investment of development finance can improve the sustainability and risk-return relationship of transactions so that the commercial sector is able to invest more with greater development impact. Development finance includes official development finance – both concessional and non-concessional-from donor governments and development finance organizations. In this context development finance organizations include multilateral development banks (MDBs), bilateral development finance institutions (DFIs) and philanthropic funds (IFC 2017). Multilateral development banks and bilateral DFIs engage in what the DFIs refer to as "concessional blended finance" where they blend donor concessional funds, e.g. in facilities, with their own balance sheet funds, but also more broadly with mobilization of private finance with e.g. syndications.

Blended finance instruments can help address perceived high risks associated with projects or uncertainty related to returns. Guarantees, for instance, are an effective tool to mobilize commercial finance in sufficiently liquid markets, while blended finance can unlock commercial finance by generating confidence among commercial capital providers. Blended finance can also enable pooling for a variety of projects and hence facilitate commercial investment at larger scale. Structured funds, for example, use concessional finance in a first loss position to provide a risk buffer for commercial investors holding more senior tranches.

Preliminary OECD data on private sector mobilization shows that development finance interventions in the forms of guarantees, syndicated loans, credit lines, direct investment in projects, shares in collective investment vehicles such as investment funds and simple co-financing mechanisms mobilized USD 152.1 billion between 2012 and 2017 (OECD 2019). Guarantees accounted for 42% of all private finance mobilized, followed by syndicated loans (18%), credit lines (17%) and direct investment in companies and projects (14%). Twenty-seven percent of private finance is mobilized in Africa with the top five countries being Nigeria, South Africa, Ghana, Egypt, and Kenya.

Blended finance can also be an important market building instrument. As such, it is a tool to crowd in commercial investment with commensurate increases in commercial finance elements, thereby, over time, enabling stand-alone commercial investment. To that end, blended finance transactions should work towards commercial sustainability and exit strategies for concessional and development finance. In doing so, blended finance instruments can cater to the development of local financial markets by mobilizing local financial institutions. That is, blended finance projects in developing countries should be commonly designed and implemented together with local actors. But to do so, development finance organizations need to take into account the local context and engage with local financial partners.

More broadly, blended finance is meant to help finance the SDGs of developing countries. Blended finance operations should thus be anchored in developing countries' needs and development strategies, as embodied in their SDG National Implementation Plans (NIPs). By enhancing both the commercial and developmental sustainability of private investment, blended finance has a development 'impact imperative'. But to be successful requires a strong connection to local context and actors, understanding local dynamics and contributing to local development objectives.

The objectives of this report are to review the main approaches and instruments adopted by DFOs to adapt to local context, identify some primary challenges and provide key take-aways on how policymakers and DFOs can most appropriately use blended finance in Africa, particularly in CwA countries (Benin, Burkina Faso, Côte d'Ivoire, Egypt, Ethiopia, Ghana, Guinea, Morocco, Rwanda, Senegal, Togo and Tunisia). The review largely focuses on DFOs from OECD member countries and provides examples where DFIs and/or MDBs explicitly and successfully identify and build on local development strategies and actions; strengthen local financial markets; enhance the capacity and enable local private and public finance institutions; foster reforms and create an enabling environment; and take into account local dynamics and incentives.

2. Research Methodology

The report is a collaborative effort of ACET, the Organization for Economic Cooperation and Development (OECD), and the European Centre for Development Policy Management (ECDPM). The project was led by ACET under the direction of Rob Floyd, Director and Senior Advisor, in consultation with the Financing Sustainable Development Division at the OECD. Primary research for this report was undertaken by San Bilal, a Senior Executive and Head of Program at ECDPM, and Dan Preston, a Clinical Associate Professor of Development Finance at Indiana University's School of Public and Environmental Affairs. Their research employed two methods. The first focused on a desk review of publicly available reports, articles and case examples published by development finance organizations as well as governments, multilateral organizations, think tanks, periodicals and academic journals. The second level of research involved engagements with officials and key stakeholders at development banks, development finance organizations listed below and public comments made by DFIs and multilateral development bank officials. The following organizations were the primary targets of the research project. Due to time and resource constraints, this is only a small sample of organizations operating in the blended finance space.

Development Banks

- Agence Française de Développement (AFD) and its subsidiary bilateral DFI Proparco
- KfW Development Bank (KfW)
- European Investment Bank (EIB)

Multilateral Development Banks (MDBs)

- African Development Bank (AfDB)
- European Bank for Reconstruction and Development (EBRD)
- European Investment Bank (EIB)

- Islamic Corporation for the Development of the Private Sector (ICD)
- International Finance Corporation (IFC)

Bilateral DFIs

- CDC Group (CDC)
- Overseas Private Investment Corporation (OPIC)

Others

- European Union (EU)
- External Investment Plan (EIP)

Local approaches and instruments employed by development finance organizations have several common approaches as well as significant differences and some known deficiencies. This is the result of having similar missions yet varied mandates, funding sources, operating procedures and regulations. For this report, we are focusing on local context to stress the need to anchor all blended finance activities in local realities, building on local development priorities and ownership, fostering local institutions and financial markets development, and in synergy with sector and economy-wide strategies.

The local context principle should not be seen in isolation, as it builds on a coherent approach to blended finance. In particular, the local dimension of blended finance is strongly connected to and also present in other OECD/DAC principles, such as:

- *"Anchor blended finance use to a development rationale", which can only be properly articulated if it rests on local considerations and ownership of development objectives, outcomes and impact;*
- *"Design blended finance to increase the mobilization of commercial finance", which includes local initiatives to mobilize commercial finance, as well as efforts to mobilize local commercial finance;*
- *"Focus on effective partnering for blended finance", which should include partnership with local actors; and*
- *"Monitor blended finance for transparency and results", which should explicitly integrate the local dimension and include the perspective of local actors.*

The local dimension is also integrated in the shared value system on blended finance under the Tri Hita Karana Roadmap for Blended Finance (OECD, 2018d), a multi-stakeholder effort to scale the impact of blended finance fostered under the aegis of Indonesia and coordinated by the OECD, which encompasses the development rationale, anchoring blended finance into the Sustainable Development Goals. In particular, it states:

- *"Blended finance should help to accelerate inclusive sustainable market development, including the local financial market. Local engagement and ownership should be pursued. At the same time, blended finance should be accompanied by efforts to promote a sound enabling environment and investment climate. In addition, availability of information relevant for market making should be coordinated among policy makers, development finance organizations, commercial investors and investees to leverage experience and track record. Ultimately, in each market, clarifying, sharing and addressing the root causes for requiring blended financing should be prioritized."*

These principles and shared values also reinforce the G20 International Financial Architecture (IFA) Working Group's Principles for crowding-in private sector finance for growth and sustainable development (Bundesministerium der Finanzen, 2017) adopted in 2017, which notably emphasizes the primacy of country ownership and the necessity to create an investment-friendly environment. The local dimension has been further stressed by the G20 Eminent Persons Group on Global Financial Governance (G20, 2018) in March 2018, which proposed that:

- *"the International Financial Institutions (IFIs) should collaborate through country platforms – in capacity-building, strengthening the investment environment, developing the supply of bankable projects, and sharing knowledge and data. These platforms should be owned by the countries' governments, with appropriate support and coordination from the IFIs."*

Further, the G20 Principles for crowding-in private sector finance published in 2017 made it clear that MDBs have agreed to focus on three main areas including one related to a local approach: "strengthening investment capacity and policy frameworks at the national and sub-national levels."

At the same time, blended finance is also an important tool in the context of the G20 Compact with Africa (CwA), which focuses on enhancing private sector investment in the twelve Compact countries - Benin, Burkina Faso, Côte d'Ivoire, Egypt, Ethiopia, Ghana, Guinea, Morocco, Rwanda, Senegal, Tunisia and Togo. Strengthening the contribution of DFIs is also one of the priorities under the CwA to ensure its effective delivery based on local ownership.

In addition to global efforts of the OECD and the G20, there have been two joint reports (DFI, 2017; DFI, 2018) published in 2017 and 2018 prepared by a group of DFOs composed of the AfDB, Asian Development Bank (AsDB), Asia Infrastructure Investment Bank (AIIB), European Bank for Reconstruction and Development (EBRD), European Development Finance Institutions (EDFI – an association representing 15 bilateral DFIs), European Investment Bank (EIB), Inter-American Development Bank (IaDB), Islamic Corporation for the Development of the Private Sector (ICD) and the International Finance Corporation (IFC). The reports help to share good practices and ensure the optimal use of concessional finance. The reports provide common principles of blended finance and guidelines for each principle. While not specifically highlighting guidelines to local engagement, they have agreed to support the commercial sustainability of local entities, address local market failures, minimize distortion of local markets and promote high standards in their conduct with local financial institutions.

3. Recommendations

The following sections address numerous factors in the local dimension of blended finance, from which recommendations and insights are drawn. These findings do not apply uniformly to all DFOs or all country conditions, but rather are areas for improvement in ensuring that blended finance is adequately accounted for local context. The research identified numerous areas where DFOs can do more to provide financing in developing countries, particularly taking into account local contexts and conditions. These recommendations are not exhaustive but point to areas where enhanced efforts can lead to greater development impact.

Organizational Insights

- If not already in place, DFOs should make policy on local context explicit and intentional, following from good global practice.
- If not already the norm, DFOs should develop country or sub-regional strategies that are aligned to national development strategies and avoid ad-hoc investment choices.
- While some DFOs strive to utilize a deep understanding of their client countries or use local partners and networks, a local presence can enhance the ability to tailor blended finance to the local context and lead to more successful and sustainable financing solutions. When feasible DFOs should ensure a local presence.
- DFOs need to ensure systematic consultations with local actors such as civil society, beneficiaries and local commercial investors and the domestic private sector, regardless of whether the client is sovereign or private.

Insights on Partnering with Local Actors

- DFOs should deepen partnering arrangements with local DFIs, national development banks, Sovereign Investment Funds (SIFs) and local pension funds to better scale-up activities and tailor to the local context. Additional country-specific research is needed on the extent that local investors, institutional investors, financial institutions are being crowded in to blended finance operations.
- Where local DFIs or development banks do not exist, DFOs should explore options for providing technical know-how and financial support to create new local institutions.
- Where appropriate, DFOs should provide support to, and work with, sub-sovereign entities such as local DFIs. They are under-resourced and have the potential in many cases to provide a more robust local solution to development challenges.

Blended Financing Insights

- There is a clear need to increase the gross and proportional amount of finance in local currency. Efforts to improve the capacity of issuing local currency securities have shown results, yet the demand for cost-effective foreign exchange (FX) solutions to mitigate foreign currency risk for international investors far exceeds the supply. More research is needed on what instruments are best suited to local approaches or which instruments are most effective at crowding in capital in local currency.
- More needs to be done to increase the proportion of local finance in blended finance. Engagement with local investors such as banks, investment funds, pension funds and individual investors is happening, but there is very limited crowding-in of local finance, especially in low income countries (LICs).
- Beyond this, in general, more needs to be done to increase the mobilization of private finance by public finance. Over time, the share of private finance needs to increase.
- DFOs must do more to extend greater blended finance to LICs, which may require the institutions to take on more risks and align with development priorities in the poorest countries – and in fragile states.

DFOs should foster more innovative approaches, such as

- More research is needed on systematic evidence on how DFOs can best effectively link economic transformation and an improved investment climate.
- DFOs activities should be better anchored in and complemented by other development initiatives, notably by development agencies.
- Developing regional solutions with multiple actors collaborating on delivery solutions, including a pooled regional fund established by DFOs;
- Further open DFI projects to local participation and have this as a key KPI;
- Build financial models in targeted sectors for local participation, to include more concessional funding and risk mitigation for this goal.

4. Key Factors in the Local Dimension of Blended Finance

The following section explores some key aspects of the local dimension of blended finance. Development finance organizations have varied levels of experience with blended finance. Some have been engaged in blended finance for well over a decade. These institutions have increasingly been incorporating concessional finance to crowd in commercial finance and have been leveraging more sophisticated financial instruments in recent years. Other institutions have started engaging in blended finance more recently and a few are still addressing how to position blended finance in their operational strategies. At one end of this spectrum, for example, an institution interviewed for this report is in the process of setting up facilities and funds that adhere to the shared principles of blended finance while also creating frameworks to ensure it is following the guidelines in the MDB/DFI joint reports and those established internally before scaling up its activities. On the other end of this spectrum is an institution interviewed for this report that has yet to formally engage in blended finance and is currently conducting the necessary research and due diligence to define how to do this within its mandate and organizational strategy.

There is also a varied level of specificity in guidelines or official policy at development finance organizations related to tailoring blended finance to the local context. Some development finance organizations spell out their local engagement policies with a high degree of detail, although in some cases these are well organized and easily accessible on their website, while in other cases the information is dispersed in different policies and documents. At the same time, other DFOs do not appear to have a clearly defined local engagement policy or more contextualized approaches taking into account local conditions.

However, a lack of a well-defined policy does not necessarily indicate an unwillingness to support local development priorities, strengthen local markets, seek opportunities to engage local financial actors or promote a sound enabling environment. In fact, many of their approaches and activities achieve some, if not many, of the OECD's principles, but there simply are not formal policies or guidelines. Nevertheless, the research does suggest that in some cases a local approach is secondary in nature. Examples of this could include a project chosen due to its connection to an exporter or investor from the country of the DFI financing the project. Further, the necessity of DFIs to be self- financing can sometimes impede their ability to make certain investments that would most appropriately respond to local conditions.

a. DFO Organizational Design

Local engagement with government, local financial institutions, civil society, project owners, financiers and other stakeholders has become an increasing priority for many development finance organizations. Some institutions can achieve this with a physical local presence, i.e. having an office in countries or sub-regions where it operates. Some DFOs have recently embraced that approach and are now establishing new offices to enhance their local footprint. Development finance organizations with a physical presence in the countries where they invest emphasize this provides them with an increased capacity to work with local regulators on improving the enabling environment, identify potential projects and cultivate local co-investors. Others have investment officers physically located in their home office, yet these officers intimately know the region where they invest, spend a significant amount of time in the regions where they invest, and frequently engage with local actors to ensure the investments achieve a positive local development impact.

One of the DFOs interviewed indicated that they choose not to have offices in the countries where they invest, but instead feel that a local approach is best achieved by partnering with local organizations, while building their local capacity, and utilizing the local partner's expertise. That said, the research revealed that some activities by development finance organizations can be reactive to goals established in their home office or responding to new requests for financing from projects or enterprises that meet the DFO's priorities, rather than being demand-driven from the client country.

In these instances, there may be minimum local engagement unless there is a particular problem requiring the institution to commit greater attention to local issues. Moreover, some DFOs have very few staff based outside their home office, which can, regardless of intent and even with a strong network of local partners, lead to possible disconnects with the local context and missing opportunities to engage local banks, institutional investors or operators. This challenge can be exacerbated when high local interest rates or outsized expected returns by local investors discourage DFOs from considering or engaging in local financing.

When DFOs do not have local offices, they rely on field missions, networks, direct contacts and contacts through their countries' embassies (in the case of bilateral DFIs) in developing countries. Teaming up with another DFI on programs or projects is also a way that some DFOs indicated they attempt to enhance financial capacity, in particular if the other DFO has a stronger local presence (Bilal, S., Große-Puppendahl, S.,2016). In practice, however, the research indicates that the full potential for such cooperation is rarely achieved. As noted by the EBRD, "With transaction-driven engagement dominant, relationships with other IFIs and international organizations are often competitive while wider policy engagement requires collaboration and 'coopetition', i.e.. collaborative competition. Investment climate support is a natural and largely unexploited area for synergy – particularly in diagnostics and policy dialogue" (EBRD, 2018).

An example of a DFO with a broad footprint is AFD, which has 62 offices across the world (not counting offices in French overseas territories) and this allows it, and its subsidiary Proparco, to better anchor their activities in local context. On the other hand, EIB is an example where there are few offices in developing countries, but it is slowly enhancing its local presence with regional offices in Georgia, India, Cote d'Ivoire, Kenya, and South Africa. EIB is also trying to foster their presence and more direct cooperation and synergy at the local level through the EU Delegations (i.e. 'embassies') in partner countries.

In the context of organizational design, it is useful to also distinguish sovereign operations directly involving the government, and thus requiring direct dialogue with the government on regulatory issues, for example, related to infrastructure development and non-sovereign operations where the DFO's clients are the private sector, where the government is not necessarily present, and where dialogue with local actors is less often undertaken. If the move towards private equity investment continues in developing countries, this will require increasingly complex local knowledge, for which multi-stakeholder dialogues may be beneficial as well.

Many DFIs, as in the case of the EIB for example, do not have their own explicit country strategies, and thus operate on an *ad hoc* basis, which also limits the opportunities for influence on wider investment climate objectives. Overall, although the rationale for blended finance is well anchored in transformational considerations of the investment climate, there is a lack of systematic evidence on how DFOs can best effectively link economic transformation and an improved investment climate. In addition to local presence, an anchor with another organization such as the World Bank for IFC, AFD for Proparco, or the European Commission and EU Delegations for the EIB is a strong asset for those DFOs. It allows them to link their activities to investment climate efforts in ways that are not possible in other circumstances.

b. Explicit Local Dimensions and Additionality

The mandates and strategies of DFOs are geared towards transformative development objectives, based on private investment. The Association of European Development Finance Institutions defines DFIs as "government-backed institutions that invest in private sector projects in low and middle income countries to promote job creation and sustainable economic growth, and to contribute to the Sustainable Development Goals, alongside aid agencies and development banks (Association of the European Development Finance Institutions, 2019). By nature, DFOs are mainly transaction-driven financial institutions and they seek to provide the most appropriate instruments to serve the local market, for instance in terms of improving access to finance, financial inclusion, sustainability criteria, infrastructure development, and local currency lending. In this respect, the notion of additionality is a fundamental principle underpinning DFOs blended finance interventions. The concept of additionality refers to the notion that DFOs strive "to support private sector operations that should make a contribution beyond what is available in the market and should not crowd out the private sector" (MDBs, 2018). While it does not only apply to DFOs, the principle of "[a]dditionality is central to the engagement of MDBs with the private sector" (MDBs, 2018). And to be applied properly, the additionality principle must be based on a careful assessment of the local context. Indeed, MDBs stress that "additionality varies by country, sector, market and client context, all of which are dynamic and evolve over time. MDBs use the project design and due diligence processes to ensure their interventions are additional relative to the condition of the market in question" (MDBs, 2018). The notions of additionality and local context are clearly closely connected.

Further, it is important to distinguish between financial and non-financial additionality, though the two concepts are linked in practice. Financial additionality relates to key financial inputs a project can contribute to addressing market gaps (as for instance in the case of local currency lending) or providing innovative financing structures. To be effective, these require a proper assessment and understanding of local market conditions, structures and actors. Non-financial additionality, such as higher standard setting and knowledge sharing are also important dimensions of DFOs' initiatives, which also depend on local context. Perhaps even more noteworthy is non-financial additionality that has spill-overs to policy and regulatory environments. For instance, the MDBs' Harmonized Framework for Additionality in Private Sector Operations identifies as one of the dimensions of non-financial additionality projects that are "designed to trigger a change in the policy, sector, institutional or regulatory framework, or enhance practices at the sector or country level" (MDBs, 2018). While additionality is a useful guiding principle to engage locally, it can be challenging in practice, and even more so to evaluation and monitoring.

c. Partnering with Local Actors

An increasingly promising approach mentioned by multiple DFOs is to partner with a national or regional development bank when engaging in blended finance. For example, the DFO may enter into a memorandum of understanding to allow the local institution to take the leading role in originating, structuring and executing the blended finance transaction. A different approach may include technical assistance and financial support to foster the creation of new national development banks. For example, the German government provided USD 200 million in technical support and financing for the recently founded Development Bank of Nigeria (DBN), which was, in part, modelled on KfW. Other investors included the World Bank, AfDB, AFD and the Nigerian government (KfW, 2015). Technical assistance through local partners was also frequently noted as an effective way to advise the national government on improving the enabling environment in line with context of the country's legal system and business environment.

Further, development finance organizations are increasingly partnering at the sub-sovereign level. For example, one DFI official highlighted an increased desire to work with cities and municipalities to build capacity for financing projects at the municipal level closely associated with goals of the community. This includes providing cities with the ability to tap into external finance but also local finance through enhanced mechanisms to raise funds via local bond issuances or increase the capacity of the local government to raise revenue equitably through taxes and levies. Such increased attention to cities is also reflected in the EU's European Fund for Sustainable Development (EFSD), which is a dedicated investment window on sustainable cities, currently with three selected programs by the Spanish Agency for International Development Cooperation (AECID)/ World Bank, EIB and AFD, respectively (European Commission, 2019).

A relatively new type of local partner for blended finance are strategic/sovereign investmentfunds. More than 20 countries have SIFs to mobilize private investors in priority sectors of the domestic economy over the last 15 years. Nigeria and Senegal have capitalized SIFs that are professionally managed (Halland et al, 2018). For example, Fonds Souverain d'Investissements Stratégiques (FONSIS) received a capital infusion of USD 1 billion by the government of Senegal to make equity and quasi-equity investments to attract additional investment in strategic projects (FONSIS, 2018). This type of fund has also been established in Gabon (FGIS) to support SMEs and produce industries capable of reducing its dependence on the hydrocarbon sector. Morocco's SIF (FMDT) was established, in part, to mobilize national and international investment in its tourism sector (Halland et al, 2016).

A 2019 Overseas Development Institute (ODI) report found on average "for every $1 of MDB and DFI resources invested, private finance mobilized amounts to just $0.37 in LICs, $1.06 in lower- middle income countries (LMICs) and $0.65 in upper-middle income countries (UMICs). Leverage ratios are generally low across sectors, with a slightly higher ratio in the social sectors and the lowest ratios in LIC and middle-income country (MIC) infrastructure" (Attridge and Engen, 2019). These low leveraging ratios suggest that foreign and local private finance are not being mobilized on a sufficiently large scale. This conclusion is supported by the database of new infrastructure projects maintained by the Project Finance and Infrastructure Journal, IJGlobal. For example, since the beginning of 2017, the vast majority of debt finance for projects reaching financial close in Sub- Saharan Africa (excluding South Africa) was provided by external DFIs, MDBs or foreign governments rather than institutional investors. This does not mean there is not an effort to engage local finance, including fixed income, but it does signal a challenge yet to be overcome by blended finance.

Of course local private financial institutions are natural partners for DFOs. By combining concessional lending or risk mitigation instruments with technical assistance, DFOs often contribute to the institutional capacity and standards of private financial institutions. Partnering with these organizations also contributed to their credibility and reputation in the local and international financial markets. While DFOs typically evaluate the impact of their operations with financial intermediaries on the end client, they tend to pay less attention to the systemic impact they may have on local financial institutions, though these may have longer term and ultimately larger benefits. A notable exception is the IFC, which tries to capture some of these effects in its impact assessment (IFC, 2013; IFC 2018d).

As noted earlier, some DFOs also engage with local public financial institutions, such as regional and national development banks. Their project-based partnership is often accompanied by technical assistance and institutional cooperation. Yet, the interviews for this research indicated there is also some reluctance to do so. This not only stems from competitors in a small market, but because of limited information and the perceived risk associated with working with weak local public financial institutions. In some instances these institutions do not have recognized standards and can be prone to domestic political capture. African institutions such as the AfDB or the DBSA do not have such reluctance, and tend to see their engagement with local financial institutions, private and public, as part of their mandate. This is likely influenced by their deep knowledge of the local institutions and local context. In doing so, local ownership and long-term sustainability can be achieved at the project level and in terms of wider development objectives.

Some DFOs however have an explicit strategy to engage with local financial institutions, including public ones. This is the case for instance with KfW, which sees national development banks as a natural partner. KfW also actively supports the development of new local public financial institutions, as in Kenya and Nigeria for instance.

d. Stakeholder Consultation

Consultation with government is a common feature of development partner engagement, including DFOs. To promote sustainability criteria and address issues such as inclusiveness, land management and tenure, and environmental and social impact, in particular in infrastructure development, DFOs in some instances engage in broader stakeholder consultations, notably with civil society organizations (CSOs) and affected communities. Another means of consultation is through platforms and associated partners, as in the case of the FinTech platform recently launched by FMO and its partners, FinForward.(FMO, 2018)

In interviews, EIB emphasized its stakeholder consultation with government, local authorities, civil society and local communities particularly in the context of sovereign financing. Such consultation is more difficult when engaging in non-sovereign blended finance with private actors, as government is generally not directly involved and EIB engagement is more specifically client- based. While EIB is mandated to align its strategies and operations to EU interests and priorities, it has been criticized for not sufficiently considering national interests and consulting adequately where it operates (Spantig, L. ,2017). Similar criticisms have been raised for other DFOs as well.

The challenge for many DFOs is that often the linkages to market-wide development objectives often not explicit and more difficult to assess, therefore making the impact of stakeholder consultation less clear. As a result, beyond a narrow range of private sector actors, non-sovereign blended finance operations generally entail more limited local consultations. This in return reduces local ownership or intentional market-wide outcomes.

5. Blended Finance Instruments for Local Partnering

There are a variety of instruments that embody a local approach to blended finance. First, equity investment has been effective at catalyzing additional local investment as well as making DFOs more vested in the long-term performance and the management team of the company, project or financial institution. Local currency facilities or funds that provide local currency finance have also proven vital. Efforts to capitalize and provide shared-loss provisions or credit lines for local banks can offer a powerful tool to mobilize local capital for growing businesses. This approach has also proven effective for local DFIs whereby the DFO provides a credit line to the local DFI who then allocates the capital better aligned to the local context and development priorities of the country.

Lending at the local level can also be supported by providing financing to the client country, which then on-lends the funds to be invested at the sub-sovereign level. Further, guarantees have proven effective in blending with a local context in mind. Approaches that result in issuing bonds locally or offshoring the issuance to mimic a local issuance strengthen the capacity of local capital markets, help develop a yield curve and offer a benchmark rate for other sub-sovereign entities (both public and private). This can also include investing in bonds issued in local currency through securitization programs at maturities beyond the current offerings to provide much needed local capital and extend the yield curve to longer maturities better matched to the long-term capital needs of the underlying assets.

Although instruments exist, as indicated above and while utilizing local currency finance is critical to blended finance, it remains very limited in developing countries. The ideal solution is to issue securities denominated in local currency via local capital markets where both local and international investors are willing to accept the foreign exchange risk without expecting enhanced yield in return. In practice, the research suggests foreign currency risk mitigation is mostly approached in a synthetic fashion through facilities set up by DFIs or MBDs, hedged through cross-currency swaps or credit/risk-sharing guarantees. The limited capacity of local public entities to provide foreign exchange swaps or guarantees, and/or high cost associated with these approaches make it difficult to issue securities denominated in local currency, puts the sustainability of financing at the mercy of foreign currency exchange rate fluctuations and limits the ability to catalyze local investment. Efforts are being made at multiple development finance organizations to make local capital market development a core part of their local approach to blended finance. Nevertheless, innovative solutions will be needed in the near term to address foreign exchange risks, especially to attract external investment by large institutional investors.

A clearer picture has emerged on which financial instruments lead to the largest amount of capital mobilized. The OECD's 2018 report on blended finance looked at private capital mobilized by official development finance from 2012 to 2015 by instrument: guarantees, shares in collective investment vehicles (CIVs), syndicated loans, direct investment in companies (i.e. equity) and credit lines (OECD, 2018). It found that guarantees account for 44% of the total while also having the most balanced distribution by income level of a country and industry. A Climate Policy Initiative 2018 report had a similar finding with 45% of private sector mobilization coming from guarantees. Convergence's 2018 report utilized its database capturing over 2,500 financial commitments to over 300 closed blended finance transactions from 2005 to 2017. It found that concessional capital and technical assistance funds are used with much greater frequency than guarantee/risk insurance and design-stage grants to mobilize additional finance. There is a lack of evidence on what instruments are best suited to local approaches or which instruments are most effective at crowding in local capital in local currency.

6. Private Investors

The type of investors involved in blended finance is also now clearer due to Convergence's 2018 report on the state of blended finance. DFIs overwhelmingly lead the way with a combined 47% of the proportional investment by active investor type. It has also registered a growing level of activity by bilateral development agencies. Nevertheless, involvement of private investors such as banks, asset managers and insurance companies only amounted to a combined 11% of the proportional investment. This indicates there is still significant work to be done to scale up blended finance. For example, a McKinsey & Company 2016 report exploring the global infrastructure investment gap estimated institutional investors hold approximately USD120 trillion in assets under management in aggregate globally. This was followed by a 2018 report by the Blended Finance Taskforce estimating the global total of capital managed by institutional investors is closer to USD 200 trillion. (Blended Finance Taskforce, 2018). There is limited research about local investors, institutional investors, financial institutions and operators and the extent that their capital is being crowded in. IJGlobal maintains a database of infrastructure transactions, and an analysis of the new projects reaching financial close in Sub-Saharan Africa (excluding South Africa) from January 2017 through June 2019 paints a dismal picture of investment outside of DFOs. Of the new projects reaching financial close, only 22% involved a private fixed income investor. In fact, only 15% of the projects were financed without co-financing from a public entity. Lastly, no projects received financing from private sources outside of the oil and gas, energy, transport and mining sectors.

There is also a better understanding of the impediments to attracting institutional investors to investment opportunities generated by blended finance. A recent survey by Blue Orchard published in October 2018 and accompanying public comments by Blue Orchard's Chief Investment Officer at the OECD Private Finance for Sustainable Development (PF4SD) conference held in January 2019 (OECD, 2019b) suggest that investors often have limited interest in unhedged foreign currency risk, securities that do not have a first loss provision, structures that are over-complicated and investments that fail to meet market returns. Public comments by a panel of asset managers of impact investment funds at the same PF4SD conference noted several other impediments to investing in securities with attributes more aligned with the local context. They mentioned small deal size, securities denominated in local currency, lack of a credit rating, illiquid nature of the securities, cost, lack of a track record, unpredictable regulatory environment and an imbalance of risk and return.

7. Market Development and Demonstration Effects

A pragmatic objective for many DFOs is strengthening local financial markets and achieving demonstration effects, both of which are anchored in local dimensions of their investments. A core aim of blended finance is to compensate for and address market gaps and weaknesses. In this respect, blended finance is often perceived as critical to building or strengthening local private sector markets (DFI Working Group on Blended Concessional Finance, 2018; IFC 2018e). Indeed, according to the IFC, "[t] o assess whether blended finance is needed and how it can be effectively structured, it is essential to understand the restrictions and market failures and the sectoral and country context, and to articulate how blended finance is supporting the creation of markets or is helping them move toward commercial sustainability"(IFC, 2018e). IFC distinguishes three phases to market creation: (IFC, 2018e)

- *"In the first phase of creating markets, the focus is on the initial triggers of market change. These typically include pioneering investments, building market platforms, and adoption of new technologies and business models";*
- *"As markets grow, the second phase of creating markets is characterized by expansion and clustering of complementary investments and government action […]. [B]lended finance can also play an important role in reinforcing markets, particularly in supporting the introduction of innovative technologies and business processes."*
- *"In a third phase, as markets mature, business models are ideally scaled up and extended, new standards and market norms are established, new financing is mobilized as additional private players join, and efficiency and dynamism are further promoted.*

This suggests a range of interventions, mostly centered on individual transactions, that can have a wider effect on market development. The DFI Working Group on Blended Finance for Private Sector Projects Joint Report also emphasized principles for reinforcing markets (DFI, 2017). For example, they note that DFI assistance to the private sector should be structured to effectively and efficiently address market failures and minimize the risk of disrupting or unduly distorting markets or crowding out private finance, including new entrants. Further they noted that DFIs should identify and, where feasible, implement measures to overcome the obstacles identified that are barriers to commercial sustainability.

In this respect, many of the DFIs' blended finance operations with the private sector contribute, directly or indirectly, to foster local market development. These range from engagement with financial intermediaries to improve access to finance for SMEs or women entrepreneurs for instance, to providing local currency operations (EBRD, 2018c), improving market liquidity, reducing risks and fostering product diversification. Innovation, demonstration effects, and pioneering new initiatives are roles that DFOs can play to create local markets and steer actors in new endeavors. FinDev Canada, the new Canadian DFI, calls for the need to "think in terms of 'making markets' and fundamentally shaping incentives to move the needle in areas like gender, equality, and women's economic empowerment" (FinDev Canada, 2018) as an objective that can be applied to other areas as well. Blended finance can have a critical demonstration effect for actors in the markets, as it can contribute "to initiate first-of-its-kind investment that can showcase commercial viability in the longer run, and thereby attract subsequent private investment on commercial terms" (IFC, 2018f).

8. Integrated Approaches

As the blended finance agenda has gained traction, some DFOs are developing integrated strategies to leverage multiple parts of their organization, with an underlying theory of change including broader development impact related to the investment climate and business environment.

The World Bank Group has formalized this in its Maximizing Finance for Development (MFD) approach to systematically leverage all sources of finance, expertise, and solutions to support developing countries' sustainable growth. The WBG institutions—IBRD, IDA, IFC, and MIGA— work in concert to help countries transform sectors to reduce poverty and inequality and support growth. They do this by collectively working to improve the enabling environment, develop regulatory conditions, build capacity, provide financing, and reduce risks.

With the MFD approach, when a project is presented, the WBG considers a spectrum of solutions, private as well as public, and helps clients tap a variety of financing opportunities, incorporate global lessons and good practices, and address equity and affordability for consumers. The underlying theory is to equip countries to attract and manage private solutions, while helping low- and middle- income countries expand their range of options for financing.

Other organizations have adopted a more explicit framework to anchor DFOs activities in the local context. The EBRD has developed an approach focused on 'transition qualities', which is supported by a comprehensive methodology and framework, and a clear set of criteria. The advantage of this approach is to combine in a single framework, the transactional role and transformational role of the organization. The challenge is to combine these two roles in practice so as to ensure effective synergy and complementarity.

Another approach is to combine the contributions of various institutions and instruments in a comprehensive approach, the action of the DFO being complemented by a development cooperation actor. This is the case for instance for IFC with the World Bank, the EIB with the EU and Proparco with AFD. In this regard, an interesting initiative is the External Investment Plan (EIP) of the EU. It is an open system of EU blended finance and guarantees which partner financial institutions to the EU can apply under the European Fund for Sustainable Development (EFSD). This integrated blended finance mechanism stands as the first pillar of the EIP. A second pillar consists of the provision of technical assistance. This technical assistance can support the preparation of projects financed under the first pillar. In can also support activities under the third pillar of the EIP, focused on investment climate (Große-Puppendahl, S. and S. Bilal, 2018). This third pillar encompasses support to investment climate and regulatory reforms to foster a more transparent, competitive and innovative business environment. The purpose of the EIP is explicitly to build on the synergy between these three pillars with all three anchored in the local context and responding to local priorities and dynamics (European Commission, 2019; Bilal, S. and S. Große-Puppendahl, 2018).

AFD with its new initiative, Choose Africa, is providing a somewhat similar framework to the EIP, though at a smaller scale. Synergy between Proparco and AFD is an explicit goal of the AFD Group. Proparco can offer commercially-driven financing solutions, as in the case of the Choose Africa initiative to support African start-ups and Micro, Small and Medium Enterprises (MSMEs), complemented by AFD support. This includes technical assistance to local financial intermediaries, MSMEs and innovative solutions and networks..

9. Ongoing Challenges of Blended Finance

The increased use of public funds in blended finance and its heightened priority in development circles has led to criticisms by some civil society organizations and more scrutiny especially by scholars and thought leaders in development studies. One of the most notable was a 2019 report by ODI indicating minimal levels of mobilization of private finance, especially in LICs. While DFIs, MDBs, multilateral organizations and think tanks are getting better at measuring capital mobilization, the 2018 OECD report on blended finance concluded there are significant shortcomings on monitoring and evaluation. The report found that project level monitoring does not always occur, some institutions lack a formalized evaluation strategy for blended finance and some governments lack guidelines for monitoring and evaluation.

This conclusion is reinforced by a pair of Eurodad reports that look more broadly at projects blending public and private finance. A 2014 Eurodad report notes a poor history of transparency and accountability, limited ownership of project companies by developing countries, weak evidence of additionality provided by MDBs and DFIs and increased risks related to debt (Griffiths et al, 2014). A 2015 Eurodad report concluded that infrastructure projects financed through public-private partnerships (PPPs) in developing countries are expensive, complex and risky with mixed results on development outcomes (Romero, 2015).

Scholars have also recently pointed out other shortcomings. Another Eurodad-Oxfam study considered blended finance problematic for a number of reasons, including the lack of focus on poverty (pro-poor activities and LDCs), lack of stakeholder's consultation and lack of alignment to developing country strategies, with some blended finance initiatives giving instead preferences to donors' own private companies (Pereira, J., 2017). Despite donor efforts, investment has predominately gone to high and upper-middle income countries and largely avoided the least developed countries (Romero, 2017).

A 2018 OECD report on blended finance reached a similar conclusion noting that 77% of private finance was mobilized in middle income countries. Infrastructure projects employing a blend of public funds and private finance rarely target development projects that help the poorest (Baer, 2017). A more recent article highlights that the resurgence of PPPs in recent years has been driven by a desire to tap into global savings without adequately addressing the drawbacks of PPPs (Bayliss and Van Waeyenberge, 2018). Those drawbacks can include projects that are expensive, complex to negotiate and contain contingent liabilities in addition to low transparency and limited evidence of development impact (Romero, 2017). Moreover, the negative effects could outweigh the positive effects derived from liberalized flows of private capital such as tax avoidance, illicit financial flows and capital flight (Garcia-Arias, 2013).

In fact, there is concern amongst some scholars that donor countries are pursuing the path towards blended finance without fully considering the dangers of greater financialization (the increasing role of financial motives, financial markets and financial actors in development) to the Global South (Mawdsley, 2016). This form of financialization leads to challenges related to complexity, transparency, accountability and risks related to over indebtedness and volatility (Mawdsley, 2018). In a recent study for Stamp out of Poverty, Kapoor concluded that blended finance, as useful as it may be, is only pertinent for a limited range of interventions, and has only limited scope for scaling up, thus reducing the expectations from blended finance (Kapour, S., 2019).

Lastly, greater attention is being paid to how the application of blended finance may crowd out local finance or distort local markets. Engagement with local investors, investees and local capital market participants can aid with pricing and determining when viable financing cannot be obtained without the introduction of a blended financial product. However, this can be difficult in practice when DFOs may be focused on the most bankable projects and avoiding risky ones; or investing in companies or projects at rates of return driven by demands from the home office rather than the local context. This can be further exacerbated by the desire of project sponsors or business leaders to obtain the lowest cost of capital possible. It simply would not be in project promoters' best interest to opt for a more burdensome or costly form of financing available to them in local markets when a DFI or MDB is offering a clearly better arrangement. One interview in the study reported this whereby local investors felt they were being crowded out by cheaper financing provided from abroad. As a result, more efforts could be made around determining when financial additionality occurs (and to what extent) as well as whether the pricing DFIs and MDB deploy is consistently at what they often refer to as 'commercial rates' or 'commercial terms.'

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Annex: Selected Development Finance Organizations

The research focused on nine development finance organizations, which provided representational insights related to the local dimensions of blended finance. The short summaries below reflect the desk research and interviews undertaken and highlight a range of concepts, issues, and element affecting the institutions' intent, willingness and/or ability to adapt to the local dimension of blended finance. These include, for example, additionality, investment climate, market development, capacity building, alignment with national strategies, partnering, local footprint, and partnerships.

African Development Bank

AfDB created the Syndications, Co-financing and Client Solutions Department in 2017 to promote innovative financial products designed to mobilize additional finance. This includes the use of guarantees, local currency financing, co-financing and syndicated loan structures. The AfDB reports its private sector investments of $2.43 billion mobilized $6.02 billion in co-financing in 2017 (AfDB, 2018a). The AfDB is also a leader in taking a local approach to its activities. One of the primary ways it achieves this is through having offices in 35 countries. Further, interviews from officials indicate the AfDB works to ensure projects in finances are based on each country's strategy and priorities set by each country.

An example of the AfDB's local approach to blended finance is its financing of a solar energy project in Mali. The launch of the solar photovoltaic project started in 2012 as a 25-year Build, Own and Operate & Transfer concession agreement with the Government of Mali with a take-or-pay power purchase agreement (PPA) with the state-owned utility Energie du Mali (EDM). The EUR 49 million project was financed by 25% equity provided by the sponsors and 75% debt. The AfDB and the IFC split evenly EUR 17 million in senior debt at commercial terms crowded in by a $25 million concessional loan (in EUR equivalent) under the Scaling up Renewable Energy Program (SREP) of the Climate Investment Funds (CIF). A cross-currency swap was employed to hedge the currency risk of the SREP loan denominated in USD and the project cash flows in CFA francs, a currency pegged to the Euro but floating versus the USD.

The Nachtigal Hydro Power Plant presents a larger scale of example of the AfDB incorporating a local approach to blended finance. The 420 MW hydroelectric project was jointly designed by the government of Cameroon, EDF (International-Electricité de France) and the IFC. Further, it was developed to meet local priorities of the country and in line with Cameroon's national development plan (AfDB, 2017). The EUR 1.2 billion project involved many actors and crowded in four local commercial banks: BICEC, SCB Cameroon, Société Générale Cameroun and Standard Chartered Bank Cameroon (Clifford Chance, 2018). In addition to a EUR 150 million loan, the AfDB provided advisory services to enhance the technical capacity of the government of Cameroon through the African Legal Support Facility (AfDB, 2017).

Agence Française de Développement

Further to the earlier discussion on the ability of donors to mix their support instruments with their private sector operations, this is the case for instance for AFD and its subsidiary Proparco (the French DFI). They seek to maximize such synergy between financing operations and effecting systemic economic change, as articulated in its strategy:

- *"Support for the design of development paths and related public policies, equivalent to support for financing projects; selection of "best path" approaches that allow more rapid completion of projects. This passage toward a more dynamic, policy-oriented and long-term conception of support assumes that AFD Group will give less emphasis to the projects it finances, and more to the actors and processes that link projects to development paths and policies. It also assumes that the Group will expand its range of nonfinancial services, with knowledge transfers and capacity building integral and complementary to funding."*[1]

On building local capacity, AFD has an explicit strategy to support the development, strengthening and work of local public financial institutions, in addition to its engagement with private financiers. For example, in Morocco and Senegal, it engages the national Caisse des Dépôts and is helping foster the establishment of a similar institution in Burkina Faso, which is carried out in a joint effort between AFD and the French Caisse des Dépôts. AFD also works with local private financial institutions to foster non-sovereign lending at lower rates for local authorities and public sector companies.[2]

CDC Group

The United Kingdom's CDC Group is the world's oldest DFI. According to their 2017 Annual Accounts report,

1 AFD (2018), Towards a World in Common: AFD Group 2018-2022 Strategy, August, p.6.

2 See for instance European Guarantee to Increase Local Governments' Access to Financing, in EC (2018), Summaries of the 28 EU External Investment Plan Guarantees, December, p.28.

it has "a dual objective: to support growth and jobs that lift people out of poverty, and to make a financial return, which we reinvest into more businesses." CDC focuses on long-term patient capital and unlike other DFIs, its primary instrument of choice is equity. As of the end of 2017, its $5.3 billion portfolio consisted of 90% in equity investments, 10% in debt and less than 1% in guarantees. This approach started changing somewhat from 2017 where commitments comprised 74% in equity investments, 19% debt and 7% guarantees (CDC, 2018d).

CDC also stands out when it comes to good practices on their local approach to blended finance. It maintains an online briefing note on external stakeholder engagement as part of its toolkit for fund managers. This describes how their process should be inclusive, culturally appropriate, timely and informed, transparent, informs decision-making and adaptable to different contexts – all important to localizing its investment approach. It provides a framework on how to assess the level of engagement as well as engage vulnerable groups and indigenous peoples who might be affected by the investment activity. It further describes how to implement stakeholder engagement successfully and engage in fragile and conflict-affected states (CDC, 2018c).

Local priorities carry over into practice. During this research, CDC staff provided insight into their work to engage local investors such as involving local pension funds, as in the case of Nigeria. This approach is driven by their view that local participants will improve the commercial prospects of investments and more importantly develop the local private sector as well as the local capital market – both key objectives of CDC. CDC also engages with pension fund regulators on ways to support the growth of pension fund investment activity and conducts seminars and training sessions for local pension funds. More recently, CDC began joint due diligence exercises where local pension funds can work alongside CDC.

Another example is CDC's efforts to cultivate local currency financing. An example is their combined debt and equity investment in M-KOPA totaling $39 million. M-KOPA is a Kenyan based company providing home solar systems in East Africa. CDC's $20 million debt financing was part of a $55 million local currency facility with Stanbic, FMO and Norfund. CDC anticipates its investment will allow M-KOPA to install solar systems in one million additional homes (CDC, 2017). Another example was described by an investment manager at CDC. It is an innovative local currency approach now under development designed to support greenfield hospital projects where CDC is seeking its first investment utilizing this structure. The approach first involves partnering with a local bank who will serve as the lender of record under a back-to-back arrangement with CDC. The bank would provide local currency financing to the hospital project and CDC would take the credit risk. The bank would earn a small overhead margin on top of the spread it would have already earned from the difference between its cost of funds (interest paid on deposits) and parking the deposits in Naira treasury securities (if applied in Nigeria) issued by the Central Bank. However, instead the bank would have CDC risk (AA/Aa2 of its sovereign sponsor) in place of Nigerian sovereign risk making it an attractive alternative. An additional rate would be embedded in the lending facility to the project and passed through to CDC to cover its credit risk exposure. In the end, it allows CDC to provide local currency financing without exposing it to foreign currency risk except in the event of default.

European Bank for Reconstruction and Development

EBRD has established an integrated framework to link its operations to local investment climate objectives and beyond, through clearly defined criteria. While this is a good model for blended finance, EBRD still faces challenges in implementation to meet these objectives. EBRD focuses strongly on additionality from its investments and services at the project level, but also to include sector and country wide impacts, including the regulatory and institutional setting. Additionality (in particular non-financial) is therefore strongly connected to EBRD's defined economic 'transition qualities' of its investments. That said, this research indicated that while additionality was at the core of the EBRD strategy (in line with MDBs additionality principles), in practice EBRD often focuses on a "project-level approach to additionality".[3] Besides the strong transactional approach, a key challenge relates to monitoring and reporting, with few linkages to market benchmarks, no clear guidance on reporting criteria or on ways to understand non-financial value addition.[4]

A recent EBRD review[5] highlights the challenges EBRD has been confronted with in operationalizing the additionality principle, but also to illustrate the more widely shared challenges that MDBs and DFIs confront.[6] While the additionality principle is central to

3 Ibid, p.v.

4 Ibid.

5 EBRD (2018), Additionality in the EBRD: Review of Concept and Application, RD Evaluation Department, March.

6 The difficulty to assess and report on additionality was a key theme at the ECDPM-CGD Roundtable on Pushing the envelope with the EFSD(+): Fostering additionality in EU external investment with Development Finance Organizations in Brussels, 25 March 2019.

the local dimension of blended finance, monitoring and reporting on it is often limited. The EBRD provides an interesting example in that respect, both because of its dedicated strategy to address systemic changes in the countries where it invests, as well as its efforts to assess its effective results in a transparent manner.

EBRD has an explicit mechanism to account for systemic impact, which is an important dimension for EBRD interventions and project selection.[7] It is underlined by a set of transition indicators. The two pillars of the EBRD transition concept are to be "competitive" and "well-governed", complemented by four other transition qualities: to be "inclusive", "green", "resilient" and "integrated" which EBRD feels is needed for a sustainable market economy. EBRD also keeps track of progress in transition and structural reforms achieved in each country through annual transition scores based on 139 indicators.[8]

An example of EBRD's approach is in Tunisia where both transaction-based and more systemic initiatives are combined to support economy-wide transformations, including in terms of investment climate. Tunisia is also an example of where donors and MDBs coordinate around investment climate, industrialization, development policy, and financing reforms. Consultations are also carried out with a broader range of local stakeholders, in particular key local civil society organizations.[9] Likewise, in the case of Tunisia, EBRD has a field office, which allows it to engage robustly at the local level.[10]

Most DFIs do not have a methodology similar to the EBRD to operationalize their transformative mandate at the local level. Yet, the EBRD model runs into practical challenges as outlined in a recent evaluation.[11] The EBRD evaluation notes that while it engages both in transaction-driven changes and in wider transformational changes, "these two roles require fundamentally different approaches to strategy design and deployment of resources. The transaction-driven role requires client commitment as it is demand-driven, opportunistic and technically focused. By contrast, the change agent role requires wider skills and engagement, including a broader knowledge of the key issues; preparatory analysis and diagnostic work; engagement with a (committed) government at higher tiers and often inter-agency co-operation; and mobilizing networks to effect institutional and behavior change. These two roles also flow from different relationships with partners – the former often reflects competitive interests while the latter benefits from synergies."[12] It further finds that "[a]dministrative processes are geared towards transaction-driven engagement and often fail to support longer-term, transformational initiatives. [...] Activities beyond those that are transaction- driven are often short of funding and human resources and rely exclusively on donor funds."[13] Asa result, investment climate "support activities have often developed *ad hoc* and opportunistically, without clear and measurable goals or intended results;[...]. The lack of higher-level goals means that there are no metrics and baselines against which progress could be measured in a meaningful and reliable way."[14]

EBRD's experience illustrates the challenge that most DFIs experience: as an investor, they seek direct development impact through their client-based, transaction-driven engagement. It is therefore with this objective that they can consider the local context. As noted by EBRD evaluation, though, "individual investments may also deliver wider value regionally, sectorally or industry-wide."[15] But such wider impact is often not explicitly monitored and assessed, at least not *ex post*. Most often, it can only be found in the *ex-ante* justification and articulation of projects. Connections with the wider transformational changes, at the macro-economic and investment climate level are thus often aspirational, and when carried out can disconnected from individual projects.

European Investment Bank (EIB)

The EIB approach also explicitly includes considerations for investment climate and regulatory environment in each country where it operates. This includes development priorities set by local authorities, as framed in the EIB's Results Measurement (ReM) framework. There are strong potential synergies between EIB operations and other EU development initiatives at the local level. For instance, in Kenya, the EIB is engaged in the energy sector, in line with the EU priority sector, responding to the Big 4 Agenda of Kenya,[16] which includes manufacturing, for which energy is an important

7 https://www.ebrd.com/our-values/transition.html

8 See EBRD (2018), Transition Report 2018-19: Work in Transition, November. https://2018.tr-ebrd.com/

9 See for instance http://documents.worldbank.org/curated/en/408781530329592442/pdf/PD-Tunisia-ICI- DPF-Board-Package-052518-fin-06052018.pdf

10 The EBRD considers that "The Bank's field presence is a clear strength – the application of context-specific local knowledge and skills put the Bank ahead of some of its international counterparts", EBRD (2018), The EBRD's Investment Climate Support Activities, EBRD Evaluation Department, October, p.2.

11 EBRD (2018), The EBRD's Investment Climate Support Activities, EBRD Evaluation Department, October.

12 Ibid, p.1.

13 Ibid, p.2.

14 Ibid, p.2.

15 Ibid, p.8.

16 http://big4.president.go.ke/

enabler. Dialogue with the government includes both the EU and the EIB, although through different entry points.

In addition to efforts to improve the investment climate and regulatory environment, EIB also focuses on market development. A recent evaluation of the EIB for instance indicated that "[t]he EIB tailored its objectives to the needs of local financial markets and selected intermediaries accordingly. Intermediated lending operations contributed to strengthening financial sectors by supporting competition, primarily through the financing of local second tier banks."[17] The Assessment refers however mainly to financial additionality, with a strong focus on transaction-based, client-driven operations, and less with potential synergy and complementarity with broader market development endeavors. The EIB support benefits mainly the intermediaries and by extension the end beneficiaries, with less attention given to potentially more systemic market development.

On local capacity building, EIB works with regional development banks, such as the AfDB, but also the West African Development Bank (BOAD), the East African Development Bank (EADB), the Trade and Development Bank (TDB), and the Caribbean Development Bank (CDB), among others. The EIB is increasingly developing new initiatives with these banks, but EIB has generally not engaged in capacity building with weaker regional development banks.

International Finance Corporation

The IFC is a member of the World Bank Group and has been at the forefront of blended finance. It has developed a disciplined and targeted approach applying loans, equity and guarantees to overcome financing challenges in developing countries. A 2016 analysis found it was able to deploy $385 million in concessional funds in 67 projects to leverage over $4 billion in third party financing (Gregory and Sierra-Escalante, 2016). A more recent analysis reached a similar conclusion noting that from 2010-2018 IFC was able to leverage $929 million of donor funds to catalyze more than $9.5 billion of IFC and private sector financing (IFC, 2019). A 2018 Convergence report describes the IFC as a 'trailblazer' when it comes to blended finance.

For example, IFC's Managed Co-lending Portfolio Platform (MCPP) is a syndications platform that creates diversified portfolios of developing country private sector loans to infrastructure projects that institutional investors participate in. As of 2018, MCPP had raised $7 billion from eight global investors, including Allianz Global Investors, AXA, Eastspring Investments (Prudential), Munich Re, and Swiss Re (Convergence, 2018). While not a local approach, it provides a valuable tool to channel institutional investment to infrastructure with 23% of committed funds targeting Sub- Saharan Africa (IFC, 2018a). An EMCompass article in 2017 describes how blending concessional funds from Sweden (Sida) enables the IFC to invest in the junior tranche, which would absorb any first loss from the loan fund. This in turn crowds-in significantly more capital in the senior tranche provided by large institutional investors. The debt fund is used to buy loans financing projects in power, water, transportation and telecom, which provide the long-term stable cash flows well suited for institutional investors. This further creates a powerful demonstration effect (IFC, 2018b).

During this research, IFC reiterated that "scaling up engagements in lower-income countries requires solutions tailored to local contexts (Sierra-Escalante et al, 2018)." One approach developed by the IFC is offshoring bond issuances to raise capital in local currency and create benchmarks for local firms to raise capital independently by establishing a AAA yield curve. This is best displayed in the Masala Bond Program where the IFC issues bonds in different tranches with varying maturities settled in USD (and subsequently in Yen) and pegged to the rupee foreign exchange rate to effectively provide local currency financing for private investment in India. Investor interest was strong leading to oversubscriptions from U.S. investors and European entities. This approach has since been replicated, notably in Rwanda where it launched a similar program in 2015 (Shi, 2017). The three-year local currency bond was issued in 2015 as a pilot, raising 3.5 billion Rwandan francs ($5 million). It was listed in Luxembourg with a 9% coupon placed with five international investors (Reuters, 2015).

Another example is IFC's Private Sector Window (PSW). The IFC was allocated $2 billion to de- risk and address the risk-return profile of projects to mobilize private finance in low income countries. Utilizing the PSW's Local Currency Facility, the IFC purchased $9 million in 12-year local-currency bonds issued by Caisse Régionale de Refinancement Hypothécaire (CRRH), a mortgage refinance company serving West Africa Economic and Monetary Union (WAEMU) countries. The investment supports the creation of an affordable housing market in these countries with the goal of increasing CRRH's portfolio to $500 million by 2021 and extending the local bond market yield curve beyond the current 10-years (IFC, 2018a). A final example of a good practice tailored to the local

17 EIB (2018), Evaluation of EIB intermediated lending through the Investment Facility in ACP, Briefing, January. See also full report EIB (2017), Operation Evaluation: Evaluation of EIB Intermediated Lending through the Investment Facility in ACP, Synthesis Report, July.

environment involves the IFC's Global SME Facility. The IFC (with support from the United Kingdom) entered into a risk-sharing agreement with EIB and Ecobank, a pan- African banking group, to provide local financing to small and medium-size enterprises (SMEs) in Burundi, Congo, Cote d'Ivoire, Democratic Republic of the Congo (DRC), Guinea, Mali, Chad and Togo. It will also provide Ecobank with enhanced capabilities to build scale in SME lending (Sierra-Escalante and Lauridsen, 2018).

Islamic Corporation for the Development of the Private Sector

ICD is part of the IsDB, an MDB with a portfolio totaling $21 billion designed to address financing needs of its member countries (IsDB, 2018). ICD reported approvals of $931 million financing 44 projects supporting the private sector for the 2017 calendar year, the majority of which goes to the financial sector. Many of the products offered by ICD are unique given the necessity to be sharia compliant. ICD works to attract co-financing in ways that would be considered a form of blended finance. This is highlighted in their 2017 annual report with a goal of mobilizing $3 for every $1 invested by 2020. ICD is now undertaking due diligence on blended finance to develop its own polices for engaging in blended finance and how to incorporate blended finance in its development financing model. Nevertheless, there are good practices currently employed by ICD that help inform local approaches and instruments.

By its nature, Islamic finance requires a strong connection to the institutions and entities it is financing. A common way the ICD works to provide local financing is through a line of finance (LOF) to local financial institutions to support local SMEs. Examples include a $40 million facility for the Oragroup, a parent company with banking operations in 12 Sub-Saharan countries; a $100 million facility for the African Export-Import Bank and a $5 million facility for the Arab Gambian Islamic Bank. ICD also provides capital to local banks through sukuk; while equity has been another core piece of their local approach with landmark investments in Morocco and Sri Lanka. Its climate finance activities have been aligned to the priorities of national governments with an example in Egypt providing senior financing alongside the EBRD for a solar park. It has further provided technical assistance to the Central Bank of West Africa to lay the regulatory groundwork for Islamic finance as well as in Suriname to advise a tradition bank to become South America's first Islamic bank.

KfW Development Bank

KfW Group is a large development bank with shared ownership by the federal and state governments in Germany. It reported assets of EUR 472.3 billion as of December 31, 2017 providing funds totaling EUR 76.5 billion for that calendar year. It's 2018 commitments to Sub-Saharan Africa were 1.744 bn EUR, or about 20% of the portfolio, while commitments to north Africa/ Middle East were 2.390 bn EUR. It is overwhelmingly financed by bond issuances to institutional investors primarily in EUR and USD at low rates commensurate with its AAA/Aaa credit rating. KfW Development Bank (KfW) is the development arm of the KfW Group; it provided EUR 8.2 billion to finance international development in 2017 (KfW, 2018). Like the IFC, KfW has been in the blended finance space long before the term was coined. As a result, it has several good practices as it relates to the local context.

Interviews with officials at KfW pointed to several unique policies, investments and initiatives. It is KfW's policy to engage its development activity at the federal level of governments, but this does not inhibit KfW's ability to take a local approach. Its focus on national and regional development banks is also a key feature of KfW's local approach. It cooperates directly with institutions such as DBSA and the Trade and Development Bank (TDB) through projects, technical assistance for developing new products and improving internal systems. Further, KfW supported the creation of a new development bank in Nigeria.

Strengthening local capital markets is a priority for KfW. Much of this activity is achieved through structured funds that invest in local companies and financial intermediaries. There are several examples such as the African Local Currency Bond Funds and Tamil Urban Development Funds. In addition to involvement in structured funds, KfW makes equity investments in microfinance institutions. Examples of this activity in Africa include Advans Groupe (microfinance holding with a presence in Cameroon, Ghana, DRC, Nigeria, Cote d'Ivoire and Tunisia), Finca Microfinance Holding (20 banks worldwide with a presence in DRC, Malawi, Nigeria, Uganda, Zambia and Tanzania) and Access Holding (ten banks worldwide with a presence in Madagascar, Tanzania, Nigeria, Liberia, Zambia and Rwanda).

KfW is also looking for ways to strengthen local currency finance, for example, the SANAD fund was initiated by KfW to provide equity and debt finance in local currency in North Africa and the Middle East. The Regional Education Finance Fund for Africa (the first regional education finance facility for Africa) was initiated by KfW and funded by German Federal Ministry for Economic Cooperation and Development (BMZ) to provide customized financial services for the education sector and has deployed in excess of $5 billion in loans to financial intermediaries. GroFin is a private development finance institution financed by KfW and approximately 30 other DFOs specializing in financing and supporting small and growing businesses across Africa and the Middle East.

In another example, KfW provided a grant and loan to the Global Energy Transfer Feed-in Tariff GETFit. The program is in its first phase in Uganda with a portfolio of 17 small-scale renewable energy generation projects promoted by private developers with a total installed capacity of roughly 160 MW. KfW provides technical assistance and applies a local approach by developing a partnership with local authorities. Further, KfW deploys grant funding to top-up the feed-in tariff. This is designed to make projects financially viable to crowd-in commercial investment. The GET FiT concept is being rolled out to other countries, with GET FiT Zambia officially launched in 2018.

Overseas Private Investment Corporation

OPIC was established to help American business invest in emerging markets and advance American foreign policy priorities. This investment is also designed to increase private investment and lead to accelerated economic development in the countries where it invests. What distinguishes OPIC from other DFIs is its capacity to provide much larger financing facilities and the kinds of instruments such as guarantees in addition to loans, political risk insurance and equity funds. According to its 2018 annual report, OPIC mobilized $8.2 billion from the private sector with the application of $2.4 billion of public investment ($1.9 billion from OPIC and the remaining from other development institutions and public entities). The Better Utilization of Investment Leading to Development Act (BUILD Act) became law in October 2018, putting into motion the creation of the U.S. International Development Finance Corporation (USIDFC) in late 2019. This modernization will more than double OPIC's investment capacity to $60 billion, and with it, additional capabilities that could help it provide finance with the local context in mind. For example, it will have the ability to make local currency loans and guarantees (CSIS, 2018). This will make the USIDFC likely the largest bilateral DFI in the blended finance space going forward.

While OPIC does not have explicit guidelines for local dimensions of blended finance, its investments often align with national priorities and/or strategies. For example, OPIC committed to directly invest $350 million to mobilize $1 billion in capital in its 2X Women's Initiative in 2018; its investments have already crowded in private finance for local banks in India and Mongolia to support women-owned businesses (OPIC, 2018c). OPIC exceeded its $1 billion goal in March 2019 by largely focusing on access to credit by providing financing to local banks who would on-lend to women and women-owned businesses (OPIC, 2019).

Similarly, among its several investments in the energy sector in Africa is the 158 MW Taiba N'Diaye Wind Farm in Senegal. The project reached financial close in 2018 with OPIC committing $250 million in financing and $70 million in reinsurance combined with a €140 million (equivalent to $161 million) loan by the Danish Export Credit Agency (EKF) for 46 Vestas wind turbines (Newsbase, 2018). Local considerations were taken to ensure it aligned with the Pan Senegal Emergent 2014 to improve energy security and diversify the energy mix of Senegal (MIGA, 2018). Likewise, a comprehensive environmental assessment was conducted and local community engagement was robust (OPIC, 2018).

Strengthening the Local Dimension of Blended Finance

A review of the local approaches and instruments employed by Development Finance Organizations (DFOs)

Knowledge Brief for G20 CwA Peer Learning Event
September 12, 2019

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