TOPIC GUIDE:
Blended Finance for Infrastructure and Low-Carbon Development

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January 2014

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DOI: http://dx.doi.org/10.12774/eod_tg9_jan2014.odi

First published January 2014

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Abbreviations and Acronyms

ADB	Asian Development Bank
AECID	Agencia Española de Cooperación Internacional Para el Desarrollo (Spanish International Cooperation Agency for Development)
AFD	Agence Française de Développement
AfDB	African Development Bank
AIF	Asia Investment Facility
AusAID	Australian Agency for international Development
BCIE	Banco Centroamericano de Integración Económica
BIO	Belgian Investment Company for Developing Countries
BOT	Build-operate-transfer
CAF	Banco de Desarollo de América Latina
CEB	Council of Europe Development Bank
CEEP	Chiller Energy Efficiency Project
CIF	Caribbean Investment Facility
CEPS	Centre for European Policy Studies
CLIFF	Community-Led Infrastructure Financing Facility
CMZR	Czech-Moravian Guarantee and Development Bank
CONFIDES	Compañía Española de Financiación del Desarrollo
CP3	Climate Public Private Partnership
CTF	Clean Technology Fund
DAC	Development Assistance Committee
DFI	Development finance institution
DFID	UK Department for International Development
DG	Direct grant
EC	European Commission
ECPDM	European Centre for Development Policy Management
EDF	European Development Fund
EIB	European Investment Bank
ENPI	European Neighbourhood and Partnership Instrument
ERR	Economic rate of return
EC	European Commission
EU	European Union
ExCom	Executive Committee
FINNFUND	Finnish Fund for Industrial Cooperation Ltd.
FRR	Financial rate of return
GEF	Global Environment Facility
GNI	Gross national income
GPOBA	Global Partnership on Output-Based Aid
IDB	Inter American Development Bank
ICT	Information and communications technology
IFC	International Finance Corporation
IFCA	Investment Facility for Central Asia
IFI	International financial institution
IFP	Investment Facility for the Pacific
IMF	International Monetary Fund
IP	Insurance premium
IRR	Internal rate of return
IRS	Interest rate subsidy
ITF	EU-Africa Infrastructure Trust Fund
LAIF	Latin America Investment Framework

M&E	Monitoring and evaluation
MFB	Hungarian Development Bank
MIGA	Multilateral Investment Guarantee Agency
MoF	Ministry of Finance
MSMEs	Micro, small and medium-sized enterprises
MW	Megawatt
NIB	Nordic Investment Bank
NIF	Neighbourhood Investment Facility
NZAID	New Zealand Agency for International Development
OBA	Output-based aid
ODA	Official development assistance
ODI	Overseas Development Institute
OECD	Organisation for Economic Cooperation and Development
OeEB	Oesterreichische Entwicklungsbank AG (Development Bank of Austria)
PIDG	Private Infrastructure Development Group
PFG	Project Financiers Group
PPI	Private participation in infrastructure
SID	Slovenska izvozna in razvojna banka (Slovenian Export and Development Bank)
SIMEST	Società italiana per le imprese all'estero
SOFID	Sociedade para o Financiamento do Desenvolvimento
SRR	Social rate of return
TA	Technical assistance
TAF	Technical Assistance Facility
VGF	Viability gap funding
WACC	Weighted average cost of capital
WB	World Bank
WBIF	Western Balkan Investment Framework

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Topic Guide summary

This guide provides an overview of both the **theory and practice of blended finance**. **Blended finance** is defined as the **complementary use of grants** (or grant-equivalent instruments) **and non-grant financing from private and/or public sources to provide financing on terms that would make projects financially viable and/or financially sustainable**. Given that certain infrastructure investments may not be commercially viable, innovative instruments have been sought to close this 'viability gap' and make a larger number of projects bankable. By blending grants with loans, this innovative approach to development finance aims to achieve a number of objectives – from increasing the volume of development finance in a context of constrained resources, to increasing the viability of investments, to enhancing the overall effectiveness of aid. Moreover, by demonstrating the long-term viability of markets, blending can potentially trigger an increase in private investment without the need for a grant element (although the evidence on this so-called 'demonstration effect' remains relatively weak).

Blending strategies of most donors and Development Finance Institutions (DFIs), such as the European Union (EU) and the International Finance Corporation (IFC), target the **infrastructure sector** for at least two reasons. Firstly, the considerable **financing gap,** estimated at $1 trillion per year in developing countries and an additional $200-300 billion per year to ensure that infrastructure investments are low emission and climate resilient, makes the financial leverage effect associated with blending extremely attractive (Bhattacharya et al., 2012). Secondly, the grant relative to total project financing can be used to **correct two types of market failures** that typically undermine the financial viability of infrastructure-related investments: **information asymmetries and externalities**.

Beyond assessing the case for blending, **the type of financial instrument used is also critical**. They include direct grants (or output-based grants), technical assistance (TA), interest rate subsidies, loan guarantees/risk-sharing products, first loss financing and risk capital that are offered at below market terms. These products can increase the investors' rate of return and/or incentivise investors and financial institutions to take more risk, whether by a signalling or demonstration effect that provides investors with new information or by mitigating a particular risk. TA helps to encourage investment by supporting the preparation of business plans, supporting technical review and/ or the structuring of projects. Criteria for using blended finance tend to vary by region, country, sector and project, and as a result blending may be justified in a wide variety of circumstances for either public or private sector projects. Careful consideration of the optimum level of blending to mobilise finance, but avoid windfall profits to investors, as well as a high level of **transparency**, is needed to ensure that grants are optimally used to meet the needs of final beneficiaries and donors.

With a number of Organisation for Economic Cooperation and Development (OECD) donors seeking to meet the 0.7% official development assistance (ODA) to gross national income (GNI) target by 2015, questions have emerged about **whether blended finance can be classified as ODA, or whether it should be additional to ODA commitments**. At present, the largely ambiguous relationship between blended finance and the formal definition of ODA is a potential disincentive/barrier to the use of blending to meet the ODA/GNI target.

The guide also goes beyond the theory of blended finance to **outline how the EU and the IFC have defined, structured and operationalised blended finance**. The EU and the IFC are two of the big players in blending for infrastructure. They have made significant strides in formalising their approach to blending, developing the associated structuring expertise and

governance arrangements. However, while the rationale for blending is broadly similar, **there is generally no one-size-fits-all approach to blending, even within the same organisation**.

In spite of the many potential benefits that can arise from blending, it needs to be carefully managed to ensure that its optimal value is realised. **The guide assesses six challenges associated with blended finance.** These are:

1. Balancing financial incentives and development principles.
2. Avoiding crowding out private financing and market distortion.
3. Ensuring developing countries' debt levels remain sustainable.
4. Institutionalising transparency and accountability.
5. Adopting clear and well-defined monitoring and evaluation methods.
6. Avoiding negative demonstration effects.

The guide concludes by identifying critical questions a donor and/or DFI could consider when assessing the opportunity of blended finance, the design of a blended finance package and its performance against the project's objectives. Despite the widespread use of blending in development finance, its development impact is largely uncertain due to the limited evidence gathered so far. For this purpose, the guide outlines areas where further research is required in order to develop a more comprehensive understanding of blending and of its impact on development outcomes.

About the authors

This Topic Guide was produced by a team of researchers from the Overseas Development Institute (ODI) comprising Shakira Mustapha (Research Officer), Annalisa Prizzon (Research Fellow) and Mikaela Gavas (EU Programme Leader and Research Fellow) with input from Lily Ryan-Collins, Infrastructure Adviser at the Department for International Development (DFID). The team would like to thank DFID for its support and helpful comments throughout the project, as well as Peter Wolff, Head of World Economy and Development Financing at the German Development Institute (DIE), for his peer review. We are also grateful to Amadi Cisse (Senior Consultant, IMC Worldwide) for his comments on an early draft.

Glossary[1]

Additionality (of blending). Measures the net impact of blending by comparing what would have happened in the absence of the grant component. The assessment is based on one or more of the following dimensions: financial, economic, project scale and timing, project quality, innovation and other benefits (such as reforms).

Additionality (of blending to official development assistance). Measures the increase in the envelope of resources for development beyond ODA, as opposed to a reallocation and/or rebranding of existing development assistance.

Bilateral development finance institutions. Finance institutions that are majority-owned by national governments and have historically served to implement government foreign development and cooperation policies.

Blended finance. Flows combining market (or concessional) loans and other financial instruments with accompanying grant (or grant equivalent) components. The scope is to leverage additional non-concessional public and/or private resources with different financial terms and characteristics.

Blending facility. Mechanisms or investment facilities that mix grants with loans, managed and financed by bilateral or multilateral development finance institutions (DFIs).

Build–operate–transfer (BOT). A form of project financing through which the government outsources public projects to the private sector. With BOT, the private sector designs, finances, constructs and operates the facility and eventually, after a specified concession period, the ownership is transferred to the government. This enables the private sector to recover its investment, and other operating expenses. Therefore, BOT can be seen as a developing technique for infrastructure projects by using private initiative and funding. Such infrastructure projects include a wide array of public facilities with the primary function of serving public needs, providing social services and promoting economic activity in the private sector.

Concessional loan. These are loans whose terms are substantially more generous than market terms, either through below-market interest rates, longer grace periods (interval to first capital repayment), longer maturity or a combination of these. The Organisation for Economic Cooperation and Development's (OECD) Development Assistance Committee (DAC) defines a loan concessional when its grant element is above 25% and where the interest rate charged by the lender is below the market rate for interest on a similar loan.

Crowding out. When a DFI invests in the place of private financiers who were willing to invest, and thus undermines the development of a healthy private sector market for financing in that sector/activity.

Demonstration effect. Projects with demonstration effects are those that lead other market participants to change their behaviour (i.e. to increase levels of investment), without direct involvement of the DFI or donor beyond the initial project.

[1] Some of the following definitions are referenced from these sources: European Commission, 2009; Gavas et al., 2011; Kingombe, Massa and Te Velde, 2007; OECD website; and Spratt and Ryan-Collins 2012.

Development Assistance Committee (DAC). The committee of the OECD which deals with development cooperation. As of September 2013, the DAC is composed of: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, the United States and the European Commission.

Development finance institutions (DFIs). These are providers of external development finance specialised in private sector development. These institutions have a developmental mandate and their main objective is to support and catalyse private investment in developing countries where access to capital markets is limited, using loans, equity and guarantees as well as other risk mitigation instruments. Their role is to bridge the gap between commercial investment and government aid, while avoiding market distortions. DFIs can be bilateral or multilateral, both of which are defined separately.

Economic rate of return (ERR). Measures the broader economic costs and benefits of the project (i.e. return to the economy as a whole), capturing multiplier and spill-over effects.

Equity. A share in the ownership of company stocks via the purchase of share capital. In the context of blended finance, these are usually non-voting shares, which intentionally restrict the management role in the companies or financial institutions.

Financial intermediary. A financial institution that facilitates the channelling of funds between lenders and borrowers. Examples include commercial banks, private equity funds, credit unions, etc.)

Financial rate of return (FRR). Measures the return on an investment taking into account only the costs and benefits specific to the investor(s). IRR is one measure of the FRR.

Grant. Transfers made in cash, goods or services for which no repayment is required.

Grant element. Measures the concessionality of a loan, expressed as the percentage by which the present value of the expected stream of repayments falls short of the repayments that would have been generated at a given reference (non-concessional) rate of interest.

Internal rate of return (IRR). Measures returns to a particular project or investor. The IRR of an investment is the interest rate at which the net present value of costs (negative cash flows) of the investment equals the net present value of the benefits (positive cash flows) of the investment. Internal rates of return are commonly used to evaluate the desirability of investments or projects. The higher a project's internal rate of return, the more desirable it is to undertake the project.

Innovative finance for development (IFD). Innovative finance for development (IFD) tends to be divided into two elements. The first element focuses on innovative sources of development finance, that is, the potential to raise revenues in ways other than relying on direct contributions from donor budgets. The other type of IFD focuses on innovative uses of development finance. The funds used in such mechanisms may be raised through traditional ODA or other mechanisms, but are spent in innovative ways. This can include bringing the public and private sector together in ways that maximise the contribution of each to development.

Leveraging. The use of grants to mobilise additional private or public financing for a project.

Loans. Financial transfers for which repayment is required.

Multilateral DFIs. They usually have greater financing capacity than bilateral DFIs and provide a forum for close cooperation between governments. An example is the Private Infrastructure Development Group (PIDG), which is an innovative multi-donor organisation that aims to encourage private infrastructure investment in developing countries. Multilateral DFIs also include arms of multilateral development banks such as the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA) of the World Bank.

Mutual reliance initiative. An initiative of the EIB (European Investment Bank), *Agence Française de Développement* (AFD) and *Kreditanstalt für Wiederaufbau* (KfW) which promotes efficient project co-financing through the mutual recognition of procedures. The initiative seeks to simplify project appraisal and monitoring, reduces transaction costs and develops best practice for the division of labour.

Non-grant financing. Consists of loans, equity and guarantees. These products are commonly offered at below-market terms in a blended finance package.

Official development assistance (ODA). Grants or loans to countries and territories on the DAC List of ODA Recipients (developing countries) and to multilateral agencies which are: (a) undertaken by the official sector; (b) with promotion of economic development and welfare as the main objective; (c) at concessional financial terms (if a loan, having a grant element of at least 25%). In addition to financial flows, technical cooperation is included in aid. Grants, loans and credits for military purposes are excluded. Transfer payments to private individuals (e.g. pensions, reparations or insurance payouts) are in general not included.

Social rate of return (SRR). Measures economic benefits as in ERR, but also measures non-traded social and environmental factors to capture the full costs and benefits to society of a project. FRR is therefore a subset of ERR, while ERR is a subset of SRR.

Weighted average cost of capital (WACC). The combined return expected by the different lenders on a project.

SECTION 1

Defining and understanding blended finance: an overview

Infrastructure is critical for development. It encompasses "energy, transport, water and sanitation, information and communications technology (ICT), water management (such as water storage, flood defences and irrigation), housing and public buildings (including schools and health clinics) (Department for International Development, 2013, p.4)." Most developing countries face a chronic deficit of infrastructure, constraining economic growth rates, leaving the world's most vulnerable communities without access to basic services and hampering attempts to achieve broad-based poverty reduction. While an estimated £494-556 billion ($800-900 billion) is currently invested in infrastructure every year (the majority of which is public finance), one recent study finds that **annual infrastructure spending will need to more than double by 2020 to meet the development requirements for infrastructure** (Bhattacharya et al., 2012). Another study suggests an annual infrastructure financing gap of £618 billion ($1 trillion) (World Economic Forum, 2013). Public finance is insufficient to fill the infrastructure funding gap. While private sector infrastructure investment has increased significantly since the 1990s, it is at present both insufficient and too volatile to bring financing up to the level required (Spratt and Ryan-Collins, 2012). It is within this context that innovative sources of development finance for infrastructure have emerged. Blended finance is one such innovative approach, enabling large infrastructure projects to be financed that would otherwise be too costly for a single donor.

The objective of this guide is threefold: to define and provide the theory and rationale behind blending, to highlight key considerations for donors and development finance institutions (DFIs) of blended finance, and to illustrate how blending occurs in practice. Certain DFIs such as the Commonwealth Development Corporation and the International Finance Corporation (IFC) tend to focus operations solely with the private sector in developing countries, while others, such as the European Investment Bank (EIB), focus primarily (although not exclusively) on the public sector via sovereign loans (Te Velde and Warner, 2007).

The guide addresses blending primarily from the perspective of donors and DFIs and is structured as follows:

- Section 1 defines blended finance and describes the various grant and non-grant instruments that can be used in blending.
- Section 2 provides an overview of the underlying rationale for blending as well as multiple criteria that govern decisions such as the size of grant and type of instrument. It also looks at the relationship between official development assistance (ODA) and blended finance.
- Section 3 demonstrates how the European Union (EU) and the International Finance Corporation (IFC) of the World Bank Group have engaged in blending to explore practical considerations around its use and application. It identifies the current entry points for donors in their respective processes.
- Section 4 assesses the main underlying issues that practitioners need to be aware of in order to ensure that they use this innovative financing tool efficiently and

effectively. This is important since, although the potential benefits associated with blending are significant, questions have been raised in some cases regarding its effectiveness, development impact and potentially distortive effects. The main challenges include balancing financial incentives and development principles, avoiding crowding out of private markets, debt unsustainability, transparency, accountability and monitoring and evaluation (M&E), as well as the possibility of negative demonstration effects.

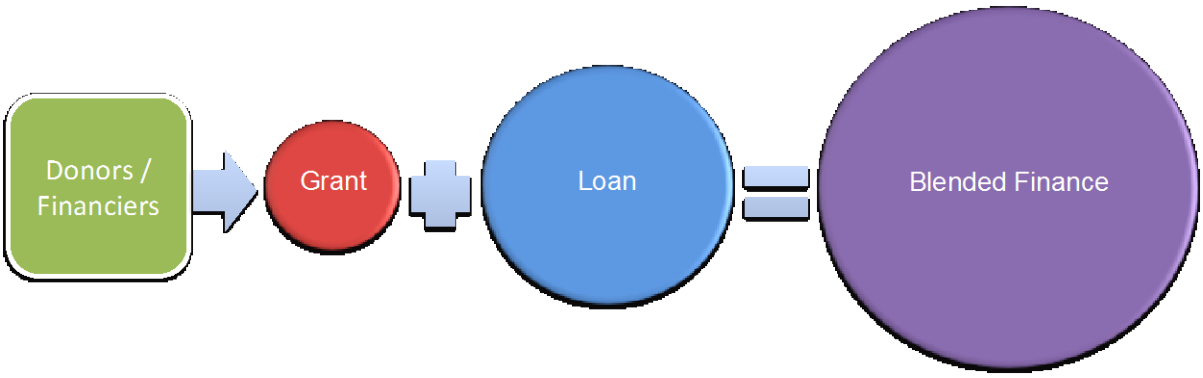
- Section 5 concludes by identifying a set of critical questions for consideration by donors and DFIs when designing a blended finance package, as well as areas where further research is required in order to develop a more comprehensive understanding of blending.

The guide assesses blended finance in the context of financing infrastructure and low-carbon infrastructure projects in Sub-Saharan Africa and South Asia with case studies of relevant projects used throughout to illustrate the following main points:

- The different motivations for blending.
- Various forms of the value added of the grant element.
- Potential improvements in donor coordination.

1.1 What is blending

Figure 1 Blended finance



Blended finance, in this guide, refers broadly to the **complementary use of grants** (or grant-equivalent instruments) **and non-grant financing from private and/or public sources to provide financing on terms that would make projects financially viable and/or financially sustainable.**

While there is some overlap in how different actors define blended finance, definitions are shaped by the mandates and constituencies of the agencies concerned, and are not therefore consistent. For example, in the context of the EU blending facilities, blending is defined as a tool which combines EU grants with other public and private sector resources, such as loans and equity, in order to leverage additional non-grant financing to support projects with partners in beneficiary countries that can be public, private or mixed (Ferrer et al., 2011). In contrast, the private sector arm of the World Bank Group, the IFC, has a narrower definition: blended finance refers to the provision of financing to a private sector investment project on financing conditions more favourable than market terms where it is expected that the need for below market terms is time-bound (International Finance Corporation, 2012c). Both of these definitions fall within the broad definition of blending that is used throughout this guide.

Grants are transfers made in cash, goods or services for which no repayment from the recipient is required.

Non-grant financing often takes the form of loan transfers – for which repayment of principal and interest by the recipient is required. Other common forms of **non-grant financing** provided by DFIs are **equity** and **guarantees.**

Some loans are concessional (or 'soft' loans) prior to blending. A concessional loan is granted on financial terms that are more favourable than that of a market/pure loan (for example below-market interest rates, longer grace periods or longer maturity). A concessional loan can be combined with a grant in a blended package. The level of concessionality tends to reflect the DFIs' assessment of factors such as the level of risk and revenue potential associated with a project as well as other parameters that are explored in greater detail in Section 2.2.

There is no global estimate of the total volume of development finance mobilised as a result of blending to date. However, as the largest provider of blended finance, the EU's experience highlights the significant financial impact of blending and its growing importance as an innovative source of development finance. For example, in 2012, EU grant contributions of more than £341 million (€400 million)[2] made investment projects possible in beneficiary countries with a total project volume of approximately £8.5 billion (€10 billion), representing a multiplier effect of 25 (i.e. £8.5 billion/£341 million). This is noteworthy when one takes into account that the value of the total project volume associated with blending was roughly 20% of total ODA expenditure in 2012 (£43.2 or €50.6 billion). In addition, since July 2011, the IFC helped structure climate change deals using more than £80.3 million ($130 million)[3] in approved donor partner funds. The funds were invested alongside more than £370.7 million ($600 million) in IFC financing to support projects with an expected total value of more than £1.9 billion ($3 billion) (International Finance Corporation 2012b).

1.2 Range of blended finance instruments

Choosing the right instruments to blend is critical. The potential range of grant and non-grant instruments that can be used in blending is varied and includes:

(i) **Direct grants (DGs)**. Provision of direct finance for specific components of a project that have substantial demonstrable social or environmental benefits, or to project components mitigating negative environmental or social impacts which are not financially viable. Therefore, the underlying logic of a DG is to get these projects or project components to the point of financial viability. A DG is similar to viability gap funding (VGF) which is mainly used by national governments, such as India and Indonesia, as an incentive for private investors to get involved in public-private partnerships that are economically but not financially viable. In 2012, the Technical Assistance Facility (TAF) of the Private infrastructure Development Group (PIDG) created a new £6.2 million project-subsidy funding window for VGF. Direct grants are generally intended to target redistributive objectives (pro-poor development) or in cases where a significant cross-border externality of the investment under consideration justifies grant coverage of part of the costs. However, pure grants can lead to perverse effects if beneficiaries expect that they will always receive them in the future, thereby weakening their incentives to develop the capacity to access financial markets and manage more commercial types of financing.

[2] Currency conversion exchange rate used: €1 = £0.85
[3] Currency conversion exchange rate used: $1 = £0.62

Example: In the India Chiller Energy Efficiency Project (CEEP) grant funds from both the Global Environment Facility (GEF) and the Multilateral Fund for the Implementation of the Montreal Protocol are being used to provide an up-front subsidy to chiller owners to encourage them to replace and upgrade older chillers (in larger-scale air conditioning systems) with more efficient ones. Despite a potential 40% improvement in energy consumption, most building owners/managers are unwilling to embrace early timely replacement of outdated chillers because of high upfront capital requirement, perceived technology risks and high opportunity costs (World Bank, 2010). Grant funding is justified here because of the significant positive environmental externalities achieved.

(ii) **Conditionality/performance-based grants** (such as output-based aid (OBA) or buy-downs) are a variant of the above-mentioned investment grant with disbursement of the grant linked to compliance with *ex ante* defined conditions or service-level performance targets. Buy-downs involve the donor(s) agreeing to pay off the debt from the project or component upon successful achievement of pre-determined performance indicators. TAF grants from the PIDG can also be made for OBA. These performance-based grants can be used to align interests of the project sponsor with the development objectives pursued by the donors.

Example: The Maji Ni Maisha project in Kenya facilitated access to finance for community-based water providers by blending output-based subsidies and commercial finance from a local microfinance bank, K-Rep Bank. Details are provided in Box 1

Box 1 Using output-based aid to extend water infrastructure in Kenya

The Maji Ni Maisha project aims to increase access to clean and reliable water supply for rural communities in Kenya, using a blend of commercial finance and an output-based subsidy (through the DFID-supported Global Partnership on Output-Based Aid (GPOBA)). The OBA subsidy leverages co-financing from K-Rep, a commercial bank so that small community-based water providers can obtain loans and then make debt service payments to K-Rep Bank. The capital subsidy is paid only upon the delivery of pre-determined and agreed outputs, and provides the following benefits:

- Reduces total loan sizes and makes the monthly repayments more affordable for the community;
- Better risk management for the lender;
- Increases incentives for project completion and subsequent performance.

The loan from the bank amounts to 80% of the total community investment, with the remaining 20% is provided by the community as an equity contribution.

It is worth noting that although this project has achieved some impressive results in the pilot, it was expensive to set up in the first place and has not scaled-up so far in other countries. The high transaction costs incurred to reach small-scale actors therefore raises concern about replicability and sustainability.

Sources: Adapted from Russell, C. 2010. Maji Ni Maisha: Innovative Finance for Community Water Schemes in Kenya. GPOBA and Trémolet, S. 2013. Donor approaches to improving access to finance for independent WASH Providers, DFID.

(iii) **Interest rate subsidy (IRS)** refers to the provision of a grant to lenders to cover part of their interest payments. It enables the lender to make loan finance available at

reduced interest rates[4]. The partner country or project sponsor thus receives a subsidised loan at a below-market interest rate, rather than a separate loan and grant. In theory, direct investment grants or IRS are equivalent in terms of enhancing the concessionality of a financing package. What differs is the impact on implementation (Ferrer et al., 2012a). For example, in the case of the IRS, the beneficiary benefits from managing a single contract and contract partner and hence reducing the transaction costs on the partners' side (Ferrer et al. 2012a). In contrast, an IRS tends to be less transparent than an investment grant because of the internal calculation processes and margins that are not disclosed amongst financiers, often for confidentiality reasons in line with banking practices. This lack of transparency can make it more prone to market distortions since it can excessively subsidise a project thereby directly reducing the competiveness of alternative private and public sector loans (Mid-term Evaluation of the EU-Africa Infrastructure Trust Fund – Final Report, 2012).

Example: An IRS of £12.8 million (€15 million) from the EU-Africa Infrastructure Trust Fund (ITF) blending facility was used in the Caprivi power interconnector project to reduce the overall debt burden to the beneficiary (Annual Report of EU-Africa ITF, 2011).

(iv) **Guarantee/risk-sharing products** that are provided below-market terms can be important tools to encourage early movers to extend their risk appetite. Loan guarantees or partial credit guarantees cover private lenders against all risks since the guarantor makes the payment when a real default occurs, irrespective of the cause of default. Alternatively, guarantees can also be used to provide insurance against specific types of non-commercial risks by insuring eligible projects against losses relating to: (a) currency inconvertibility and transfer restriction, (b) expropriation, (c) war, terrorism and civil disturbance, (d) breach of contract, and (e) non-honouring of sovereign financial obligations. These products reduce the project risk and thus the interest rate charged to the borrower, mimicking an IRS. They may also help lower collateral requirements and extend maturity. The Multilateral Investment Guarantee Agency (MIGA) – an arm of the World Bank − offers coverage for these five non-commercial risks and makes available special guarantee facilities and trust funds to encourage investment in areas of special need.[5] For example, MIGA has established the Conflict-Affected and Fragile Economies Facility a multi-country, donor-funded facility that will allow the Agency to further expand its business in conflict-affected and fragile economies.

Example: Grants and guarantees were provided via Community-Led Infrastructure Financing Facility (CLIFF), a venture capital facility funded by donors to enable organisations of the urban poor to access greater public, private and civil society sector resources for sustainable housing and basic services projects for slum dwellers (including sanitation). With support from this fund, implementing partners and organisations of the urban poor take out loans through local financial institutions which were initially unwilling to offer affordable loans in the absence of a guarantee because of the borrowers' lack of collateral (Trémolet, 2013).

(v) **Structured finance − first loss financing** differs from a guarantee as it involves donors investing in the highest risk tranche of a project. Essentially the highest risk tranche is the first loss tranche that absorbs initial losses, shielding other investors from a pre-defined amount of financial losses, thereby enhancing credit worthiness

4 In practice, the financier retains the grant, and in effect uses it to reduce the amount of the loan provided rather than the interest rate charged so finance contract rates remain unchanged.

5 http://www.miga.org/investmentguarantees/index.cfm?stid=1809

and improving the financial profile of an investment. Blending allows sub-market pricing of the first loss tranche which is important since market-based pricing for the first loss tranche is likely to be prohibitively expensive in new sectors where the perceived risk is high.

The following two instruments are not forms of blending as defined in the introduction of this section. Although they are used widely in the context of loan-grant blending, they differ in that technical assistance does not entail a monetary transaction to the partner country and risk capital does not include a grant or loan component.

(vi) **Technical assistance (TA)** is non-financial assistance during the project preparation and/or project implementation. Some common forms of TA include preparatory work for eligible projects, such as due diligence, pre-feasibility and feasibility studies, environmental impact assessments, project supervision and project-related capacity building. In several cases, donor funded TA is considered to be a desirable incentive for the project sponsor to accept implementation guidance. Moreover, donor funded TA can be important in addressing the so called '**first mover disadvantage**' associated with highly innovative projects or risky projects in new markets. This disadvantage stems from the fact that other people may benefit from the first project's investment, research and work without having to share the cost (Department for International Development, 2012). Investors are aware of this and may refrain from investing first, slowing down the development of the market. However, free or near-free TA can be market distorting in two ways: (i) directly competing with projects offered by private providers of technical assistance services; and (ii) indirectly competing with other financiers by effectively cross-subsidising an investment it has with the same client. While this is largely a matter of judgement, safeguards based on asset allocation for country risk and the commercial attractiveness of sectors could be one way to avoid the potential for distortion resulting from TA (Spratt and Ryan-Collins, 2012).

Example: The Renewable Energy for Rural Economic Development project in Sri Lanka is a World Bank and Global Environment Facility (GEF) assisted programme that blends grants, equity and loans. One component involved using £2.4 million in grants from the World Bank's International Development Association and the Global Environment Facility (GEF) to finance technical assistance throughout the programme. This included policy advice to the government, capacity building for project developers and participating credit institutions, as well as advice on technologies and business planning.

(vii) **Risk capital** includes equity investments for high-risk projects which have not been able to attract finance on their own terms (Ferrer et al., 2011). **Better access to equity is often fundamental to unleashing significant private sector finance for infrastructure in developing countries, as it is the first and most risky form of capital.** Equity can be subsidised through a discounted rate of return or lower expectations of dividends.

Example: The UK-supported Climate Public Private Partnership (CP3) programme is designed to attract equity finance from pension funds and sovereign wealth funds by encouraging investment alongside the UK Government, the Asian Development Bank and the International Finance Corporation in commercially managed private equity funds. The CP3 programme as a whole is expected to mobilise private finance (equity and debt) at all levels of the funds and projects, resulting in up to 3,500 MW of renewable energy and preventing the equivalent of up to 130 million tonnes of carbon dioxide emissions over the projects' lifetime.

It is worth noting that the IFC's blended finance approach involves offering debt products (interest rate reductions and/or longer tenors), guarantees/risk sharing products and equity/quasi-equity products at below-market terms. Most of the abovementioned instruments are offered by the EU blending facilities though their eligibility varies across facilities as shown in Annex 1.

The size of grant in a blended finance package tends to be a relatively small proportion of the total project cost, though it can vary considerably across projects. For example, in the EU-Africa Infrastructure Trust Fund blending facility, the average grant share is 2.28% (i.e. grant as a proportion of the total project cost) though for individual projects, it ranges from as low as 0% to as high as 20% (Gavas et al., 2011). For the IFC sustainable energy project in Peru in 2006, concessional funds from the Global Environment Facility (GEF) accounted for 1.5% of the total blended finance package (IFC, 2012c).

SECTION 2

Rationale and criteria for blending and the relationship with ODA

This section is divided into three parts. The first part highlights the rationale for blending from the perspective of donors and DFIs. The second part briefly outlines the main criteria underlying decisions regarding the type of instrument and the size of the grant. Finally, there is a discussion of the ODA eligibility of blended finance.

2.1 Rationale for blending

The potential advantages of blending grants and loans are manifold. Annex 2 provides a theoretical comparison of the advantages and disadvantages of blended finance relative to pure grants and pure loans in three broad areas: economic, financial and operational criteria. While this comparison is useful, it is an oversimplification since contextual factors, such as whether the project is (potentially) commercially viable and the country context, can alter the conditions under which a particular type of financing is appropriate.

The remainder of this sub-section focuses on five main potential benefits associated with blended finance: (i) improved financial viability of projects, (ii) additionality (the net impact of blending after taking into account what would have happened in the absence of the grant), (iii) positive demonstrative effects, (iv) improved financial sustainability and (v) improved coordination and cooperation among donors and DFIs. Moreover, the grant component can reduce the potential debt burden to a country resulting from the investment.

(i) Improved financial viability and gaining access to private sector finance

By mitigating risks and/or increasing private returns, blended finance can enable projects to access private sector finance and thus beneficiaries can gain access to funds from the private sector or DFIs that would not be available under 'normal' market conditions. This is particularly relevant for projects that fail to attract sufficient resources at normal market rates due to some form of market failure (see Box 2).

Box 2 Examples of market failure in the infrastructure sector corrected by blended finance

Blended finance can help address two types of market failure that limit access of partner countries to financial markets:

(i) **Externalities**: Infrastructure investments often generate positive or negative externalities, defined as spill-over effects that make society better or worse off respectively, but which are not reflected in the investor's financial rate of return for the project. Blending mechanisms may be used to finance projects with a high positive social and/or environmental impact (positive externality), but which are not financially viable. The grant element compensates for the insufficient financial return (at least in the short term) until the project becomes sustainable. Blending mechanisms can also use the grant element to bear any additional cost needed to

solve the issue of negative externalities associated with a given project. For example, a direct grant (DG) of £2.6 million (€3 million) was approved from the ITF to the Mauritius Ports Authority to mitigate the negative environmental and social impacts of the project.

(ii) **Information asymmetries**: Capital market imperfections arise from the uncertainty and limited information surrounding the (future) profitability of projects, on which basis lenders determine the probability of repayments of their funds (Baudienville et al., 2009). Low-carbon infrastructure projects and innovative projects in general, tend to involve the use of relatively new and unproven technologies or business models that are perceived to have a high cost and risk profile. As a result, lenders are often unwilling to finance such projects at an affordable rate. Blended finance has been a common approach for supporting such innovative projects on a small scale to demonstrate their technical and commercial feasibility, while facilitating learning in order to stimulate larger transformational processes in the long run.

(ii) Additionality

Additionality, in the context of blended finance, measures the net impact of blending after taking into account what would have happened in the absence of the grant. Given the large infrastructure financing gap and the significant pressure on government budgets, the financial additionality provided by blending potentially plays an important role in increasing the net impact of donor funding, as every unit of donor money attracts non-grant funds which are several times higher than the original donor investment. Financial additionality is the main rationale behind blended finance, but there is also the potential to create other forms of additionality. Definitions of a number of types of potential additionality are provided below:

Financial: The volume of additional funding (public or private) mobilised by the grant component. Different indicators for measuring this financial mobilisation effect are described in Box 3. Financial additionality is a prerequisite for blended finance projects. If the project would have been financed by the private sector without the grant, its use is not justified and, in fact, the grant will be doing harm by providing rents to the private sector and distorting markets.

Economic: The expected benefits and positive results of the grant element of the funding (e.g. affordability of a service for the poor and contribution to country debt sustainability). Blended finance can encourage investors to undertake investments with significant social benefits that they would not otherwise pursue because of the return to the private investor being insufficient relative to costs. These concepts are explained in greater detail in Section 2.2.

Project scale: The outreach and results of the project in terms of more beneficiaries or more emission savings.

Project timing: Speeding up the delivery of the project so that benefits are realised more quickly.

Project quality: Enhancing the quality of the project's technical solution or increasing its chances of successful implementation, and/or promoting higher standards for implementation (e.g. Environmental and Social Guidelines).

Innovation: The creation of incentives for innovative elements and projects that could not have been implemented without grant support because of uncertain future revenues and/or the country environment of the project.

Other benefits: Support for parallel actions to ensure that the project remains sustainable and that benefits continue beyond the life of the project. They could include structural reforms, supporting changes to legislation, regulation or policy or developing capacity within the public sector.

The full range of additionality benefits should be considered when making decisions on allocating grant resources to blended finance projects.

Box 3 Measuring the financial leverage effect

The financial leverage effect is at the core of blending with the grant expected to leverage loans and other financial products from DFIs and, in some cases, private or other forms of productive investment (see definition in Section 1). There are different ways of defining leverage ratios looking at the mobilisation of different components of the funding package. The following are common leverage indicators (see Ferrer et al., 2012b):

1) *Investment leverage* (or multiplier effect) is the most widely used measure, comparing all funding (i.e. total project cost) to the grant element. So, if the grant element is £100 million and the total project cost is £3 billion the multiplier effect would be £3 billion/£100 million = 30.

$$\text{Investment leverage} = \frac{\text{grant element}}{\text{total project cost}}$$

2) *Instrument leverage* (IL) is the amount of funding the grant contribution has mobilised. For example, if a DFI offers guarantees and loans worth £1 billion for a grant of £100 million, the IL is £1 billion/£100 million = 10.

$$\text{Instrument leverage} = \frac{\text{grant element}}{\text{loans and guarantees}}$$

3) *Project leverage* (PL) represents the amount of additional funding the project has attracted. It compares the abovementioned total instrument leverage (i.e. the DFI's loan generated by the grant) to the total project cost that includes the grand total of funding that was raised (including other public or private financial institutions, other public grants, etc.). This means that if a project's total funding is £3 billion and the instrument leverage £1 billion, then the PL is £3 billion/£1 billion = 3.

$$\text{Project leverage} = \frac{\text{total instrument leverage}}{\text{total project cost}}$$

4) *Private loans/grant leverage* measures the amount of private sector (non-grant) financing mobilised as a financial input into the investment project divided by the amount of grant(s).

Generally DFIs or project sponsors that apply for grants for blending provide an *ex ante* assessment of leverage using one or more the abovementioned ratios**.** These are subsequently updated *ex post***. The importance of these ratios, however, should not be overstated. A large leverage and multiplier effect is not automatically synonymous**

with a high level of additionality. Consequently, when evaluating potential projects, both the multiplier effect as well as the more qualitative elements of additionality should be considered in order to determine the instrument's overall impact.

Source: Adapted from Ferrer et al., 2012b

(iii) Positive demonstration effects

Blending can create positive demonstration effects, i.e. the project leads other market participants to change their behaviour. Changes in behaviour may include a bank deciding to start lending in a new sector. More specifically, the IFC defines demonstration effect as "an increase in quantity or quality of private investment in infrastructure (not involving IFC) that is influenced by an IFC activity in infrastructure" (Castalia Strategic Advisors, 2011). Given that the funding DFIs have at their disposal (including the funding they are able to mobilise) is small compared to the global infrastructure financing gap, creating a demonstration effect is an important part of the rationale of many DFIs.

To test for demonstration effects, it is important to identify the mechanisms by which this influence may occur. For example, in some instances DFIs can demonstrate that private investors have an inaccurate view of risks and returns, i.e. that the risk-return ratio is better than they perceive. However, 'proving' demonstration effects tends to be challenging because of the difficulty of finding a counter-factual and of isolating the effect of the grant or the overall investment in a highly complex and rapidly changing environment with a multitude of potential explanatory variables (Spratt and Ryan-Collins, 2012). This is exacerbated by the question of timescale, as any demonstration effect may take years to come to fruition.

(iv) Improved financial sustainability of projects

Blending can improve financial sustainability over pure grants in three ways: (1) from a recipient country perspective the process for loan approval requires an appraisal process of its costs and benefit via feasibility studies, assessment of counterpart funding and parliamentary oversight, which are not part of the standard process of grant negotiations; (2) the loan component can have a positive impact on financial discipline given that beneficiaries need to repay loans and contribute their own funds; (3) when appropriately calibrated, blending can allow for a better allocation of funds by enabling financing through loans rather than pure grants where repayment capacities exist.[6] At the same time, it is important to acknowledge that grant funding will be most appropriate for certain projects where financial returns are unviable.

(v) Promote cooperation and coordination among donors and DFIs

Blending can improve the quality of interventions as many blended finance projects involve more than one DFI or donor. This can result in a sharing of expertise, skills, practices and lessons learnt. Collaboration can also encourage innovative ideas to further enhance mechanisms at the operational level. For example, the *Agence Française de Développement* (AFD)-European Investment Bank (EIB)-*Kreditanstalt für Wiederaufbau* (KfW) Mutual Reliance Initiative supports the division of labour between financing institutions on the implementation level by reciprocally delegating project management tasks to one of the three institutions acting as Lead Financier in joint co-financing. It is based on mutual recognition, rather than harmonisation of procedures.

6 Some specific grant instruments used in blended finance can also improve a project's financial sustainability by generating re-flows. These re-flows can in principle be redirected to new operations without further commitment of further resources, partially reducing the budgetary costs of donors.

2.2 Criteria for using blended finance

This subsection explores the criteria underlying the blended finance decision-making process. We have defined these criteria as falling within four broad categories: macroeconomic, microeconomic/financial, operational and/or political. These factors can influence the size of grant as well as the type of instrument through which the grant is deployed.

(i) **Macroeconomic criteria**. Assess the economic and budgetary situation of the borrowing government, particularly their foreign debt position, to ensure that there is adequate fiscal space for absorbing the loan component of the blended finance instrument. This criterion applies to projects where the public sector (rather than the private sector) contracts a loan only (in other words when a debt-creating transaction is involved).[7] For example, classified at low risk of debt distress by the International Monetary Fund (IMF), Uganda can borrow on highly concessional terms. Thus, for the Eastern Africa Transport Corridor project, the EU's ITF provided an IRS to lower the interest rate of the EIB loan of £46.9 million (€55 million) to the Government, satisfying the 35% IMF concessional element required by Uganda for taking up additional debt (Annual Report EU-Africa ITF, 2011).

(ii) **Microeconomic/financial criteria**. Project specific and usually involve a comparison of three financial variables: (i) social rate of return (SRR) which represents the socio-economic value of the project (i.e. return to the society as a whole), (ii) internal rate of return (IRR) which represents the return to the financier and is a measure of the project's financial profitability; and (iii) the weighted average cost of capital (WACC) which is the combined return expected by the different lenders (European Commission, 2009).

The investment is financially viable when the IRR exceeds the WACC. However, there are many types of infrastructure and social sector investments that donors may wish to support, for which the SRR exceeds the IRR, while the latter does not reach the WACC. In such a situation, a grant can be used to introduce a portion of capital where the expected direct financial rate of return is nil, thereby reducing the WACC. If the WACC falls below the IRR, the investment becomes financially viable, though other factors may still discourage the investment.

Based on these criteria, the grant share should be just enough to attract additional financing without generating excess operating surpluses and windfall profits, and will, therefore, depend on the size of the gap between the IRR and WACC (European Commission, 2009). Blending addresses the gap between the IRR and the WACC by reducing the cost of investment, for example through a subsidy, or alternatively, by increasing the anticipated potential return.

(iii) **Operational criteria**. The operational costs and complexity of procedures for approval and implementation.

Costs and fees associated with the management of blending operations include: the direct financial costs of establishing the programme; funding the subsidies needed to sustain the programme; and the various transaction costs incurred in operating and participating in the programme. These costs should be compared to the expected benefits of using blended finance to determine the net benefits as well as the potential for scaling up the project. These net benefits could also be compared with

[7] This criterion does not apply to the private sector given that the latter does not add to government's debt unless a PPP arrangement is involved.

the expected net benefits of alternative financing options to determine which option provides the best value for money.

The pooling of funds from different partners often brings with it higher transaction costs, not only because of the higher number of involved parties, but also because of diverging internal rules and procedures. Differing views on conditionality between donors may generate additional administrative costs and/or delays in the decision-making procedure in particular at the initial phase.

(iv) **Political criteria.** Usually based on the geographic, sector and thematic priorities of the donors and the DFIs.

These four criteria are not unique to blended finance, and are often used to guide decisions related to the suitability of pure loans and grants. Moreover, the relevance of each is also likely to vary with the type of project. A benchmarking exercise, assessing each project against these criteria, can help in designing a baseline for future projects, thereby increasing predictability and transparency of decisions pertaining to the grant size and type.

2.3 ODA eligibility of blended loans

With a number of OECD donors seeking to meet the 0.7% ODA/GNI target by 2015, questions have emerged about **whether blended finance can be classified as ODA, or whether it should be additional to ODA commitments**. At present, the largely ambiguous relationship between blended finance and the formal definition of ODA is a potential disincentive/barrier to the use of blending to meet the ODA/GNI target.

A loan is classified as concessional if its grant element is at least 25% of the value of the loan. For blended finance this is calculated on the basis of factors such as the extent to which the interest rate and loan tenor are concessional. Given that the current OECD/DAC discount rate is far higher than the current market rate (i.e. the calculation of the grant element is based on a 10% interest rate), the 25% grant element is not difficult to achieve for longer tenor loans.

In the case of blended finance, the **level of concessionality of a loan depends on how the grant and loan are linked.** If a grant is given separately from a loan, even for the same project, the loan can only be recorded as ODA if it fulfils the concessional loan criteria on a stand-alone basis (25% grant element).[8]

In addition, ODA only recognises official government flows and not flows from private financiers. Even if a loan is concessional based on the DAC definition, it must still be demonstrated that the payment is being made by an official donor to an ODA eligible beneficiary.

Ultimately, because of the regulations over ODA, this arrangement appears to be a disincentive to the use of blending facilities unless funding from private individuals is directed initially through an ODA donor (Gavas et al. 2011).

[8] If the grant is not separate from the loan, ODA concessionality criteria will be applied to the entire package (grant and loan).

The OECD's DAC is currently discussing a proposal for a comprehensive framework for reporting on development finance, including an internationally-agreed definition of development finance, a new high-profile statistical measure of total official support for development and representation of data on both 'donor effort' and 'recipient benefit' of development finance. It will propose a revised ODA concept and criteria for the assessment of concessionality. This will potentially have an impact on the ODA classification of blended finance.

SECTION 3

Blending in practice

This section gives an overview of how donors and DFIs design and implement blended finance packages for infrastructure and low-carbon infrastructure projects in Sub-Saharan Africa and South East Asia. Specifically, this section outlines the differing approach, governance structures and processes of two of the big players in blending for infrastructure, the EU and the IFC.

3.1 The European Union

Blended finance is a key source of innovative development financing for the EU, accounting for 67% of the total funds allocated to innovative financial instruments over the period 2010-2012 (European Commission, 2013). Moreover, since 2007, the EU has established eight loan/grant blending facilities, the key characteristics of which are described in Annex 1. Boxes 4 and 5 compare the value added of two ITF projects in the energy and transport sectors.

The EU's blending facilities mainly support public investment projects. Only 10% of the grant contributions made so far have gone to projects that involve the private sector (European Commission, 2013). However, the EC is currently working to extend the use of innovative financial tools such as risk capital and guarantees with a view to unlocking additional private investments.[9]

Box 4 Important role of the ITF in the 'Caprivi Interconnector' cross-border Energy Transmission Project

At a total project cost of £257.8 million (€302 million), the Caprivi project consisted of the construction of a 200 MW (designed to be upgradeable to 600 MW) high voltage Direct current transmission connection from Zambia to the Namibian electricity network, interconnecting the northern and western parts of the South African Power Pool network. The project was financed through long-term funding by the EIB, AFD and KfW with each institution providing £29.9 million (€35 million) support, with an additional £12.8 million (€15 million) interest rate subsidy from the ITF. NamPower, Namibia's national power utility, funded the balance together with the Development Bank of Namibia. **Overall, the leverage effect was high at 20.1, and predominantly the result of the IRS mobilising public funding.**

Based on the mid-term evaluation, the value added of the grant element was rated as

[9] In addition, the EU Platform for Blending in External Cooperation was officially launched in December 2012, with the aim of improving the quality and efficiency of EU development and external cooperation blending mechanisms. The Platform has been tasked with reviewing the existing blending mechanisms, and is currently developing a common framework to measure their impact and providing recommendations and guidance on how to blend public and private resources to increase the impact of EU development cooperation. The platform will develop key principles for blending to ensure that blending activities are coherent, coordinated and flexible.

very important (Mid-term Evaluation of the ITF, 2012). The alternative to the Caprivi Interconnector would have been the purchase of coal-generated energy from Zimbabwe, or to construct small, relatively inefficient and polluting, fossil fuel projects which would be environmentally unattractive and offer no security of supply benefits to the region. By offering an IRS to NamPower, the ITF facilitated the investment into the economically and environmentally preferable option, with benefits beyond the Namibian borders. It also partly compensated NamPower for the higher investment cost and for the fact that their future share in the economic benefits of the project was uncertain.

Source: Mid-term Evaluation of the EU-Africa Infrastructure Trust Fund-Final Report, 2012.

Box 5 Less important role of the ITF in the Port de Pointe Noire Project

This project entailed the renovation and upgrading of the main infrastructure of the Port de Pointe Noire in Central Africa and its adaptation to developments in containerised traffic, and on the improvement of financial management by increasing competencies and providing support. At a total project cost of £109.6 million (€128.4 million), ITF provided an IRS of £5.6 million (€6.6 million) to enhance the concessionality of the AFD loan and a £1.7 million (€2 million) grant for technical assistance to finance capacity building for the financial and accounting staff of the Port Authority.

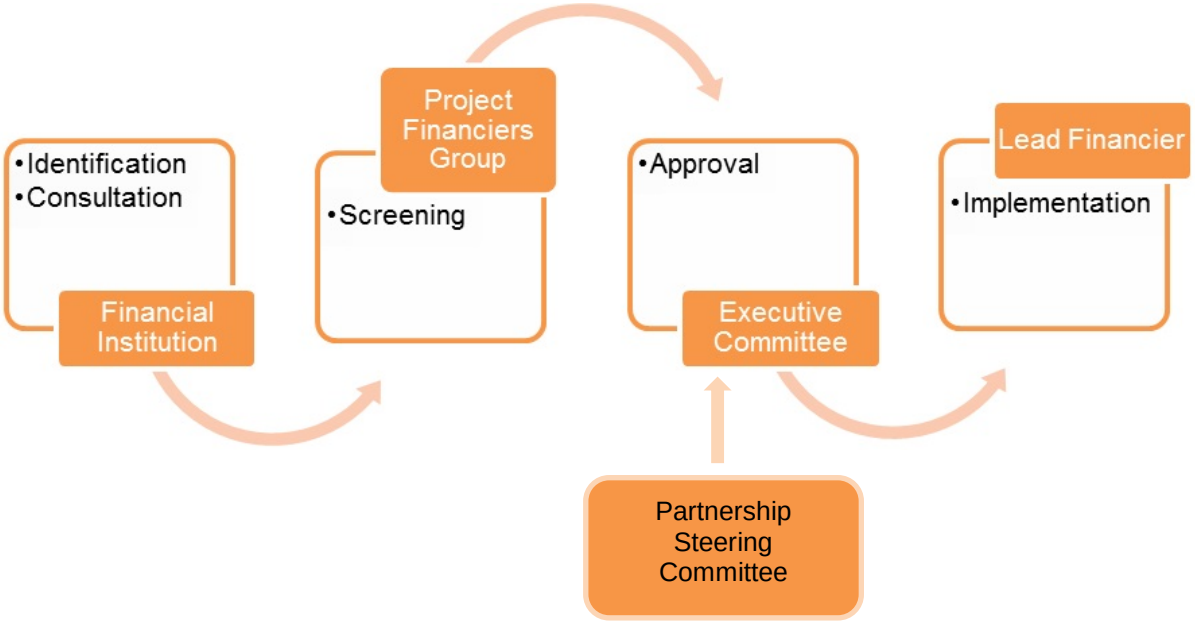
In contrast to the Caprivi Interconnector, the contribution of the ITF was rated as relatively less important. According to the 2012 Mid-term Evaluation of the ITF, the ITF's contribution to this project has been a windfall for the Port authorities. In addition, the project sponsor stated that funds could have been procured from elsewhere in the absence of the ITF, for example, sub-regional debt markets, thus suggesting that the ITF potentially crowded out other sources of financing. Crowding out may reflect a poor screening process and/or intense pressures faced by DFIs to bring in deals which results in them being pulled toward sectors with greater commercial prospects (Spratt and Ryan-Collins, 2012).

Source: Mid-term Evaluation of the EU-Africa Infrastructure Trust Fund-Final Report. 2012.

Governance structure

Figure 2 shows the basic decision-making process and project cycle of the EU's blending mechanisms. Each step is outlined below.

Figure 2 Basic EU blending process



Source: Authors' design based on Gavas et al., 2011 and Bilal and Krätke, 2013.

Project identification and consultation: Each facility offers grants, but does not promote projects directly. The process for accessing blended facilities starts with participating/eligible financial institutions, such as PIDG in the EU-Africa ITF, proposing projects to the Project Financiers Group (PFG) after consultation with the respective partner country. **Donors therefore have limited policy influence at this stage** (Gavas et al., 2011).

Project screening: The PFG screens proposals and provides technical analysis.

Project approval: As members of the decision-making body, known as the Executive Committee (ExCom), donors can influence which screened project should receive grants. The decisions of the ExCom are likely to be influenced by the work of the Partnership Steering Committee, which provides the overall strategic direction of the blending facility (e.g. where grants should be targeted).

Implementation: The project is implemented by the Lead Financier, which tends to be the accredited financial institution that allocates the largest share of the loan, but may be based on other criteria, such as expertise in the region or area of intervention.

For an assessment of the ITF's governance structures, see Annex 3.

3.2 International Finance Corporation (IFC)

The IFC is the largest DFI focused exclusively on the private sector in developing countries, and has been increasingly active in promoting private sector participation in climate-friendly investments in these countries**. Although the IFC generally favours providing financing on commercial terms so that projects are expected to cover their full costs, including a reasonable return on capital, it has utilised blended finance in its portfolio, though within clearly defined boundaries.** Hence, in contrast to the EU's blending facilities, the IFC uses blending to provide finance to **private sector investment projects on terms more favourable than the market, but only when it is expected that the need for below market terms is time bound**.

The IFC sources its concessional funds primarily from donor facilities, such as the IFC-Canada Climate Change Program and the Global Agriculture and Food Security Program.

The following four key principles underlie the IFC's approach to blending are:

(i) **Finding solutions**. The IFC defines blended finance as funds invested (for example, loans, guarantees or equity)[10] at concessional, or below market, rates alongside the IFC's own funds to support investments in particular sectors where blending concessional funds may catalyse investments that would not otherwise happen because of market barriers (International Finance Corporation, 2012a). Blended finance is therefore seen as suitable choice when two key conditions are met: the intervention must address a critical barrier to private investment and it must result in socially desirable investments that are financially sustainable.

(ii) **Sustainability and additionality**. Projects are expected to demonstrate the business case for such investments and pave the way for similar projects. As a result, future investments of a similar nature should need fewer or no subsidies, thereby leading to sustainability.

(iii) **Minimising concessionality**. This is to avoid market distortions and crowding out private finance or IFC non-concessional financing. In other words, subsidies are kept to a minimum, i.e. should not be greater than necessary to induce the intended investment. Activities are also expected to become commercially viable within a specified timeframe which depends on the barriers impeding investment and is likely to vary with the market or sector. The IFC's approach to minimising subsidies is described in Section 5.2. The time-bound principle also means that the amount of subsidy should ideally reduce over time to ease transition toward commercial terms.

(iv) **Upholding transparency and effective governance**. Transparency helps to provide clear demonstration effects to future investors since it signals to the market when such subsidies are necessary and when they are not. Transparency is also important for managing potential conflicts of interests and to ensure that the IFC fulfils its obligations to donor partners. It does this through segregation of funds, separate investment staff overseeing the structuring of donor concessional funds within a blended package and separate approval bodies for donor concessional funds as needed.

To date, the IFC has mostly used blended finance in the area of climate change, which has included low-carbon infrastructure investments, such as the construction of solar plants and conversion of biomass to renewable energy. Box 6 provides an example of IFC blended finance for a power plant project in Ghana**.** In 2012, the IFC approved more than £80.3 million ($130 million) in concessional funds for climate-related investments and advisory projects. This was blended with £370.7 million ($600 million) in IFC co-financing for climate change investments supporting projects that are collectively worth more than £1.9 billion ($3 billion) (International Finance Corporation, 2012b)**.** It has also recently created new facilities to deploy concessional funds for small and medium size enterprise financing and agribusiness. Nevertheless, the IFC has explicitly stated that blended finance projects are expected to remain a small portion of its overall business, and will continue to use it "sparingly and in a highly selective way" for cases where the social returns from an investment (SRR) exceed the private returns (IRR) expected to be captured by the investor (International Finance Corporation, 2012c).

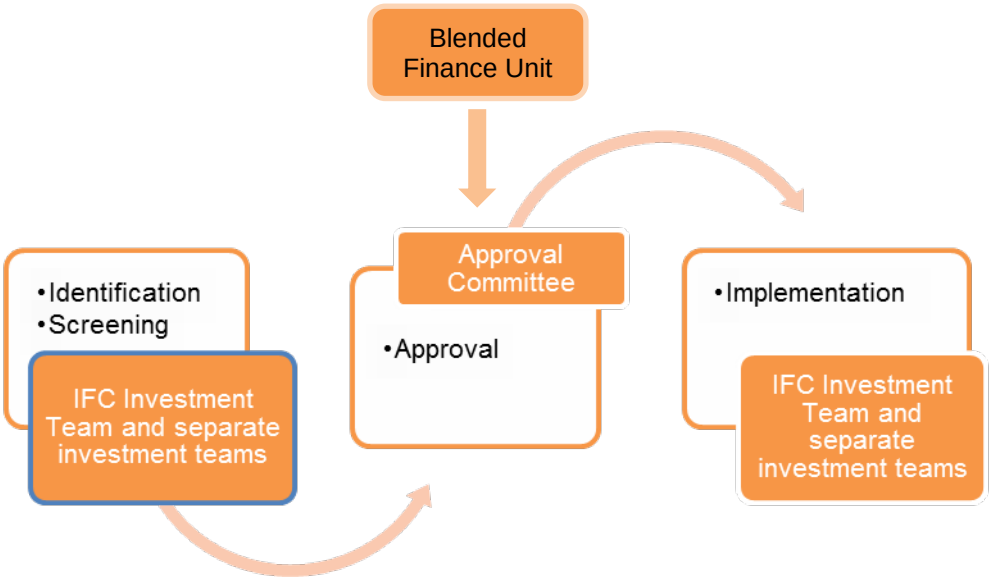
[10] The grant element might be structured through grants, the provision of risk sharing products on below-market terms, the provision of debt financing with differences in rate, tenor, security or rank, or through equity investments with *ex ante* expectations of below-market returns.

Governance structure

To address concerns around the blending of concessional funds with its own funds, the IFC has established separate investment teams which are responsible for structuring, managing and supervising the concessional portion of blended finance interventions. These teams operate at arm's length from the IFC Investment Team responsible for processing and supervising any related investment for the IFC's own account. However, these teams work closely and in partnership with the IFC Investment Team throughout the project to structure the subsidy element in the blended finance package for the client (International Finance Corporation, 2012c).

In addition, it is worth noting that in some cases the donors who fund the subsidy element in blended instruments retain the authority to process and approve particular uses of their resources. This is the case, for example, with projects supported by the World Bank-managed Global Partnership for Output-Based Aid[11] (International Finance Corporation 2012c). In other cases, the donors delegate authority to the IFC to process and approve blended finance projects on their behalf. Figure 3 shows the basic decision-making process and project cycle when donors delegate authority to the IFC.

Figure 3 Basic IFC blending process



The main advantage of donors delegating authority to the IFC is that it expedites investment processing enabling greater alignment with the IFC's own deal processing. Transaction costs may also be reduced. This is often a key requirement when working with private sponsors, though it increases the need for transparency since the IFC acts as an Implementing entity with obligations to the donor (International Finance Corporation, 2012c). In most cases, the terms and conditions for the use of resources for which the donor has delegated authority to the IFC are specified in trust fund agreements and in the IFC's own policies and procedures. IFC has also established a separate approval committee to approve the use, structure and terms of donor funded concessional finance used as part of an overall blended finance package in these cases. This committee is comprised of IFC Vice Presidents and Directors who have no conflicts of interest related to the investments under consideration.

[11] The IFC blends some of its own resources with concessional funds from GPOBA.

Furthermore, in order to reinforce the IFC's disciplined approach to blending, the Blended Finance Unit was formally created in July 2008 to manage concessional donor funds and work with IFC investment and advisory staff to blend these funds alongside IFC financing. The Blended Finance Unit provides a credit review on the concessional investment and quality assurance support for Blended Finance interventions. It also provides the Blended Finance Committee with qualified opinions on each blended finance transaction, paying particular attention to ensuring that each transaction meets with IFC's blended finance principles, particularly the principles of additionality, minimum concessionality (minimum subsidy), sustainability and transparency.

Box 6 IFC uses blended finance to expand power plant in Ghana

The IFC participated in a project in which a $15 million concessional loan was made to Takoradi International Company (TICO) to boost output at a 220 MW power plant in Ghana by 50% without any additional fuel consumption. Approved in 2012, the proposed transaction consisted of a secured senior loan of up to £74.1 million ($120 million), composed of a £64.8 million ($105 million) loan for the IFC's own account blended with £9.3 million ($15 million) in concessional funding from the Canada Climate Change Program. It is estimated that 118,000 tonnes per year of greenhouse gas emissions would be avoided (equivalent to taking 23,600 cars off the road every year).

Source:
http://ifcext.ifc.org/ifcext/spiwebsite1.nsf/651aeb16abd09c1f8525797d006976ba/b595b8cc659b56ff852578a40074a570?opendocument

SECTION 4

Challenges to the use of blending

Although many benefits can be realised through blending, there are several challenges that need to be carefully monitored and managed by DFIs and donors to ensure that blending is optimally used. This section assesses some of the challenges associated with blending: balancing financial incentives with development objectives; avoiding crowding out and market distorting effects; adverse impact on debt sustainability of developing countries; ensuring transparency and accountability; adopting clear and well-defined monitoring and evaluation (M&E) methods; and avoiding negative demonstration effect.

4.1 Balancing financial incentives with development objectives

While blending potentially allows investments to access the discipline, skills and expertise of the private sector, which can in turn improve a project's long-term sustainability, using grants to leverage private sector investment can also entail an opportunity cost. This opportunity cost arises if DFIs use limited grant resources to support projects that do not have significant development outcomes. DFIs are structured in such a way that financial returns will always be a strong motivating factor; without this they would not serve their purpose. But, given that they spend donor grant funding, they also have strong reasons to ensure that their investments are clearly poverty reducing. Balancing developmental and financial objectives when selecting and designing projects is therefore an important challenge facing most DFIs. It is worth noting that DFIs themselves are not homogenous, with some having a more developmental mandate than others (Spratt and Ryan-Collins, 2012).

At present, a vast majority of blending projects do not directly target poverty eradication, but instead address economic development in general through investments in energy, transport and other infrastructure. For example, out of the ten case study projects reviewed for the mid-term evaluation of the EU's ITF, only two of them explicitly mention poverty reduction outcomes in the ITF application documentation while the remainder focus solely on the project's contribution to economic development and trade. Beyond the EU, there is currently an increased focus amongst partner countries and donors on economic development as potentially the most effective route to poverty reduction, given the strong evidence that growth is the principal enabler of long-term poverty reduction. However, gaining a better understanding of how growth translates to poverty reduction in the case of these investments is important.

4.2 Avoiding crowding out private financing and distorting markets

Crowding out is when DFIs invest in a project that would, in fact, have been commercially viable (i.e. that could have attracted full private sector financing) without any grant subsidy. Where this occurs, it not only means that scarce donor funding has been misspent, but it also has the potential to distort markets and undermine the development of a healthy private sector market for infrastructure financing.

While this concern is valid, it should not be exaggerated. Firstly, in most blending packages, the grant share is a relatively small fraction of total project cost and hence is unlikely to have a large crowding out effect. Secondly, the risk of crowding out of other possible (private)

sources of finance is less relevant in low-income countries where financial markets are insufficiently developed, and investors are unlikely to have access to international capital markets at affordable rates in the absence of the grant. Furthermore, governance processes and structures can be used that significantly decrease the risk of crowding out. For example, the IFC's approach to minimise the subsidy in blended financing involves evaluating the barriers impeding investment in each market and the required discount needed in a financial product to entice the investment (International Finance Corporation, 2012c). Where feasible, competitive bidding can be used to elicit market information, such as when rival firms are invited to bid for projects on the basis of the least subsidy required. However, in cases where this is not feasible, commercial negotiations are required on a project-by-project basis, informed by relevant market benchmarks.

These processes, if done well, significantly decrease the likelihood of crowding out and market distortion. Nevertheless, the difficulties of obtaining accurate information on the condition of markets and investment conditions, particularly in countries where there is very little private sector investment in infrastructure at present and therefore little to compare to, should not be underestimated.

4.3 Ensuring developing countries' debt levels remain sustainable

This concern applies specifically to blended finance projects that increase public sector liabilities − in other words debt-creating transactions − and is therefore recorded in governments' ledgers, as opposed to private sector debt, which is not. Blending instruments that use grant support to promote public borrowing for development investments can aggravate the debt situation of partner countries. In particular, low revenue projects may jeopardise public debt sustainability. While blending strategy papers generally opt for technically and financially sound projects with sufficient revenue potential, blending has also been used for social projects and public goods that would otherwise not be viable because of the greater importance of macroeconomic and political criteria. While defining the amount of outstanding loans leading to unsustainable debt paths is challenging, if not impossible (Ferrer et al, 2012a), in order to avoid future debt traps, debt sustainability requirements have to remain a key element of the project appraisal process for public sector investments. They should also be in line with the debt sustainability framework of the IMF and the World Bank.

4.4 Institutionalising transparency and accountability

Transparency can be understood as a way of operating characterised by openness and accountability. Transparency is important in all areas of aid operations and, many would argue, particularly so where grants (public funds) are used to subsidise and leverage private investments. However, there are certain characteristic of blended finance processes − in particular the need for commercial confidentiality when dealing with the private sector − that create a unique set of challenges to full transparency.

Most DFIs engaged in blending provide limited publicly accessibly information regarding how projects are selected, how the grant share in blended finance is determined or how responsibilities are assigned between parties involved. While the situation could be improved, it is important to recognise that there are genuine issues with commercial confidentiality in projects involving private investors that restrict the release of information. This is particularly the case with the IFC.

Areas in which donors and DFIs should consider how and whether transparency could be enhanced include: how projects are selected; how the grant share in blended finance is determined; and/or how responsibilities are assigned between different parties internally. In

addition, those DFIs that use financial intermediaries to reach micro, small and medium enterprises have had difficulties tracing the use of funding offered to financial intermediaries because of rigid banking confidentiality of loan agreements, which prevent them from providing disaggregated data on which projects and companies they support. Improved M&E systems would help to improve understanding and transparency around the development additionality that financial intermediaries provide.

Increasing transparency is important and, many would argue, could and should be improved amongst DFIs. The need for increased transparency will always need to be balanced with considerations around commercial confidentiality and the transaction costs resulting from processing and publishing information.

4.5 Adopting clear and well-defined monitoring and evaluation methods

Effective M&E systems are critical for improving accountability and fostering learning and knowledge generation. Traditional the M&E challenges inherent in all development projects are the lack of reliable data, the time consuming and costly nature of data collection, as well as the technical and conceptual challenges of linking inputs and activities to well-defined outputs and outcomes.

In addition to these traditional challenges, M&E systems of blending mechanisms are **further complicated by the different M&E systems implemented by the various co-financiers**. To overcome these challenges, for instance, the EU adopts the standards and procedures of the Lead Financier, provided that the minimum requirements of other partners are met and that they can be beneficial. Another possible strategy is to develop basic templates that include standard output and outcome indicators which should be measured, when feasible, for all projects in a given sector, coupled with a certain degree of flexibility in adopting alternative 'project specific indicators'. The added advantage of this approach is that it would facilitate comparisons across projects within a sector, thereby making it easier to identify best practices. In fact, a significant group of International Financial Institutions (IFIs), including the IFC and PIDG, signed a memorandum in 2013 to support the principle of harmonising development results indicators for private sector investment operations. The memorandum includes an initial set of indicators, definitions and units of measurements, which have been submitted to and approved by each of the participating IFIs.[12]

Another M&E challenge specific to blended finance relates to the need to measure **the value added by the grant component of the blended financing package**. Assessing whether blending mechanisms are successful is not limited to the ratio of investment raised against grants invested, but also to the evaluation of the development impact of actual projects financed, and the extent to which the grant element has further enhanced impact (Bilal and Krätke, 2013). However, this is generally not straightforward for methodological reasons (lack of counterfactuals) and the difficulty in disaggregating the economic and social effects of the blended project between the loan and the grant component (Gavas et al., 2011). There are a number of possible ways to address this. One proposal is set out in Table 1 below, which suggests a series of questions that could be addressed in both *ex ante* and *ex post* evaluations, covering each dimension of additionality (see Section 2.1) and could be integrated into the project's results monitoring and reporting arrangements with relevant indicators. However, it should be noted that sourcing the information required to answer

[12] See Indicators in Annex of Memorandum at http://www.ifc.org/wps/wcm/connect/d7d1128041773cdb9af3bb9e78015671/Harmonization+MOU.pdf?MOD=AJPERES

some of these questions can be challenging. Ensuring that evaluations include interests and views of the concerned population/citizens is another way to improve the quality of M&E.

Type of additionality	Questions
Financial	***Does the project create financial additionality or crowd out private investment?***
Economic	***When the purpose of the grant goes beyond financial additionality, are there any social and economic benefits that are provided by the grants separate from those resulting from other sources of financing?***
Demonstration effect	***Does the project have an impact on the probability of subsequent private sector funded projects in the same area?***
Project scale	***What is the effect of the grant on the scale of the operation or number of project beneficiaries?***
Project quality and standards	***What is the effect of the grant on the quality of outcomes as well as the project's likely success?***
Project timing	***What is the effect of the grant on the timing of the operation and delivery of benefits?***
Innovation	***What innovations in the project result from grant support and what are the benefits of that innovation?***
Benefits sustainability	***What are the spin-off effects of the grant that may improve the sustainability of the project such as influencing reform in the partner country?***

Table 1 Questions for monitoring and evaluating additionality of blending mechanisms

4.6 Avoiding negative demonstration effects

Where projects do not succeed, either because of factors such as lack of political support, or the application of the wrong business model or funding mechanism, the demonstration effect can be negative, discouraging private investors from further involvement in the sector or even the country.. An example is given in a 2011 report evaluation of the IFC's Demonstration Effect: "the Rift Valley Railway in Kenya and Uganda, in which the IFC was heavily involved as both investor and advisor to the Government of Kenya. This project was described in both countries as a failure, and in Kenya has made transport sector officials cautious about (but not outright against) PPI" (Castalia, 2011, p. v.). While this example was not financed through blending, it illustrates the general uncertainty that characterises the demonstration effect, and hence highlights **the critical role of up-front work on project appraisal and structuring to increase the probability of positive demonstration effects**.

SECTION 5

Conclusion: key considerations and areas for further research

Amid growing global challenges and increasingly scarce resources for external cooperation, donors and DFIs are committed to enhancing aid effectiveness. Against this background, the blending of loan and grants has emerged as an attractive financing mechanism through which scarce resources can be leveraged to increase the volume of development finance while simultaneously providing a mechanism through which various aid effectiveness commitments, such as donor coordination and country ownership, can be translated into action. Furthermore, leveraging on blending instruments can improve financial viability and sustainability of projects.

While there are several economic, financial, operational and even political benefits to using blended finance, there are also a number of associated challenges which donors and DFIs need to manage. These include: the potential for financial incentives not to be correctly balanced with development objectives; for crowding out of private finance and market distortions where markets and investment indicators are not correctly assessed; for debt increasing to a level that becomes difficult to service in the case of public borrowing; challenges around ensuring transparency and accountability given commercial confidentiality requirements; and for demonstration effects to be negative where projects are not successful.

Blended finance is a flexible instrument, providing customised solutions depending on the involved parties' priorities and based on the particular sector, project type and context. **Thus, there is no 'one-size-fits-all' approach to blending, even for the same DFI.** Nevertheless, a careful balancing act is needed in order to realise the potential benefits of blending and to simultaneously meet the requirements of donors and the needs of recipients. Thus, we would propose that **decisions on whether to use blended finance, the design of a blended finance package and its performance against the project's objectives, could be guided by the following questions**:

1. Are there any alternative sources of public or private finance for the project? Is blended finance the most appropriate financing mechanism for the project under evaluation? Are the economic and political motivations strong enough to justify the use of blended finance over other sources of finance and modalities?

2. Which grant or non-grant instrument is the most appropriate for the project? What is the expected value to be added by the grant component? How will this be measured?

3. What influence is DFI engagement likely to have on the probability of subsequent private sector funded projects in the same area (i.e. the demonstration effect)?

4. If the grant will be provided by an existing blending scheme or facility, does the project meet the relevant criteria to access the subsidised finance?

5. What are the key criteria to be used when deciding the grant instrument as well as the grant share of financing?

6. What is the proposed division of labour and responsibilities among the different financiers?

7. Is the decision-making process sufficiently transparent to internal and external stakeholders? If a high level of transparency is not feasible, what is the justification?

8. Will (and how will) a new blended loan to the public sector (albeit at below-market terms) affect the risk of debt distress of public debt?

9. Is it possible to identify whether the grant component has primarily supported and benefited local companies in the recipient country or foreign companies in the donor country depending on the type of the project and contractual arrangements?

10. If the project involves using a financial intermediary to channel funds, does the intermediary have the tools or system to track where public funds are being invested?

11. What is the M&E framework for measuring the overall impact of the project as well as the value added by the grant component?

12. Will the project be sustainable once grant support expires?

Despite the widespread use of blending in development finance, its development impact is, to a large extent, uncertain because limited evidence has been gathered so far. The following are seven key areas where further research is recommended:

1. Poverty reduction. An assessment of the mechanisms through which infrastructure projects funded by blended finance have had an impact on poverty[13].

2. Private sector development. An assessment of the strategies through which grants have been successfully used in blending to support companies in partner countries.

3. Use of financial intermediaries. Given the critical role of financial intermediaries in facilitating private sector investments, their development impact needs to be assessed. Also which types of intermediaries (i.e. commercial banks, private equity funds or credit unions) are the most appropriate for development-oriented projects and under what conditions? What are advantages and disadvantages of alternative arrangements through which DFIs and donors can channel public and/or private funds to support local micro, small and medium-sized enterprises (MSMEs) in developing countries?

4. Country ownership. Has blended finance strengthened country ownership? This could involve assessing the extent to which projects that have received blended finance are aligned to national priorities of beneficiary countries and are likely to

[13] The evidence base on the *poverty reduction* impacts of economic infrastructure is limited in general, in large part because of the methodological challenges associated with generating clear evidence on this question (see, for example, Estache, A. and Fay, M. 2007. Current Debates on Infrastructure Policy. Washington D.C.: World Bank). It is generally accepted that improved economic infrastructure is a key enabler of economic growth and that economic growth is a key enabler of large-scale poverty reduction (see, for example, Commission on Growth and Development. 2008. The Growth Report. Washington D.C). Nevertheless, there are strong arguments for creation of a stronger evidence base in this area.

involve evaluating the role of national governments in these countries in screening and designing projects.

5. Policy leveraging. An assessment of the extent to which blending has enabled donors to have a wider impact on the policy environment of recipient countries. This is particularly important since it is perhaps one of the least substantiated arguments proposed in favour of blending in the context of EU blending facilities.

6. Designing a strategy to address the capacity needs of lower income countries to attract and mange blended finance.

7. Developing a framework for identifying, screening and prioritising projects that may be eligible for blended finance.

Annotated reading list

Blending facilities

Arvantis, Y. 2013. Blending grants and loans for private sector development: The use of grant elements and the AfDB's experience. African Economic Brief. AfDB. Vol. 4. No. 13.
http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/Economic%20Brief%20-%20Blending%20grants%20and%20loans%20for%20private%20sector%20development-%20The%20use%20of%20grant%20elements%20and%20the%20AfDB%E2%80%99s%20experience.pdf

This brief assesses the conditions under which grant elements should be used in private sector operations by DFIs. In particular, it seeks to (i) clarify the use of grant elements in private sector lending, (ii) enumerate a number of criteria that should guide the selection and design of operations in cases where grant elements are involved, and (iii) undertake a short evaluation of selected AfDB projects against the defined criteria. The results suggest that blended grant/loan finance should be subject to careful analysis in order to fully gauge the extent to which grants are needed.

Buiter, W. and M. Schankerman. 2002. Blended finance and subsidies: an economic analysis of the use of grants and other subsidies in project finance by multilateral development banks.
http://www.willembuiter.com/subcepr.pdf

The paper provides an economic analysis of the appropriate use of subsidies, including technical cooperation funds, in projects financed by multilateral development banks.

Bilal, S. and F. Krätke. 2013a. Blending loans and grants: to blend or not to blend?
European Centre for Development Policy Management (**ECPDM)**
http://www.ecdpm.org/Web_ECDPM/Web/Content/Download.nsf/0/A6790674176EA2A2C1257B8200414B22/$FILE/Bilal%20&%20Kratke%20-%20ECDPM%20-%2022-05-13%20Blending%20(1).pdf

After having briefly defined blended finance and outlined its main characteristics, the paper reviews arguments in favour and against blending mechanisms. The authors suggest a balanced approach in evaluating the opportunity of leverage on blending mechanisms, in particular by assessing the added value beyond projects already funded by private investment, in particular in terms of development objectives and sustainability and the opportunity cost of investing in blending facilities instead of the more straightforward public or private investment.

European Commission. 2009. Working group on the additionality of grants in the framework of blending mechanisms – final report. EC Directorate General Economic and Financial Affairs. Brussels, 18 December.
http://www.dev-practitioners.eu/fileadmin/Redaktion/GroupsFolders/Division_of_Labour/Loans_and_grants/WGBlending_FINAL_complete_report_181209.pdf
This paper identifies the objectives and potential weaknesses of loan and grant blending. It also outlines a set of key parameters to guide the grant share decision [macroeconomic and

sector policy and project related (microeconomic)]. Given the multi-dimensionality of these parameters and the difficulty in weighing them against each other, the authors provide a guidance template for projects in order to minimise the likelihood of decisions which could lead to a waste of resources and unequal treatment.

Ferrer, J.N. et al. 2012a. Blending grants and loans for financing the EU's development policy in the light of the Commission proposal for a development cooperation instrument (DCI) for 2014-2020. Policy Department for the Directorate-General for External Policies of the Union.
http://www.suedwind-institut.de/fileadmin/fuerSuedwind/Publikationen/2012/2012-26_Blending_Grants_and_Loans_in_the_Light_of_the_New_DCI.pdf

This study analyses the operations of the EU blending facilities. For example, the authors find that blending has a significant leverage effect, the size of which depends on the local needs and characteristics and the type of projects undertaken. The authors also noted several risks associated with blending, such as the current lack of a robust and direct relationship between blending and poverty reduction for most projects as well as the possibility of increasingly tied aid. Ultimately several recommendations emerge from this report regarding areas where greater research and action are needed in order to ensure that blending is used optimally, for instance the establishment of (i) *ex ante* poverty impact assessments within screening process of eligible projects to safeguard the poverty focus of blending instruments and (ii) an overarching structure to set minimum standards and improve coherence.

Ferrer, J.N. et al. 2012b. The use of innovative financial instruments for financing EU policies and objectives: implications for EU and national budgets. Centre for European Policy Studies (CEPS) special report No. 68. Centre for European Policy Studies. Brussels.
http://www.ab.gov.tr/files/ardb/evt/1_avrupa_birligi/1_9_politikalar/1_9_9_ekonomi/The_Use_of_Innovative_Financial_Instruments_Implications_for_EU.pdf

This report analyses the proposed expansion of innovative financial instruments, such as blending instruments, in the EU Multiannual Financial Framework for the 2014–2020 period. It presents the economic rationale, governance principles and criteria in project selection that these instruments should follow. In particular, the need for better governance structures was emphasised, such as the development of coherent basic rules on the obligations and benefits for financial institutions, as well as the importance of ensuring that the development objectives are not neglected in the pursuit of revenue-generating projects.

Ferrer, J.N. and A. Behrens. 2011. Innovative approaches to EU blending mechanisms for development finance. Centre for European Policy Studies special report.
http://www.dev-practitioners.eu/fileadmin/user_upload/EU_Blending_Mechanisms.pdf

This report briefly presents the EU blending facilities and describes their operations and analyses the theoretical rationale for these financing mechanisms. It assesses the functioning and the operations of the blending facilities in more detail, pinpointing specific strengths and weaknesses. Finally, the paper provides recommendations on some potential improvements to the functioning of the facilities.

Gavas et al. 2011. EU blending facilities: implications for future governance options. ODI European Development Cooperation Strengthening Programme.
http://www.odi.org.uk/sites/odi.org.uk/files/odi-assets/publications-opinion-files/6658.pdf

This study reviews the existing EU blending mechanisms, providing insights into their different governance arrangements, and considers the pros and cons of governance options for blending operations. It also identifies key principles which may help to inform the best possible governance option, such as a 'policy driven' screening of grant requests and the need for transparent and formal checks and balances on the proposals of project financiers at early stages.

International Finance Corporation. 2012. Blended finance at IFC: IFC's approach to blending concessional funds.

http://www.ifc.org/wps/wcm/connect/02ad63804d920789b2dab748b49f4568/Blended+Finance+at+IFC.pdf?MOD=AJPERES

This brochure describes the definition of blended finance and its principles adopted by IFC, the main geographic areas where the organisation operates and targeted sectors.

Irwin, T.C. 2003. Public money for private infrastructure: deciding when to offer guarantees, output-based subsidies, and other forms of fiscal support. Working paper 10. The World Bank: Washington, DC.
http://elibrary.worldbank.org/doi/pdf/10.1596/0-8213-5556-2

In the context of financing private infrastructure services, the paper provides analytical tools to assess and compare costs and benefits of six fiscal instruments: (a) output-based cash subsidies, (b) in-kind grants, (c) tax breaks, (d) capital contributions, (e) guarantees of risks under the government's control, and (f) guarantees of risks not under the government's control.

Mid-term evaluation of the EU-Africa Infrastructure Trust Fund-Final Report. 2012.

http://www.eu-africa-infrastructure-tf.net/infocentre/publications/mid-term-evaluation.htm

The EU-Africa Infrastructure Trust Fund (ITF) aims to mobilise resources for regional interconnectivity infrastructure projects in Africa. This report assesses the performance of the ITF over the period 2007-2010 against key OECD/DAC evaluation criteria to make recommendations for the future work of the ITF. Although, the objective was not to assess individual projects, project level information has been reviewed for 10 projects as part of a case study analysis. This case study analysis is extremely useful in showing the different forms of value added by grants from the ITF as well as how the real value added by the ITF is variable depending on the individual project and ITF instruments mobilised.

Climate finance and low-carbon infrastructure development

Baudienville, G. et al. 2009. Assessing the comparative suitability of loans and grants for climate finance in developing countries. Report for DFID and Department for Energy and Climate Change. Overseas Development Institute. London: UK. Second draft, 26 October 2009.

This paper reviews the specific circumstances under which it is preferable for climate change funds to provide (concessional) loans rather than grants as part of a mixed funding package. The authors find that there are mainly two types of principles guiding the provision of an appropriate combination of loans and grants (from a recipient's point of view): (i) country level (macroeconomic and institutional conditions) and (ii) project level (mainly financial).

World Bank. 2010. Beyond the sum of its parts − combining financial instruments to support low carbon development. International Bank for

Reconstruction and Development, World Bank Group: Washington, DC. http://siteresources.worldbank.org/ENVIRONMENT/Resources/DevCC2_Blending.pdf

This paper looks at three mitigation-related climate financing instruments available for the World Bank Group − Global Environment Facility (GEF), Clean Technology Fund (CTF) and Carbon Finance − and their application in the context of specific projects and national policy frameworks to help reduce the growth in greenhouse gas emissions in developing countries. It also draws lessons on how resources from different climate financing instruments can be combined to expand impact, increase leverage and enhance efficiency. While blending is beneficial when finance is scarce, the paper finds that, effective blending involving these three climate financing instruments requires sophisticated institutional and technical capacity.

Leveraging private sector finance

Bretton Woods Project. 2012. Leveraging private sector finance: how does it work and what are the risks?
http://www.brettonwoodsproject.org/doc/private/leveraging.pdf

This paper highlights several misconceptions and inconsistencies relating to the use of the term 'leverage' in development finance debates. It recommends a relatively narrow definition of leverage that excludes political influence, donor pooling or catalytic public investments. Furthermore, it sets out ten reasons why arguments in favour of leverage should be treated with scepticism. For example, it suggests that the higher the leverage ratio, the stronger the private sector influence and the lower the likely financial additionality.

Castalia Strategic Advisors. 2011. Evaluation of the demonstration effect of IFC's involvement in infrastructure in Africa. Final report commissioned and funded by the IFC and the Private Infrastructure Development Group.

This report evaluates whether and how IFCs' activities in infrastructure in Africa have generated demonstration effects. They find that many IFC activities have not had a discernible positive demonstration effect though a few cases have contributed to more subsequent PPI in the sector, as well as helping build legal and regulatory frameworks and government capacity. In order to create more widespread demonstration effects, they recommend a few key actions that IFC could consider, such as choosing projects strategically for their demonstration potential and focusing on the creation of strong legal and institutional frameworks.

Kwakkenbos, J. 2012. Private profit for public good? Can investing in private companies deliver for the poor? European Network on Debt and Development (Eurodad).
http://eurodad.org/wp-content/uploads/2012/05/Private-Profit-for-Public-Good.pdf

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used by most DFIs as delivery vehicles for channelling development finance to small local companies in developing countries.

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The paper provides a comprehensive systematic review of the evidence of the impact of DFI support (including PIDG support) for private participation in infrastructure (PPI) on economic growth and poverty reduction. It found that while for most DFIs there is little hard evidence of an impact, DFIs have created financial additionality in low-income countries and have also influenced project design to boost growth. The authors also provide insight into the importance of demonstration effects as well as its limits.

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Annex 1 Summary of the characteristics of the EU blending facilities

	ITF[14][15]	NIF	LAIF	IFCA	AIF	CIF	IFP	WBIF
Grants funds allocated	***308.7 million from 10th EDF + 64 million from EU Member States budgets (as of 31.12.2010)***	***700 million for 2007-2013 from EU budgets + 64.4 million from EU Member States budgets (as of 31.12.2011)***	***125 million from the 2010-2013 EU budget***	***20 million from the 2010 EU budget***	***30 million from the EU budget***	***40 million from the 10th EDF***	***10 million from the 10th EDF***	***166 million from EU budget + 10m EIB, 10 million EBRD, 10 million CEB + 47.6 million in grants from MS budgets (+Norway) as of 31.12.2011)***
Participating financiers	***AFD, AfDB, BIO, COFIDES, EIB, FINNFUND, KfW, Lux-Development, MoF Greece, OeEB, PIDG, SIMEST, SOFID***	***AECID, AFD, CEB, EBRD, EIB, KfW, NIB, OeEB, SIMEST, SOFID***	***AFD, BCIE, IDB, CAF, EIB KfW, NIB, OeEB***	***NIF accredited institutions can participate***	***EIB, EBRD, NIB, ADB, AFD, KfW, OeEB, SIMEST, SOFID***	***EIB, NIB, CDB, IDB, others joining***	***EIB, AFD, KfW, AusAID, ADB, NZAID, WB***	***CEB, EBRD, EIB, World Bank Group, KfW, MFB, CMZR, OeEB, SID***
Grant type	***IRS, TA, DG and IP***	***TA, DG, IRS and risk capital***	***TA, DG, IRS, risk capital and loan guarantees***	***TA, DG, IRS, risk capital and loan guarantees***	***TA, IRS and risk capital***	***TA, IRS, risk capital***	***TA, IRS, risk capital***	***TA, DG, IRS risk capital, and IP***
Region covered	***Sub-Saharan Africa***	***ENPI countries[16]***	***Latin America***	***Central Asia***	***Asia***	***Caribbean***	***Pacific***	***Western Balkans***
Sector covered	***Energy, water/ sanitation, transport and ICT***	***Private sector (MSMEs), environment protection/ adaptation, energy, water/ sanitation, social services infrastructure, transport***	***Private sector (MSMEs), environment protection/ adaptation, energy, water/ sanitation, social services infrastructure, transport***	***Private sector (MSMEs), environment protection/ adaptation, energy, water/ sanitation, social services infrastructure, transport***	***Private sector (MSMEs), environment protection/ adaptation, energy, water/ sanitation, social services infrastructure, transport***	***energy, water/ sanitation, social services infrastructure, transport, ICT and disaster prevention/ mitigation infrastructure***	***Private sector (MSMEs), environment protection/ adaptation, energy, water/ sanitation, social services infra-structure, transport, ICT, disaster prevention/mitigation infrastructure***	***Infrastructure development within the environment, energy, transport, social sectors and private sector development***

Source: Adapted from Ferrer et al., 2012a.

14 Please see list of abbreviations and acronyms at the beginning of this document. ITF is concerned only with regional infrastructure and sustainable energy projects (regional and national).

15 ITF is concerned only with regional infrastructure, and sustainable energy projects (regional and national).

16 Countries eligible for the European Neighbourhood and Partnership Instrument (ENPI).

Annex 2 Assessing Blending vs. Pure Loans and Pure Grants

	Blending vs. pure loans		Blending vs. pure grants	
	Pros	**Cons**	**Pros**	**Cons**
Economic criteria	*Contribute to solve the issue of debt sustainability in heavily indebted countries*	*Market distortions*	*Can mitigate the fiscal side effects of pure grants, the loan element can constitute an asset with the repayment offering a return which is not reflected in a pure grant scenario*	*Reduced debt sustainability* *Risk of financial principles outweighing development policy principles*
Financial criteria	*Financial leverage through risk mitigation.* *Can offer more flexibility with regards to disbursement conditions, initial costs or project speed.*	*Potential transparency issues. Risk of imprudence in recipient countries* *Cannot eliminate risks but just transfer them to the EU*	*Financial leverage, especially in low-income countries* *Can offer more flexibility in adapting the volumes of funds to specific projects needs than pure grants*	*Potential transparency issues*
Operational criteria	*Can allow speeding up projects. Can enhance project quality* *Can enhance coordination between donors and lenders* *Can allow for knowledge transfer and demonstration effect*	*Loss of control of individual donor* *Potential slowdown of decision-making*	*Can provide greater incentives than pure grants for donors to monitor funded project* *Give donors access to project management expertise of lenders* *Can enhance coordination between donors and lenders. Demonstration effect* *Can allow risk sharing and mitigation*	*Loss of control of individual donor* *A monitoring and evaluation framework can be difficult to implement* *Potential slowdown of decision-making*

Source: Gavas et al. 2011

Annex 3 Mid-term evaluation of the EU-Africa Infrastructure Trust Fund

The mid-term evaluation of the EU-Africa ITF over the period 2007-2010 highlighted strengths and weaknesses of the ITF, which are partly related to the main issues discussed in Section 5.

Strengths include:

(i) Effective coordination of financiers has been achieved through the nomination of a Lead Financier whose procedures are followed. This has simplified processes for beneficiaries in dealing with financiers and has generated very limited additional administrative burden.

(ii) The ITF governance structure is clear, in that it is based on a clear definition of tasks between the three different bodies. The regular meetings of the ExCom and the PFG allow frequent and up-to-date reviews of grant operations. Also the PFG constitutes a frame of cooperation among DFIs allowing information sharing and project reviews.

(iii) ExCom members apply a sufficiently rigorous approach to the approval of grant operation requests, which has been facilitated by an ITF application cover sheet template.

(iv) The value added by the ITF is clear to some extent, particularly in the case of the IRS which is the ITF's main grant element. Specifically, it has enabled heavily indebted poor countries to be granted concessional loans, the terms of which are better aligned with debt sustainability requirements. Moreover, the risk of distortions usually associated with IRS was perceived to be very low since the financial markets of recipient countries were underdeveloped.

Weaknesses*:*

(i) The quality of the grant operation papers is variable between grant operation requests. For many grant operations, certain criteria have not been addressed on the cover sheet, and justification in supporting documentation is, at times, not sufficiently rigorous.

(ii) On the whole, the real value added by the ITF was deemed variable depending on the individual project and ITF instruments mobilised. Value added appears more evident for the Caprivi Connector (see Box 4), and less so for Port de Pointe Noire (see Box 5), as examples.

(iii) Leverage across the ITF for the 10 case study projects was estimated at 12:1, i.e. €12 of finance leveraged per €1 of ITF funding. However, it is not clear whether the ITF substitutes monies which donors would have provided anyway.

(iv) Although project objectives and expected outputs are often clearly defined, expected outcomes and impacts are not always quantified, making it difficult to follow the chain of results and establish the monitoring and evaluation arrangements. Similarly, there is rarely data available on monitoring indicators to quantify project progress.

Source: Mid-term Evaluation of the EU-Africa Infrastructure Trust Fund-Final Report. June 2012.