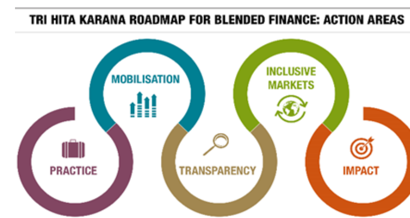
Tri Hita Karana Roadmap for Blended Finance Practices Working Group



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What is Blended Finance?

Abstract

Meeting the objectives of the 2030 Agenda for Sustainable Development and the Paris Agreement (SDGs) will require significant investments. Blended finance is the use development finance in an innovative way to mobilise commercial investments by improving the risk-return profile of investments and helping projects to become economically viable.
This short working note presents an overview of blended finance – concepts, definitions, actors, instruments – and highlights the current state and role of blended finance in scaling up private investments for development.

Introduction

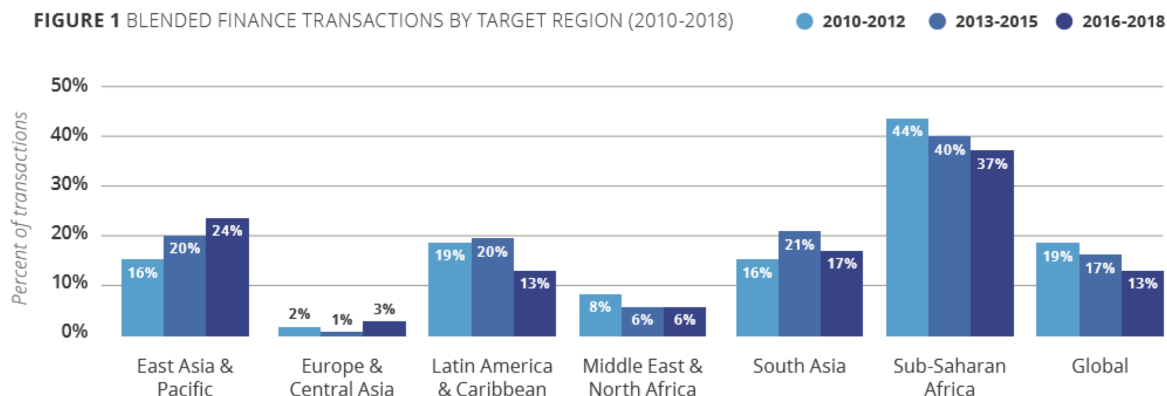
Public resources will not be sufficient to meet the investment needs required to achieve the *Sustainable Development Goals* and the goals set by the *Paris Agreement* (SGDs), estimated at US$4.5 trillion per year between 2015 and 2030 in emerging countries alone. Achieving the SGDs require a massive increase in private capitals in developing countries on a scale that requires close coordination between public and private actors. To put private capital to work towards achieving the SGDs, private capital needs to be directed to projects, sectors, and geographies where current engagements are scarce as they are seen unattractive from a risk-return perspective[1].
Blended approaches allow actors with different objectives to invest alongside each other while achieving their own objectives. This helps mobilise and leverage much-needed additional resources from other actors (private investors) by improving risk-return profile and commercial viability, allowing them to invest in places and projects where they wouldn't go otherwise, by mitigating risks (both real and perceived) and challenging difficult investment environments.

Recent trends

Blended finance has been adopted over the years for the development of many least developed countries (LDCs), which are those countries who exhibit the poorest socio-economic indicators. While there is appetite from some policymakers and concessional capital providers to increase operations in LDCs, data from Convergence suggest that many providers still tend to overlook these markets. LDCs still receive a small pie of the blended finance pie and the average deal in LDCs mobilise less private finance and require greater level of concessional support than those in other developing countries.

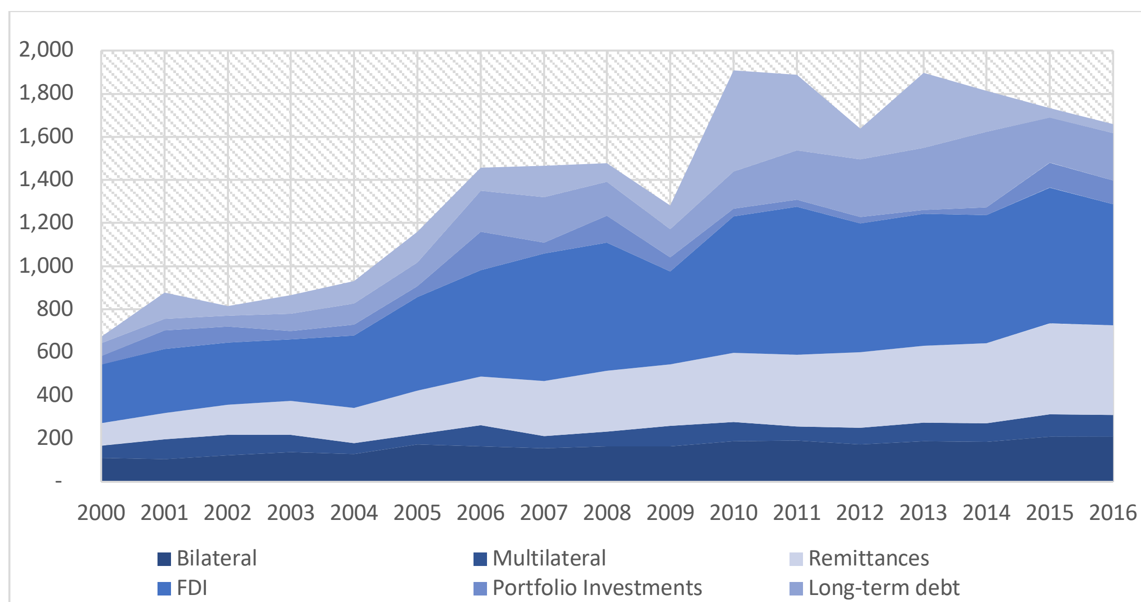
According to Convergence, the proportion of blended finance transactions targeting LDCs has been declining (2010-2018), mirroring the trend in global foreign direct investment (FDI) and official development assistance (ODA).

[1] Specific risks that are considered by private sectors investors include: geopolitical and security risk, macroeconomic and investment climate risk, currency risk, interest rate risk, liquidity risk, business model risk, climate risk, reputational risk, sector specific risk, etc.



We should not be surprised by the concentration of blended finance in middle-income countries (MICs)[2]. It reflects a broader trend in the flow of other external private capital flows, such as foreign direct investment, which flows to countries with more favourable investment climates, stronger accountability, rule of law and is commensurate with the relative size of their economies compared with LICs.

The figure below depicts the main sources of cross-border flows to developing countries from 2000 to 2016, as reported by the OECD in 2019. Only a very small amount of these flows (likely [2-4%]) are associated with Blended Finance. There is, thus, a great need to further mobilise additional resources from both private and public actors and working group such us the THK Roadmap are meant to build capacity, create more coordination between initiatives, knowledge exchanges and development of blended finance principles, standards, methodologies and tools.



[2] According to Convergence, 73% of blended finance transactions closed in the last three years have targeted one or more lower middle-income countries, which is an increase from the two previous three-year periods from 66%.

Definition

A critical first step to effective blended finance is a common definition. The term "blended finance" has been used for more than a decade in international development, but there is much ambiguity and variety in the ways blended finance is defined[3].
While there is then a broad agreement on the main objective of blended finance, there is a wide variation on how organizations and actors define it. Generally blending is analysed across two dimensions: the **degree of concessionality** of finance that is blended and the **combination of participating actors**, e.g. *public-public*, *public-private* or *private-public cooperation*. In all cases, the rationale for blending is based on mobilising private or additional investments for the SGDs.

Some donor organizations such the EU Commission, are mainly engaging in the "public-public blending", which uses concessional finance to unlock non-concessional finance within the development finance system. For example, guarantees or grants provided through EU Commission blending facilities have allowed other European development finance institutions, such us the EIB and other bilateral DFIs such us KfW, to investment in projects that would have otherwise not been feasible based on their financing and statutory terms.
Such blending through guarantees has enabled important investments by bringing financing to countries and sectors that have not had access to private finance due to the high cost of capital associated with investing in these areas.
An important example is the EU-Africa Infrastructure Trust Fund (EU-AITF) was created in 2007 by the European Commission and several EU Member States. The EU-AITF's objective is to promote infrastructure investment in sub-Saharan Africa and thereby help eradicate poverty and stimulate sustainable economic growth. The EU-AITF works by blending grants, provided by the Fund's donors, and long-term financing, provided by participating financiers, including EU development finance institutions (EIB, CDP, Cofides, ADF, KfW…) and the African Development Bank.
Such blending takes place essentially among different types of development finance actors, and as such is less focused on growing the investment base for development by mobilising additional sources of financing that do not have a specific development mandate. This is mainly due to the lack of local private investors or foreign private investors interested to invest in the local Sub-Saharan markets.

"Public-private" blending approach is growing and focuses on mobilising private investments (thus outside the development finance circle) that do not have a specific development mandate, but rather sees blended finance as a way to reach their financial objectives: diversify their investments and generate risk-adjusted positive returns.

Definition: The OECD Development Assistance Committee (OECD DAC) defines blended finance as the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries.

- Development finance includes official development finance (i.e. both concessional and non-concessional development finance) and private funds that are governed by a development mandate (e.g. financing provided by philanthropic organisations).
- Additional finance refers to commercial finance such as public and private sources of finance whose principal purpose is commercial rather than developmental.

Source: http://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/OECD-Blended-Finance-Principles.pdf

The OECD DAC definition takes a broader policy perspective to blending compared to the more operationally focused approach taken by multilateral development banks (MDBs) and development finance institutions (DFIs). Under this broad approach, development finance providers may be governments, foundations,

[3] London Development Initiative cites up to 15 different definitions (The role of blended finance in the 2030 Agenda: Setting out an analytical approach, 2016).

development finance institutions (DFIs), etc.; resources may be concessional or non-concessional; and the investee may be public or private.

MDBs and DFIs have adopted a narrower definition, which focuses on the use of concessional finance: *combining concessional finance from donors or third parties alongside DFIs' normal own account finance and/or commercial finance from other investors, to develop private sector markets, address the SDGs, and mobilize private resources*.

This is a very small subset of their total operations and does not include what the OECD would identify as blended finance.

We thus find ourselves in an [unsatisfactory] situation in which the OECD DAC defines blended finance in a way that is different from MDBs and DFIs. Consequently, some operations identified by the OECD as blended finance might not be identified as blended finance by the MDBs and DFIs, raising comparability issues when wanting to analyse data on blended finance transactions.

Methodologies

The main use of donor funds to mobilise private capital is core to blended finance and has been to (i) reduce risk or (ii) alter risk-return to convert an unacceptable investment opportunity to an acceptable investment opportunity.

At the heart of blended finance projects is the mobilisation of a broad set of private actors and increase the supply of funds, although in some cases, and especially in very immature and high-risk contexts, the scope for mobilisation could be limited to public-public blending approaches. In these and other situations, blended finance is deployed because of its expected catalytic effect – by demonstrating the viability of the project and accelerate market development.

Concessionality is, therefore, a regular feature in blended finance transactions. The need for minimum concessionality is central to reducing the risk of distorting markets.

A Working group of the DFIs[4] has been examining different methods of calculating the level of concessionality in their blended concessional finance transactions and has tested several different approaches. Their report includes a strengthened methodology for blended concessional finance, using more refined definitions, accounting methodology and reporting. These can be categorized into three main methodologies, as follows:

1. DFI estimated commercial price
2. Estimated commercial price from a simplified risk framework
3. Modelling revenues and expected losses

Actors

- **International organizations and Donor Governments**

International organizations and Donor Governments are increasingly engaging with the private sector as a way to promote development, deliver poverty reduction and, in particular, mobilise and/or align new and current investment for the SGDs.

This large group includes

1. Donor Governments (of both developed and developing countries)

[4] Please refer to the Joint Report on Blended Concessional Finance for Private Sector Projects (2018) and EIB's Definition of Concessional Lending (2018) in the Bibliography.

2. International organizations who provide policy guidance (e.g. OECD or the UN) or that invest in development programmes related to different parts of the SDG agenda (e.g.UN and other international development organizations)
3. International organizations actively involved in blending (EU Commission)

Donor governments play a multi-faceted role in blended finance, providing capital to blended finance transactions both 'directly' (i.e., in-house) as well as 'indirectly' (e.g., through contributions to multilateral organizations, funds and programs), which makes their activities complex to map.

Many donor governments choose to provide 'direct' commitment to their blended finance transactions using their bilateral development banks (such us Germany's KfW) and development agencies (such us USA's USAID or Sweden's SIDA), and have established DFIs as specialised institutions to work with the private sector. This multi-layered governance has an effect on the management and perceived transparency of blended finance. To lesser extent, other government ministries (e.g., ministries of finance) as well as specialized government funds / programmes (e.g., Dutch Good Growth Fund) have also funded direct commitments to blended finance transactions.

Donor governments can also support blended finance transactions 'indirectly' through their contributions to a variety of multilateral vehicles that use blended finance approaches for some or all of their activities, including (i) multilateral development banks (MDBs), (ii) multilateral organizations, and (iii) multi-donor funds and programs.

International organizations can be distinguished in two groups, those who provide guidance and policy assistance such us the OECD and those who are actively involved in blended finance transactions such us the EU Commission. The EU Commission's latest initiative the 'EU External Investment Plan', it is expected to leverage over €44 billion of investments through a EU input of €4.5 billion.

As noted by the OECD, the most commonly cited *Principles for Blended Finance*[5] are:

1. Anchor Blended Finance use to a Development Rationale
    - 1A - Use development finance in blended finance as a driver to maximise development outcomes and impact
    - 1B - Define development objectives and expected results as the basis for deploying development finance
    - 1C - Demonstrate a commitment to high quality

2. Design blended finance to increase the mobilisation of commercial finance
    - 2A - Ensure additionality for crowding in commercial finance
    - 2B - Seek leverage based on context and conditions
    - 2C - Deploy blended finance to address market failures, while minimising the use of concessionality
    - 2D - Focus on commercial sustainability

3. Tailor blended finance to local context
    - 3A - Support local development priorities
    - 3B - Ensure consistency of blended finance with the aim of local financial market development
    - 3C - Use blended finance alongside efforts to promote a sound enabling environment

4. Focus on effective partnering for blended finance
    - 4A - Enable each party to engage on the basis of their respective development or commercial mandate, while respecting the other's mandate.
    - 4B - Allocate risks in a targeted, balanced and sustainable manner.

[5] For more details about each point we refer to OECD (2018), OECD DAC Blended Finance Principles.

- 4C - Aim for scalability.

5. Monitor blended finance for transparency and results
   - 5A - Agree on performance and result metrics from the start.
   - 5B - Track financial flows, commercial performance, and development results.
   - 5C - Dedicate appropriate resources for monitoring and evaluation.
   - 5D - Ensure public transparency and accountability on blended finance operations.

❖ **Philanthropic foundations and NGOs**

This group includes Philanthropic foundations who are actively involved in blended transactions and NGOs who instead provide policy guidance and research.

Philanthropic foundations are individuals and non-profit, non-public organizations that provide charitable funds to serve the public good. They are uniquely placed to support the SGDs, both as long-term investors as well as blenders or providers of catalytic finance. Their objective is to realize their organizational mission that usually is in line with the SGDs.

Some foundations are recognising the potential of their endowments as a tool to reach their programmatic goals especially in the hardest sectors and geographies. With fewer regulatory restrictions, low adverse risk aversion, willingness to invest for SGDs, plus a mission driven mandate, foundations are well engaged to allocate part of their endowments to blended finance. The Bill and Melinda Gates Foundation has actively pursued blended finance approaches since 2013 when it committed to guarantee to catalyse private sector development in health (e.g. R&D in vaccines through advanced market commitments), water sanitation and children's education.

The most active foundations and NGOs over the past five years in terms of number of financial commitments (The State of Blended Finance 2019) have been:

1. The Rockefeller Foundation
2. Shell Foundation
3. Bill & Melinda Gates Foundation
4. Children's Investment Fund Foundation
5. Sorensen Impact Foundation

❖ **Private investors and commercial companies**

Private investors and commercial institutions are increasingly attracted to emerging and frontier markets for their young populations, booming middle classes, high growth rates and the historical strong market returns. Despite these positive trends, investments in emerging markets remain low with only a limited part of private equity funds flowing to these markets.

Perceived risks are often cited as a limiting factor, despite these being usually overemphasized. The business and investment climate has improved in many, though not all contexts; legal, regulatory and governance reforms have eased business environment and contributed to increased investor confidence in many countries and sectors, though again not all. Consequently, blended finance is a tool that helps to alleviate concerns faced by private investors in these markets, mitigating risks and managing returns in line with similar investments in developed countries. They will take advantage of the downside protection offered by blended finance to increase their portfolio exposure to new investments like emerging markets infrastructure and Environmental, Social, and Governance (ESG) businesses.

Current private involvement is limited but growing rapidly. Many investors have invested in one or two transactions with financial services and energy & climate being the main sectors of focus for blended finance transactions.

Beside private institutional investors, also impact investors are playing a strategic role. Impact investing is an investment philosophy, where investors are driven by the desire to make a positive impact. In the last decade,

impact investing has grown exponentially, with impact investors becoming an increasingly established group internationally, though to very different degrees and in different ways in specific countries and regions.

It is important to remember that private financial investors vary widely in their investment mandates, missions, ticket sizes, risk appetites, and return expectations. While investment banks may tolerate additional risk in order to achieve higher returns, pension funds have fiduciary duties (capital preservation, minimize volatility, etc.) that may preclude them from taking a similar investment position. Similarly, investors operating in specific countries or regions will be subject to different regulations and generally different contextual factors shaping their mandates, expectations and capacity to invest in different sectors.

- **Multilateral Development Banks and Development Finance Institutions**
  including EDFI (European Development Finance Institutions); AfDB, ADB, AIIB, EIB, EBRD, IDB, World Bank Group (=International Finance Corporation, IFC), NDB, CEB, etc.

Multilateral development banks (MDBs) and development finance institutions (DFIs) are finance institutions that provide financing for economic development. Blending finance is a tool that will increase development impact of their projects, crowd-in private investments while ensuring minimum concessionality and enhance trust and transparency. MDBs and DFIs usually act as intermediaries for blended finance by deploying instruments and structuring mechanisms, but can also utilise their own finance for blending.

MDBs and DFIs have developed principles[6] for deploying concessional finance in private sector projects that aim to minimise the risks and challenges associated with the use of concessional finance in private sector projects. Although these principles were formulated by MBDs and DFIs, they are in line with the OECD DAC's principles and can be considered as general principles for all blended finance arrangements.

These principles address five aspects: *additionality/rationale for using blended finance*; *crowding in and minimum concessionality*; *commercial sustainability*; *reinforcing markets*; and *promoting high standards*.

I. Rationale for Using Blended Concessional Finance: DFI support for the private sector should make a contribution that is beyond what is available, or that is otherwise absent from the market, and should not crowd out the private sector. Blended concessional finance should address market failures.

II. Crowding-in and Minimum Concessionality: DFI support for the private sector should, to the extent possible, contribute to catalysing market development and the mobilization of private sector resources and minimize the use of concessional resources.

III. Commercial Sustainability: DFI support for the private sector and the impact achieved by each operation should aim to be sustainable. DFI support must contribute towards the commercial viability of their clients. Level of concessionality in a sector should be revisited over time.

IV. Reinforcing Markets: DFI support for the private sector should be structured to effectively and efficiently address market failures, and minimize the risk of disrupting or unduly distorting markets or crowding out private finance, including new entrants.

V. Promoting High Standards: DFI private sector operations should seek to promote adherence to high standards of conduct in their clients, including in the areas of corporate governance, environmental impact, social inclusion, transparency, integrity, and disclosure.

[6] Please refer to the Joint Report on Blended Concessional Finance for Private Sector Projects (2018).

Instruments

Blended Finance Instruments	Definition and Use in Blended Finance Transaction
Catalytic Capital (Funded Risk Participation) **Catalytic Guarantee or Insurance** (Unfunded Risk Participation or Contingent Risk Participation)	Risk participation means that the institution bears parts or all of the risks of the obligor, on a funded or unfunded basis. Usually equity risk participations are all funded, as the institution enters into the equity of the obligor, while debt risk participations can be funded or unfunded. Funded risk participation means that the institution funds the deal in risk participation; unfunded risk participation means that the institution does not provide immediate funding, but instead enters into an agreement to repay the private investor some or all the amount owed to them if the borrower should default. Layered funds combine tranches with different rates of risk/return and different sources of capital (philanthropic, public, private).
Viability Gap Funding	It is a one-time or deferred grant, provided to support infrastructure projects that are economically justified but fall short of financial viability. Through the provision of a catalytic funding assistance of the capital costs, several projects may become bankable and help mobilise private investment in infrastructure.
Smart subsidies	Subsidies are usually provided by governments and are direct or indirect (monetary) benefits to a sector in order to overcome initial barriers of serving certain markets that are barely viable and only very limited providers do want to serve. Smart subsidies should be used in such way that if they are stopped enterprises do still exist. In this sense, one-time subsidies are smart while continued subsidies may distort markets and lead to collapsing supply chains and business models if withdrawn.
Local currency financing	Demand for local currency financing in developing countries is far greater than supply. Loans are often denominated in hard currency, but development projects often generate cash flow and returns in local currency. It may be appealing to issue a bond or receive a loan to fund a development project in a major currency like the Euro, given that they have lower yields and longer terms than instruments in local currency. However, this can place too much foreign exchange risk on the project or entity because the potential depreciation of the local currency can increase financing costs, when the revenue is generated in local currency. Local currency financing solves this issue. This instrument will address risks associated with currency depreciation, and boost lending in local currency for project development. It usually lower the cost of funding, and enable many more project developers to access to funding.
Grants	Grants are a direct monetary contribution to a project or fund without the expectation of a repayment in the future. They are granted by way of donation to beneficiaries, usually to implement large scale infrastructural projects in least developed countries.

Loans	Loan is the lending of money to a recipient (i.e. the borrower) who incurs a debt, and is usually liable to pay interest on that debt until it is repaid, and also to repay the principal amount borrowed. They can be senior or subordinate. Subordinate debts are repayable only after all other senior debts are paid.
Guarantees	Borrowing can be difficult for certain project developers, particularly if they lack collateral or if they do not have a long enough track record or credit history. To help address this issue and obtain loans from banks, guarantees can help compensate for a lack of collateral or creditworthiness by reducing the banks' risk. A guarantee is a commitment that if a negative event occurs, the guarantor will take action if the guaranteed party can not or will not. For example, a guarantee can be used to ensure that if a company fails to repay the lender, a development funder will cover part of the repayment. Guarantees can help to ensure that investors receive a minimum level of returns, or can limit an investor's losses if an investment underperforms expectations. With guarantees, a guarantor agrees to pay part of or the entire value of a loan, equity, or other instrument in the event that the guaranteed party cannot reimburse the claims or the project otherwise fails. They optimize the use of public resources, as these resources are only disbursed in the case of losses. When a covered event occurs, the investor has protection from losses as stipulated by the guarantee agreement. Both private and public entities provide guarantees. Private entities are profit-motivated in their pricing; public entities such as sovereign or multilateral institutions take other objectives into consideration.
Insurance	Like guarantees, insurances are contracts issued by a third party agreeing to make a payment in the event of a particular event happening, preserving the capital for the lender. Risks could include expropriation, war, terrorism, civil disturbance, breach of contract, all of which may impact on the value of the investment. In this way, they can reduce actual or perceived risks. Benefits of Risk Underwriting include: – Making more development projects commercially viable, by shifting the risk-return ratio and reducing the cost of capital. – Enabling development funders to support a larger number of projects than other instruments. Instruments such as guarantees and insurance policies typically require no immediate outlay of capital and only require funding when called, which will only happen in a proportion of cases. This enables a given pot of funding to be spread across multiple projects. – The ability to respond to project needs and/or investor needs, to ensure funds are channeled into the highest impact sectors.
Hedging	The Institution can provide hedging for project developers, since hedging might be very expensive or inaccessible. Hedging usually protects against local currency depreciation or basic materials

	price fluctuations.
Advance market commitments (AMCs)	It is a binding contract, typically offered by a government or other financial entity, used to guarantee a viable market for a product once it is successfully developed. Generally AMCs are used in circumstances where the cost of developing a new product is too high to be worthwhile for the private sector without a guarantee of a certain quantity of purchases in advance. Examples: In 2009 the Pneumococcal AMC incentivised pharmaceutical companies to make investments in their production capacity and develop the vaccine.
Outcome funding and results-based funding	To address capital intensive activities the provider of blended finance capital promise private investors to repay them with a premium based on the outcomes and results of the intervention. In such instances (both 11 and 12), the increased visibility into financial returns enables investors to quantify the risks and make informed investment decisions.
Direct equity/equity-type – common shares and mezzanine capital	The Institution can invest directly in the project by buying directly common shares of the project or invest in other equity-type such us mezzanine (surbordinate) capital. The key characteristic of a mezzanine capital is that one actors agrees to only be paid if the organization that received the funds has first repaid other (senior) investors, this should reduce the risk to private investors making them more likely to invest.
Technical assistance	Technical assistance constitutes a broad range of activities. Within blended finance, development finance providers usually contribute technical assistance in the project preparation phase to support activities. It normally involves the provision of know-how in the form of short and long term staff placements, training and research, policy and advisory services, studies, communication and knowledge sharing. Technical assistance also can take the form of monetary contributions, when multilateral development banks, other development banks or development finance institutions provide the financing for technical assistance. The advantage of Technical Assistance is the ability to highly leverage capital which can lead to considerable benefits, including: – Greater project viability. – Improved performance of investee enterprises, leading to enhanced investment performance. – Enhanced local knowledge and capacity, which benefits across the full project cycle. – Ability to cover upfront costs (e.g. project preparation) which would otherwise have been covered by investors, thus increasing the return on investment.

	– Increasing the efficiency of local markets.

Conclusion and Bibliography

Both established and new communities of practices are advancing the field of blended finance. The Tri Hita Karana Roadmap for Blended Finance is just one of the many projects. Another well-established body, the DFI Working Group continues to harmonize blended finance practices and principles among the MDBs and DFIs. Meanwhile, the Global Impact Investing Network (GIIN) launched a new Blended Finance Working Group in 2018, with the goal of decreasing costs in Blended finance project's design and increase frequency and scale of the investments.