PART I

Applying blended finance in LDCs
CHAPTER 1

BLENDED FINANCE: KEY CONCEPTS

Working definition of blended finance in this report

The working definition of blended finance44 in this report is aligned with that contained in the Addis Ababa Action Agenda: blended finance is the strategic use of concessional finance to catalyse additional private-sector or commercial investment in SDG-related investments in developing countries. Concessional resources can be both domestic and international, as well as public and private (in the case of philanthropy,45 for instance). For the most part, this report focuses on international public finance that is concessional—in essence, ODA—given its importance to most LDCs.

Many of the data on blended finance in this report come from the OECD, which maintains the most authoritative data available on private finance mobilized through blended transactions. It is important to note that the OECD employs a broader definition of blended finance, one that extends beyond concessional finance: “The strategic use of development finance for the mobilization of additional finance towards the SDGs in developing countries”, where ‘additional finance’ refers primarily to commercial finance not currently addressing development objectives. ‘Development finance’ is taken to include both concessional and non-concessional resources.

The data presented in Chapter 2 are consistent with the OECD’s definition. As a complement to this definition, the ‘OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the SDGs’ aim to make blended finance more effective and efficient.46

Maintaining a narrower focus—elsewhere in this report—on ODA and its deployment through blended transactions raises questions that are particularly poignant in an LDC context. Most notably, these include the importance of blended transactions adhering to the same standards that apply to the use of other activities supported by ODA.

Concessional finance

Concessional finance refers to any financial instrument that accepts returns lower than market level or, as in the case of technical assistance or grants, no returns at all. The most common concessional tools covered in this report include grants, concessional loans (usually featuring low interest rates, flexible collateral requirements, long maturities and grace periods), credit and risk guarantees and technical assistance. Concessionality can also come in a variety of other forms, such as first-loss equity tranches, deeply subordinated debt, and hedging of interest rates and currency exposures. It works best when it is tailored to a project. Given the focus on ODA, this report primarily looks at providers of concessional finance (or ‘providers’) that include bilateral and multilateral development agencies, DFIs and multilateral development banks (MDBs).

The role of blended finance: mobilizing private or commercial resources

It is important to see blended finance as part of complementary public and private financing options available to LDCs. Some projects or sectors are best funded by public finance alone, including the provision of many forms of basic infrastructure, expanding access to free education, or helping to strengthen the enabling environment. Other projects can be and are already being financed by private or

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44 There is no single, universally accepted definition of blended finance. In background research for this report, some three dozen definitions were found. In addition, the four scoping studies carried out suggest that officials in each LDC understood blended finance to mean slightly different things. In Bangladesh, for example, blended finance is seen mostly as the role of external concessional resources in mobilizing private finance; in Uganda, it is seen as the public sector’s incentive to the private sector to invest in specific sectors (Bhattacharya, Debapriya, and Sarah Sabin Khan (2018, forthcoming). ‘Is blended finance trending in LDCs? Perspectives from the ground’). See also Development Initiatives (2016a). ‘The Role of Blended Finance in the 2030 Agenda: Bristol Development Initiatives, Annex I, which provides a list of blended finance definitions and characteristics: http://devinit.org/wp-content/uploads/2016/07/The-role-of-blended-finance-in-the-2030-Agenda-Discussion-paper-July-2016.pdf


commercial investments, in which case it may not be appropriate to provide concessionality. Yet there are cases where the opportunity for private investors is not clear-cut, and the use of concessional finance can improve an investment’s risk–return profile, making projects with SDG impact commercially investable.

The private sector generally makes its investment decisions on the basis of risks and financial returns. Many of the poorest and most vulnerable countries in the world, or localities or smaller projects within those countries, may offer poor return prospects or may be perceived as doing so. This is partly because of investor concerns around enabling environment risks—such as those related to rule of law, corporate governance, macroeconomic and political vulnerability, or poor infrastructure—and partly because of project-specific risks and barriers, such as high transaction costs relative to the small investment size, a lack of a track record of investments in a sector, a dearth of quality project sponsors, and limited market data (such as on credit records).

Investors can also face greater uncertainty in these markets, along with institutional constraints that prevent them from allocating investments there, such as financial regulations to which they are subject and/or fiduciary responsibilities. If a project is seen as highly risky or too early stage or poorly structured, the cost of private finance is likely to be too high for the project sponsor to afford, or private investors may refuse to be involved altogether.

As shown in Figure 2, this is where blended finance has a potential role to play, in adjusting risk–return profiles of specific projects to make them financially attractive to private or commercial investors.

For there to be a role for blended finance, in LDCs and elsewhere, it is important that projects have the potential to be sufficiently profitable to compensate private investors for the risks they assume. If a project does not generate returns, the remuneration of private capital, even in a blended format, is impossible. As a result, the use of blended finance will be more challenging in sectors where social equity considerations reduce profit prospects, or where revenue streams are either non-existent or very limited. Thus, blended finance transactions tend to target SDG investment areas where the business case is clearer, such as energy, other forms of infrastructure and SMEs. In contrast, blending is much less prominent in such areas as ecosystems, which reflects the public good character of these investments, and where public finance is often the most effective financing option.47 This does not, however, rule out altogether that blended solutions could work in some of those cases too.

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**FIGURE 2. Using blended finance to achieve a commercially acceptable optimal risk/reward ratio**

- **Return (%)**
- **Risk-free rate**
- **Optimal risk/return profile for private investors**
- **Deal pre-blending (unattractive to private investors)**
- **Blended deal with de-risking**
- **Blended deal with return enhancement**

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Blended finance must focus on achieving the SDGs without crowding out other investors. The use of blended finance is advisable in accordance with a number of principles (see Chapter 5). Two critical ones are: (i) sustainable development additionality (direct development impact and alignment with the SDGs); and (ii) financial additionality (the project would not be funded by commercial sources alone without concessional support). A corollary to financial additionality is that concessionality should be kept to a minimum—just enough to make a project attractive to commercial investors.

A project has development additionality if it produces social, economic and environmental impact, and contributes to the pursuit of the SDGs, with the goal of leaving no one behind. In addition to targeting specific impact, development additionality entails incorporating social equity considerations into project design and execution, including pricing products and services which need to be made available to all households at affordable levels. The gap between financial and social/economic returns normally results from externalities (positive and negative), such as emission reductions, reduced inequality, or physical and market infrastructure. Ideally, blended finance should encourage the maximum delivery of SDG outcomes or address the incremental cost of going the extra mile beyond standard practice in the sector in question.

Concessional resources should, to the extent possible, help develop a market that responds to appropriate incentives to provide the desired goods or services. Concessional finance providers should abide by the principle of minimum concessionality: their support is meant to be just enough to get a blended deal off the ground, by addressing market failures such as externalities and information asymmetries. Moreover, concessional resources should not become a substitute for, and neither delay nor disincentivize, more sustainable commercial or policy interventions, such as reform aimed at improving the enabling environment.

Financial additionality and minimum concessionality ensure that concessional finance is not directed at transactions that could be funded exclusively from private or commercial capital. The objective is to minimize market distortions, not over-subsidize the private sector, and avoid generating unfair competition (‘crowding out’) for private investors that would be unable to match the terms of a blended capital structure. To minimize these risks, concessional finance providers should abide by the principle of minimum concessionality: their support is meant to be just enough to get a blended deal off the ground, by addressing market failures such as externalities and information asymmetries. Moreover, concessional resources should not become a substitute for, and neither delay nor disincentivize, more sustainable commercial or policy interventions, such as reform aimed at improving the enabling environment.

Determining the amount and structure of concessionality is also difficult, especially in LDCs. While the principle of ‘minimum concessionality’ is widely accepted, the risk of over-subsidizing the private sector and deploying more concessionality than needed is always present, for several reasons:

- In search of development additionality, concessional finance providers may be tempted to label any investments that combine concessional and private finance as additional. This risk may be more prevalent in LDCs, where SDG financing gaps are larger and blended transactions more difficult to get off the ground than in MICs.
- It can be difficult to gauge at what terms private capital would be willing to undertake a project on its own and fine-tune concessionality accordingly (‘getting the price right’). Investor risk propensity is not a given: some investors seeking development impact may be willing to finance a transaction at terms generally deemed below market, and other investors may do so perhaps in the context of a broader portfolio diversification strategy.
- Particularly in LDCs, the previous problem is compounded by the scarcity of market data and pricing references, be it listed security prices or comparable precedent transactions.
- If the project (typically infrastructure) provides a public service that must be accessible to all households irrespective of their ability to pay, and government sets user tariffs with social equity considerations in mind, then tariffs may be insufficient to recover investment and operation and maintenance costs; in these cases, there is a question of whether the investment will ever be profitable, and the only way to attract private capital to the deal may be through a certain (possibly high) level of concessionality.

48 For an example of an infrastructure project, see ‘Case Study 2: Mali. A solar power project’.
51 ibid
• Especially in LDCs, the investor universe is limited, and deals are often the initiative of one investor or project developer. Running tenders to select the most competitive developers—a standard process in many advanced economies—is not always feasible. In the absence of a competitive process, it is primarily bilateral negotiations with the developer that will need to ensure minimum concessionality.

• Market conditions and deal structures evolve. A deal that was unpalatable to private investors yesterday may be palatable today, because of improved market conditions or deal repackaging, among other reasons.

Types of projects supported by blended finance

Many blended finance projects tend to fall into two categories: infrastructure projects and corporate investments. The former entails the development, financing and operation of infrastructure, such as electricity and water distribution, often under long-term concession schemes negotiated with a regulator or government agency; they attract infrastructure investment/lending specialists who are able to navigate the legal, regulatory and engineering complexities of such projects. Corporate investments are usually equity or debt investments in new or established companies, usually aimed at financing the next growth phase and negotiated bilaterally with the company owner(s); they attract private equity and debt investors, direct investors (domestic and FDI), and a broader range of commercial lenders than those specialized in infrastructure (e.g. including loans to financial institutions that are then on-lent to domestic SMEs).

Infrastructure and corporate investments present different development opportunities and challenges. Infrastructure projects can be large, and their successful execution can make a significant difference to national development agendas. Given their large user bases and the difficulty many households in LDCs have in paying market rates for services, social equity is a crucial consideration in project design (especially tariff setting). Project failure can seriously hamper the prospects of achieving the SDGs, and the large size of investments in what are often uncertain markets with untested regulatory regimes raises the risk of over-subsidizing the private sector. These projects require close coordination with and the involvement of national authorities and local actors to ensure they are supporting national development agendas and structured and tailored to local needs.55

Corporate projects, on the other hand, are typically more confined in nature, and their success or failure, in most cases, may not have as systemic an impact on national development agendas. While there are risks of distorting markets also in these cases, such transactions generally seek to support directly the growth of the domestic private sector.

This report pays particular attention to the use of blended finance in the ‘missing middle’ segment of the corporate sector. While there is no universally accepted definition or measure of the missing middle, it is generally meant to refer to those SMEs that are too big to access microfinance and too small or seen as being too risky to access commercial loans offered by mainstream financial institutions. The concept of the ‘missing middle’ highlights that in many developing countries the private sector is split into two segments: on the one hand, most SMEs are small, often micro or informal, rather than medium-sized, while, on the other hand, there are also some very large enterprises.56

Getting finance to the missing middle is essential for achieving the SDGs. They promote innovation; help to diversify economic activity in local economies beyond capital cities; deliver goods and services to excluded populations; and can be a powerful force for integrating women and youth into the economic mainstream. Most formal jobs in emerging markets are SME jobs—7 out of 10 formal jobs are created by SMEs—and this rises to 9 out of 10 jobs in some low-income countries.57

In LDCs, there is a high concentration of very small firms with fewer than 10 employees. These firms find it hard to make the transition to medium-sized enterprises. In particular, in LDCs, the factors that contribute to low productivity and competitiveness include low rates of small firms with bank accounts (25 percent for small firms and 40 percent for medium-sized firms) and the low proportion of SME investment financed by banks.58

Supporting missing-middle projects in LDCs can be costly. In UNCDF’s experience, SMEs in LDCs typically need credit ranging from $50,000 to $1 million. That is credit normally extended by local banks, yet local banks often find such projects too risky and too expensive to support—or have investment options offering better returns. For their part, many DFIs do not routinely directly support smaller projects, often because of the transaction costs involved, although they may use instruments such as guarantees to encourage increased lending to SMEs.59 This leaves a wide gap in the financing-for-development architecture of projects that can transform local communities but need much more technical assistance and project preparation support as well as financing to get off the ground. This makes it important to understand what role blending can play in helping to fill this gap.60

55 See, for example, ‘Case Study 4: Rwanda. Kigali bulk water supply PPP’.
59 See the guest piece by Malena Rosman, ‘The power of guarantees in mobilizing private finance’.
60 Some of these challenges are further presented in ‘Case Study 1: Democratic Republic of the Congo and Central Africa Republic. A first-time private equity fund’ and in ‘Case Study 5: Tanzania. Mwenge, an agriculture value chain project’.
According to the OECD, in the four years from 2012 to 2015, official development finance unlocked $81 billion in private finance for development globally. Of that amount, some $5.5 billion of private capital—or less than 7 percent of the total—was for LDCs. An additional $11 billion in private finance was mobilized through regional operations, some of which may have included LDCs.

The data currently available are only able to quantify the amount of private finance mobilized, but not how much ODA was allocated to mobilize that private finance.
The surveyed donors\textsuperscript{64} mobilized private capital in 35 out of 48 LDCs,\textsuperscript{65} as of 2015. This is roughly one third of all countries where private capital was mobilized, excluding regional operations. On average, for each LDC captured in the data, the total private finance mobilized between 2012 and 2015 was roughly $157 million. When the three Small Island Developing States (SIDS)\textsuperscript{66} where private finance was reported mobilized are excluded, the average of total private finance mobilized in LDCs over the four years increases to $170 million. When excluding landlocked developing countries (LLDCs), the average private finance mobilized increases to just over $175 million. This likely highlights the even greater difficulties SIDS and LLDCs face in attracting private finance.

The trend in private finance mobilized in LDCs is one of growth (see Figure 4). Annual private capital mobilized for the LDCs almost tripled between 2012 and 2015 (compared to a 78 percent increase for all developing countries), albeit from a low base.

As Table 3 suggests, the amount of private finance mobilized that benefited LDCs may not be indicative of an underweighting relative to the size of their economies, though it does suggest that blended transactions may be more difficult in LDCs. The ratio of aggregate private finance mobilized to aggregate gross national income (GNI) over 2012–2015 is marginally higher in LDCs than in the Lower MICs. The LDC figure is higher than that for the Upper MICs, which is not surprising given the very large size of those economies overall.\textsuperscript{67} The ratio of private finance mobilized to aggregate ODA over this time period, however, is much lower in LDCs than it is for both Lower MICs and Upper MICs, a reflection perhaps of the larger reliance LDCs have on ODA for a broad range of interventions.

\begin{table}[h]
\centering
\begin{tabular}{|l|c|}
\hline
\textbf{YEAR} & \textbf{PRIVATE FINANCE MOBILIZED ($MILIONS)} \\
\hline
2012 & 132 \\
2013 & 153 \\
2014 & 207 \\
2015 & 209 \\
\hline
\end{tabular}
\caption{Private capital mobilized for LDCs (2012–2015)}
\end{table}

\textsuperscript{64} The OECD DAC survey was answered by 72 bilateral and multilateral institutions working for development—including aid agencies, bilateral and multilateral DFIs, and development banks, as well as a few PPPs and investment funds focusing on resource mobilization.

\textsuperscript{65} There are currently 47 LDCs. Equatorial Guinea graduated from LDC status in 2017 and is, therefore, included in the data set.

\textsuperscript{66} These are Guinea-Bissau, Haiti, and São Tomé and Príncipe.

\textsuperscript{67} This analysis looked at those countries covered by the responses to the OECD survey—i.e., only those countries where private finance was mobilized.
Blended Finance in the Least Developed Countries

Private finance mobilized is positively correlated to GNI per capita (see Figure 5). Countries are eligible to enter or leave the LDC category if they meet the defined inclusion or graduation thresholds of three criteria: the Economic Vulnerability Index (EVI), the Human Assets Index (HAI) and GNI per capita. Private finance mobilized in LDCs does appear to be positively correlated with GNI per capita, as captured in Figure 5. This may be because it is easier to mobilize private finance in contexts where more capital exists, or perhaps because a higher GNI per capita signals either larger market opportunities or a stronger enabling environment.

<table>
<thead>
<tr>
<th>Table 3. Private finance mobilized in relation to GNI and ODA</th>
</tr>
</thead>
<tbody>
<tr>
<td>LDCs</td>
</tr>
<tr>
<td>Lower MICs</td>
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<tr>
<td>Upper MICs</td>
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</tbody>
</table>


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Further analysis showed that the correlation between private finance mobilized and the EVI and HAI country scorings is statistically insignificant. When looking at the sub-indices of both the EVI and HAI, only the correlation with the share of agriculture, forestry and fishing in GDP is statistically significant. The relationship between these two variables is negative, implying that the more a country’s GDP is composed of primary industries, the lower the amount of private finance mobilized. This further highlights the differences in mobilizing private finance between countries within the LDC category, and not only between country categories.

Geographically, private capital mobilized is aligned with the number of LDCs by region. Three quarters (77 percent) of private finance mobilized for LDCs went to sub-Saharan Africa, 22 percent to Asia (mostly South and Central), and 1 percent to Central America, where there is only one LDC (Haiti). This distribution is roughly consistent with the number of LDCs in each region and also with the distribution of ODA by region: over 2012–2015, 65 percent of ODA in LDCs went to sub-Saharan Africa, and 32 percent to Asia (mostly South and Central).

The amount of private finance mobilized varies significantly among LDCs (see Figure 6).

In 2012–2015, the three LDCs benefiting from the largest amounts of private capital mobilized were Angola (over $1 billion), Senegal and Zambia (over $500 million each). In contrast, less than $10 million was mobilized for Liberia, Djibouti, São Tomé and Principe, Guinea-Bissau, Yemen and Gambia. The 13 LDCs with no private capital mobilized were mostly small islands and conflict-affected States.

Data by country are also skewed by large one-off transactions, which may not be indicative of future trends. In Angola a small number of operations—supported mainly by guarantees from both multilateral and bilateral organizations—mobilized large per-deal amounts (over $100 million on average), in sectors including water management, metal industries, information and communication technology and telecommunications, trade and financial services.

Mauritania, Nepal, Myanmar, Bangladesh, Lao People’s Democratic Republic (Lao PDR), Malawi, Zambia and Mozambique mobilized more than $10 million per operation. Guinea-Bissau, Yemen and Gambia, on the other hand, registered the lowest mobilization per transaction, at less than $1 million.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>No. of deals</th>
<th>Private finance mobilized ($ thousands) in 2012-2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angola</td>
<td>50</td>
<td>$250,000</td>
</tr>
<tr>
<td>Senegal</td>
<td>25</td>
<td>$500,000</td>
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<tr>
<td>Somalia</td>
<td>7</td>
<td>$750,000</td>
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<tr>
<td>Zambia</td>
<td>10</td>
<td>$1,000,000</td>
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<tr>
<td>Bangladesh</td>
<td>20</td>
<td>$500,000</td>
</tr>
<tr>
<td>Mozambique</td>
<td>15</td>
<td>$750,000</td>
</tr>
<tr>
<td>Gabon</td>
<td>10</td>
<td>$250,000</td>
</tr>
<tr>
<td>Cameroon</td>
<td>15</td>
<td>$500,000</td>
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<tr>
<td>DR Congo</td>
<td>13</td>
<td>$750,000</td>
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<td>Tanzania</td>
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<td>Lao PDR</td>
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<td>Mauritania</td>
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<td>Niger</td>
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<td>South Sudan</td>
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<td>Libya</td>
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<td>Liberia</td>
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<td>$250,000</td>
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<tr>
<td>Djibouti</td>
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<td>$250,000</td>
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<tr>
<td>São Tomé and Principe</td>
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<td>Guinea-Bissau</td>
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<td>Yemen</td>
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<tr>
<td>Gambia</td>
<td>10</td>
<td>$250,000</td>
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</table>

70 Highly significant at the p<0.1 level.
71 This analysis is based on United Nations Committee for Development Policy Secretariat, “Triennial Review Dataset 2000-2018”, https://www.un.org/development/desa/dpad/least-developed-country-category/ldc-data-retrieval.html. (Last accessed June 2018.) Though this result is interesting and suggestive of the relationship between a country’s economic structure and private finance mobilized, there is a clear need for analysis to be completed over a longer period of time.

Private finance mobilization and ODA targeted different countries. Over 2012–2015, Afghanistan, Ethiopia, Bangladesh, Tanzania and Myanmar were the largest recipients of ODA (in that order), with more than $10 billion each. This perhaps confirms the different, but complementary roles of development assistance and blended finance. Only Bangladesh appears within the top five of both private finance mobilized and ODA recipients.

OECD data confirm the small size of blended finance transactions in LDCs. LDCs represented only 7 percent of total private finance mobilized over 2012–2015, but 23 percent of the number of blended finance transactions reported (or 701 out of 3,035 deals).

On average, around $7.9 million was mobilized per blended finance transaction in LDCs, less than 30 percent of the average for the whole survey population ($26.7 million). Lower mobilization may reflect the smaller size of private-sector transactions in LDCs and/or the higher use of concessional finance per transaction.

Over one third (38 percent) of the blended finance deals reported in LDCs mobilized less than $1 million in private capital, and more than half mobilized less than $2 million (see Figure 7). Fewer than 5 percent of the LDC transactions mobilized more than $50 million in private finance. This speaks to the fact that transactions are not standardized, but also suggests that there is a high demand for finance in the missing middle and that mobilization ratios may need to be ‘right sized’ to the context, with providers adjusting their expectations depending on whether they are operating in LDCs or MICs.

In terms of blended finance instruments deployed in LDCs, credit and risk guarantees generated the highest absolute mobilization of private capital in 2012–2015 (see Figure 8). They were used in 73 percent of the blended finance transactions in LDCs (compared to 50 percent for all developing countries) and were responsible for 71 percent of private finance mobilized in LDCs (compared to 44 percent for all developing countries).

The second most popular instrument was syndicated loans—used in 11 percent of the blended finance transactions and responsible for 14 percent of private finance mobilized in LDCs. Over 40 percent of the total amount mobilized by syndicated loans was for LDCs. Donor agencies participated as lenders in syndications arranged both by them and by third parties.
One factor that likely explains the high historical use of guarantees in LDCs is the choice of sectors targeted by this instrument (see also Figures 11 and 12). Credit guarantees are applicable only if a project or company generates sufficient cash to service a loan, to which the guarantee is attached. In the case of infrastructure projects, for example, regulated tariffs (e.g. for water or electricity) and long concession contracts ensure cash flow stability, making those projects prone to lending. In addition, infrastructure projects are also particularly suited to non-credit guarantees, such as political risk insurance. These, for instance, can protect equity investors from the risk that a government (often a new one) slashes previously agreed tariffs, with a negative impact on equity internal rates of return.

The World Bank Group is the largest mobilizer of private finance for LDCs (see Figure 9). Forty-two of the bilateral and multilateral institutions surveyed by the OECD confirmed using blended finance instruments, but only 28 (17 bilateral and 11 multilateral) reported private finance mobilized in LDCs over 2012–2015. Multilateral agencies mobilized more private capital in LDCs than bilateral ones did (60 percent of the total). This is true of the entire developing world and not just LDCs, and perhaps is simply a reflection of the larger scale of multilateral agencies’ operations.
Among the multilateral providers, the Multilateral Investment Guarantee Agency (MIGA) mobilized the largest volume of private finance in LDCs in 2012–2015 (and ranks third when looking at the entire universe of developing countries). It was the only donor reporting over $1 billion mobilized in LDCs. This finding also speaks of the effectiveness of guarantees as a mobilization tool, particularly in LDCs.

The International Finance Corporation (IFC) and International Development Association (IDA) are also in the top three, making the World Bank Group the largest donor in terms of private finance mobilization in LDCs. Its prominence is likely to increase after the recent launch of the $2.5 billion IDA Private Sector Window as part of the 18th IDA replenishment round. The Private Sector Window was created to catalyse private-sector investment in 54 eligible countries, 39 of which are LDCs, with a focus on fragile and conflict-affected States. The Private Sector Window supports blended finance activities through a $600 million blended finance facility, a $500 million guarantee facility administered by MIGA, a $400 million local currency facility and a $1 billion risk mitigation facility.73

The European Union (EU) may also see a greater focus on mobilizing private finance in LDCs in the future. The EUR4.1 billion European Investment Plan and its European Fund for Sustainable Development include a budget of EUR2.6 billion and guarantees for EUR1.5 billion.74 Their objective is to leverage additional financing, in particular from the private sector, by incentivizing greater private investment in contexts of high perceived risk, including LDCs in Africa, and absorbing potential losses incurred by financiers and investors.75

Currently, the United States and France are the bilateral donors mobilizing the highest volume of private finance to LDCs ($852 million and $618 million, respectively), with Agence Française de Développement (AFD) and the Overseas Private Investment Corporation (OPIC) being the top bilateral agencies, reporting over $500 million each. The United States tops the list of bilateral donors for both private finance mobilized and volume of ODA provided to LDCs, whereas France comes in second and sixth, respectively.


74 See also the guest piece by Marjeta Jager, ‘The EU’s External Investment Plan: Attracting more investment to the world’s Least Developed Countries’.


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**FIGURE 9.** Private capital mobilized for LDCs by donor ($ thousands, 2012–2015)

<table>
<thead>
<tr>
<th>Donor</th>
<th>Bilateral</th>
<th>Multilateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>MIGA</td>
<td>1,350,000</td>
<td>1,800,000</td>
</tr>
<tr>
<td>AFD</td>
<td>900,000</td>
<td>1,350,000</td>
</tr>
<tr>
<td>OPIC</td>
<td>450,000</td>
<td>700,000</td>
</tr>
<tr>
<td>IFC</td>
<td>450,000</td>
<td>700,000</td>
</tr>
<tr>
<td>USAID</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>IDA</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>PIDG</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>IBRD</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Norfund</td>
<td>350,000</td>
<td>350,000</td>
</tr>
<tr>
<td>EIB</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>FMO</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>ADB</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>AFD</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>JICA</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Sida</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>CGIIF</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>IFU</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Finnfund</td>
<td>250,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Proparco</td>
<td>250,000</td>
<td>250,000</td>
</tr>
<tr>
<td>BIO</td>
<td>250,000</td>
<td>250,000</td>
</tr>
<tr>
<td>KfW</td>
<td>250,000</td>
<td>250,000</td>
</tr>
<tr>
<td>CDC Group Plc</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>SOFID</td>
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<td>200,000</td>
</tr>
<tr>
<td>Swedfund Int'l</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Camoes Institute</td>
<td>150,000</td>
<td>150,000</td>
</tr>
<tr>
<td>SIFEM</td>
<td>150,000</td>
<td>150,000</td>
</tr>
</tbody>
</table>

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AFD is the largest bilateral agency by capital mobilized in LDCs in 2012–2015 ($585 million), based on what was declared to the OECD. Senegal, Madagascar, Mali, Chad, Cambodia and Guinea received 70 percent of this amount. Except for Cambodia, these countries are all on the list of 19 priority countries in the French development policy. The LDCs represented 35 percent of all private capital mobilized by AFD.

OPIC is the largest of the US agencies by volume of private finance mobilized, globally and in LDCs. Even with more than $500 million mobilized, the LDCs only represent 3 percent of total private finance mobilized by OPIC. Of this, 74 percent was concentrated in three countries: Zambia (40 percent), Myanmar and Mozambique (17 percent each). The United States Agency for International Development (USAID) mobilized less private capital in LDCs than OPIC in absolute terms ($330 million), but more as a percentage of the amounts mobilized by their total development cooperation (15 percent).

Other donors whose private finance mobilized was significantly concentrated on LDCs include Japan (Japan International Cooperation Agency—JICA), Portugal (Camoes Institute and Sociedade para o Financiamento do Desenvolvimento—SOFID), Norway (Norwegian Investment Fund for Developing Countries—Norfund) and Belgium (Belgium Investment Company for Developing Countries—BIO).

High-income countries—other than the provider—were the largest source of private finance mobilized in LDCs (almost $2 billion, or 36 percent of the total amounts mobilized) (see Figure 10). When private finance came from high-income countries, the amount mobilized per transaction was quite high—almost $22 million on average.

The second largest source of private capital stemmed from the beneficiary countries themselves, with over $1.3 billion mobilized (24 percent of the total), suggesting that many deals already involve domestic investors. This amount was spread over a very large number of transactions: 68 percent of the deals occurring in LDCs occurred in partnership with a local private counterpart. As a result, the average mobilization ($2.8 million) per deal with local counterparts was relatively small. Private entities based in the reporting donor countries were the third largest source of capital mobilized ($720 million), with an average of $10 million per transaction.

In LDCs, as in all developing countries, **blended finance is focused on revenue-generating sectors and, by implication, the SDGs more closely associated with those sectors.** This finding is corroborated by both the OECD survey and the database of Convergence, the global network for blended finance.

OECD data show that industry/mining/construction, energy, and banking and financial services absorbed 80 percent of the private capital mobilized in all developing countries and 60 percent (a smaller but still significant percentage) in LDCs in 2012–2015 (see Figure 12).

Water supply/sanitation and communications also feature prominently in LDCs but are relatively less present in other developing countries. The water supply and sanitation, and government and civil society sectors show very high mobilization per deal in LDCs, even higher than in other developing countries. Guarantees were the only instrument to have mobilized private finance in these two sectors, as well as in the education sector, in LDCs. The volume of private finance mobilized in population and reproductive health or general environmental protection is negligible, both in LDCs and in other developing countries.

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**FIGURE 11.** Private finance mobilized by sector ($ thousands, 2012–2015)

- **Private finance mobilized ($ thousands)**
- **No. of deals**

---

**Notes:**

77 This focus on revenue-generating sectors is also suggested by the four scoping papers which included overviews of blended transactions in LDCs in question.

78 Convergence generates blended finance data, intelligence and deal flow to increase private-sector investment in developing countries. The OECD data, as previously noted, are based on a survey covering a four-year period and five instruments used to mobilize private finance across a range of entities in DAC members, and are captured in aggregate figures. The Convergence database captures granular information on historical deals, including deal structure, blended finance approach, investors and intended impact. A portion of the deals may be captured in both the OECD survey and Convergence database, but overall the data sets cover complementary subsets of blended finance activity to date. Of the 320 blended finance transactions in its database as of July 2018 when the authors accessed it, 95 took place in part or entirely in LDCs (30 percent of the total). For a preview of Convergence’s proprietary database, see [https://www.convergence.finance/blended-finance](https://www.convergence.finance/blended-finance).
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The Convergence database confirms a similar allocation to economically productive sectors, especially energy and infrastructure. This was the case for all 320 deals in the database, including the 95 deals that took place in part or entirely in LDCs, and the 38 (out of those 95 deals) that took place wholly in LDCs. There was a slightly lower proportion of deals in financial services and a slightly higher proportion of deals in infrastructure in LDCs as compared to the total database.\(^79\)

\(^79\) Note: Deals can target more than one sector, which is why the total in Figure 13 adds up to more than 100 percent.
At the same time, according to the OECD, the top three sectors for ODA in LDCs in 2012–2015 (36 percent of the total) were concentrated on public goods: government and civil society was the largest, followed by emergency response, and health. Another prominent industry for ODA spending in LDCs was population policies, programmes and reproductive health, a category that did not attract any country-allocable private finance in 2012–2015. This appears to confirm that blended finance is targeting different but often complementary sectors to development assistance.

From an SDG perspective, and as captured in Figure 14, the Convergence database shows that blended finance transactions—all 320 deals, including those taking place partly or wholly in LDCs—targeted SDGs where there are clearer opportunities for generating revenue: SDG 9 (industry, innovation and infrastructure), SDG 8 (decent work and economic growth), SDG 10 (reducing inequalities), SDG 13 (climate action) and SDG 7 (clean energy). All deals in the database also targeted SDG 17 (means of implementation), while almost all targeted SDG 1 (poverty eradication).

The OECD has also conducted a separate survey on blended finance funds and facilities. While the data are not disaggregated by country income group, such funds and facilities have also been shown to mostly target those SDGs concerning economic growth and jobs (SDG 8), infrastructure (SDGs 6, 7, 9 and 11), climate change (SDG 13) and cross-cutting themes (SDGs 1 and 17). This is not surprising.

All are sectors that combine the potential for financial returns with strong development impact. The guest piece from the Climate Policy Initiative (CPI), for instance, highlights the potential of blended finance to expand access to clean energy in four LDCs.
Concessional finance providers, working together with private and commercial investors, project sponsors and the government, as appropriate, determine the applicability and structure of a blended finance solution. The analysis includes understanding the risks to private capital presented by a project. **Risks materialize at two levels:**

- **Enabling environment level:** regulatory, governance, infrastructure and market risks that often require policy solutions or reforms but sometimes can be addressed or circumvented by project-specific blended solutions; and
- **Project-specific level:** these include operational and contract risks, factors which have a direct impact on project cash flows and returns, as well as the operating costs incurred by investors to source, structure and execute a transaction.

These risks are present in LDCs, as in any other developing country, but in different permutations and intensities; they also differ by country and by sector, and may evolve over time as countries and markets develop. This chapter discusses the features of the barriers that are more prevalent in LDCs. Some of these barriers are described concretely in the case studies in Part II.

**Enabling environment barriers and risks**

A weak domestic enabling environment is a powerful deterrent to private investors, both domestic and international. It raises the risk premium required by commercial investors and, as a result, the cost of financing projects. In the worst case, it may scare investors away altogether.

Across all countries, the list of enabling environment barriers and risks is long and diverse, and includes:

- political and macroeconomic instability
- undeveloped capital markets
- weak institutions and the rule of law, resulting in risks surrounding contract enforcement, for instance
- currency volatility
- lack of essential physical infrastructure
- the informality of the economy
- capital controls
- poor corporate governance standards
- undeveloped capital markets
- absent, poor or new and untested regulations, such as tariff regimes for infrastructure

Many LDCs have made notable efforts to address enabling environment barriers, including through improving transparency and reforming legal frameworks. Still, feedback from commercial investors and concessional finance providers interviewed for this report and some quantitative benchmarks suggest that, in many LDCs, many of these barriers remain high or are perceived as being higher in LDCs than in other developing countries.

LDCs rank predominantly in the third and fourth quartile, out of 190 participating countries, in a number of the components of the World Bank’s Doing Business 2018 survey which reflect some of the enabling environment barriers listed above.
In particular, access to finance is a serious challenge in LDCs, where about 35 percent of firms identify this as a major constraint to business operations; that figure is 24 percent in the rest of the developing countries.82 UNCDF experience and the scoping studies confirm there is often a severe lack of working capital or long-term financing available for SMEs in LDCs, with domestic banks and other investors perceiving financing risks as too high for the returns on offer. In many cases the unwillingness of banks to lend reflects objective bankability concerns affecting prospective borrowers, such as accounting issues or lack of collateral. In many LDCs, businesses are also constrained by skills gaps,83 which may contribute to their bankability issues.

This highlights the need to make finance more inclusive. Access to credit and other financial services can support SMEs to develop and grow.84 Increased account ownership, for example, can help increase domestic savings, and support greater credit flowing through the financial system. The World Bank’s Global Findex shows that the share of adults in LDCs who have an account with a financial institution or through a mobile money service, for example, was around 37 percent in 2017, up from 24 percent in 2014,85 but still lower than the developing economies’ share of 63 percent.86 While there is a persistent gender gap in account ownership of 9 percentage points in developing countries, this gap is 14 percentage points in LDCs.87

Drawing on complementary data from UNCDF diagnostic assessments, Figure 15 highlights financial inclusion in select LDCs, looking at the percentage of the population that is banked formally; has access to services from other formal financial service providers (not licensed as banks); has access to informal financial services; or is financially excluded.

\[\text{FIGURE 15. Financial inclusion in select LDCs}\]

<table>
<thead>
<tr>
<th>Country</th>
<th>Banked</th>
<th>Other formal (non-bank)</th>
<th>Informal only</th>
<th>Financially excluded</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burkina Faso</td>
<td>18%</td>
<td>27%</td>
<td>15%</td>
<td>40%</td>
</tr>
<tr>
<td>Cambodia</td>
<td>17%</td>
<td>42%</td>
<td>12%</td>
<td>29%</td>
</tr>
<tr>
<td>DRC</td>
<td>12%</td>
<td>24%</td>
<td>12%</td>
<td>52%</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>12%</td>
<td>36%</td>
<td>28%</td>
<td>23%</td>
</tr>
<tr>
<td>Madagascar</td>
<td>12%</td>
<td>17%</td>
<td>30%</td>
<td>41%</td>
</tr>
<tr>
<td>Malawi</td>
<td>27%</td>
<td>7%</td>
<td>15%</td>
<td>51%</td>
</tr>
<tr>
<td>Mozambique</td>
<td>20%</td>
<td>4%</td>
<td>16%</td>
<td>60%</td>
</tr>
<tr>
<td>Myanmar</td>
<td>25%</td>
<td>23%</td>
<td>22%</td>
<td>30%</td>
</tr>
<tr>
<td>Nepal</td>
<td>25%</td>
<td>40%</td>
<td>21%</td>
<td>18%</td>
</tr>
<tr>
<td>Togo</td>
<td>25%</td>
<td>13%</td>
<td>21%</td>
<td>40%</td>
</tr>
<tr>
<td>Zambia</td>
<td>25%</td>
<td>13%</td>
<td>21%</td>
<td>41%</td>
</tr>
</tbody>
</table>

Source: UNCDF Making Access Possible programme.

As can be seen in Box 1, the United Nations Conference on Trade and Development (UNCTAD) found that, in LDCs, start-up registration costs are higher (relative to income per capita) and procedures lengthier than the global average. This is despite the positive steps taken by many LDCs to lower such costs over the past decade; as Figure 17 shows, the cost of starting a business (relative to income per capita) in LDCs fell by more than 80 percent on average from 2004 to 2017.

**BOX 1. Registration procedures and start-up regulations in LDCs**

One area of particular relevance for LDCs pertains to the regulations for start-up registration. Registration procedures represent a key element of the incentive structure affecting the creation and formalization of new enterprises, thereby having a bearing on the rate of emergence of start-ups capable of stimulating competition and challenging the business models of incumbent firms. Yet, while certain provisions and regulations are justified in light of economic, administrative or even social and environmental objectives, others unnecessarily tax potential entrepreneurs, with the ensuing fixed costs discouraging start-ups and their formalization.

In the period 2015–2017, 33 LDCs (out of 46 for which data are available) displayed higher start-up costs, relative to their own income per capita, than the world average, with countries such as Chad, CAR, Somalia, Haiti and South Sudan being disproportionately affected. In the same vein, the number of procedures required to start up a business exceeds the world average in 21 LDCs, leading to higher time costs for prospective entrepreneurs. Moreover, while in most cases cumbersome procedures affect men and women entrepreneurs alike, sex-disaggregated data reveal that in a handful of LDCs (Afghanistan, Benin, Guinea-Bissau, Sudan and Yemen) women are subject to an additional procedure to start up their business.

While administrative burdens disproportionately hamper business registration in LDCs, additional factors are also at play, most notably the limited awareness of registration procedures, and the widespread perception that registration may entail insufficient benefits to justify the upfront fixed costs. These considerations, coupled with the incidence of start-ups beginning as informal firms and registering only at a later stage, suggest that, at least in some cases, informality results from a deliberate decision on the part of entrepreneurs to remain ‘below the radar’ until reasonably confident about the viability of their business model.

**FIGURE 16. Costs and procedures to start up businesses in LDCs, compared to the world average (2015–2017)**


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Two other barriers are worth highlighting. One is that many LDC sovereigns are already constrained in their ability to assume much more debt, given their high risk of debt distress. Another is local currency risk, mentioned almost unanimously by international investors interviewed for this report as a major issue affecting their activities in LDCs, as discussed in Box 2.

**Box 2. Impact of currency risk on private investment in LDCs**

Local currency volatility is a major risk factor for international investors operating in ‘hard’ currencies, such as the US dollar and the Euro. Typical examples are currencies of commodity exporters that can depreciate significantly when commodity prices (denominated in dollars) drop and, with them, the flow of hard currency to the country. Many LDCs have free-floating currencies highly exposed to reversals in capital flows. Others have currencies pegged to regional or international currencies, but pegs can be abandoned, and the local currency can experience a sudden devaluation. While this happens in non-LDCs as well, currency risks can have a larger impact in LDCs owing to the difficulties and costs that may be involved in hedging foreign exchange risk in these countries.

In terms of attracting private investors into a deal, currency risks manifest in several ways:

- International equity investors exchange hard currency for local currency when purchasing equity stakes in LDC businesses. Exits can take years to materialize. If, by that time, the local currency has materially depreciated and the company’s valuations has not increased enough to offset currency depreciation, the investor will suffer a loss in hard currency terms.

- If the company has borrowed from international lenders in hard currency, the company is obliged to repay the loan in hard currency. If the company’s revenues are in local currency, because it sells products or services predominately to the domestic market, a depreciation will result in lower hard-currency-equivalent cash flows. As a result, the company may be unable to pay the interest and principal on the foreign loan and default. This risk applies, for instance, to local banks, other financial institutions or microfinance institutions (MFIs) that borrow wholesale from foreign lenders and use the proceeds to lend to their customers in local currency.

- Accessing long-term funding locally is particularly difficult in LDCs, where financial markets may be absent, nascent or underdeveloped. Therefore, when longer-dated funding is available, it is often from international sources with a capital base in hard currency. Emerging-market corporates and financial institutions can then secure longer-term funding needs, but not in their own currency, creating a currency mismatch. This is where organizations such as The Currency Exchange Fund (TCX—see Case Study 3: Myanmar. Currency hedging to support lending to MFIs) can come in, helping to address the shortage of solutions to hedge foreign exchange risk.

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Blended Finance in the Least Developed Countries

The need to improve the enabling environment highlights the importance of policy de-risking interventions which seek to remove the underlying barriers that are the root causes of risks. In some cases, policy de-risking—for instance, supporting policy design and enhancing institutional capacities—may take priority over project-specific blended solutions or be pursued in parallel. In the case of renewable energy, evidence suggests that policy de-risking in developing countries can be more effective—in terms of reducing project financing costs—than paying direct financial incentives to compensate investors for higher risks. In other words, it can be advantageous first to change the fundamental risk–reward trade-off that energy investors face in a given country. This topic is discussed further in Chapter 6.

While not a proxy for the enabling environment, sovereign credit ratings—published by S&P, Moody’s and other rating agencies—provide an indication of a country’s risk of default. Nine of the LDCs have an S&P credit rating; all are sub-investment grade (BB+ or below). One LDC is currently in selective default, meaning that it has breached obligations under some of its sovereign liabilities. Sovereign credit ratings can have an indirect impact on a country’s ability to mobilize private finance, in particular for projects (such as infrastructure PPPs) where the sovereign is a significant counterpart.

Overall, enabling environment, political and macroeconomic factors impact the risk premia in LDCs. While not a proxy for the enabling environment, sovereign credit ratings—published by S&P, Moody’s and other rating agencies—provide an indication of a country’s risk of default. Nine of the LDCs have an S&P credit rating; all are sub-investment grade (BB+ or below). One LDC is currently in selective default, meaning that it has breached obligations under some of its sovereign liabilities. Sovereign credit ratings can have an indirect impact on a country’s ability to mobilize private finance, in particular for projects (such as infrastructure PPPs) where the sovereign is a significant counterpart.

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There is a strong need for expanded access to energy in Nepal, and the government is evaluating how it can make the country’s renewables and other sectors more attractive to international investors.

At present, there are about 7,000MW of hydro projects under development, with investment costs of about $10 billion, or almost 50 percent of GDP. Of this, only about 3,000MW of projects have actually mobilized sufficient financing and are under construction at present, according to the World Bank. The lack of private financing will continue to constrain hydro projects from reaching financial close, and, therefore, hinder the addition of more capacity to Nepal’s grid.

The gap for renewable energy finance in Nepal is explained in part by a range of enabling environment barriers. While there is a mature market for hydro in Nepal, the solar market is still in its early stages. The government recently dropped the maximum solar tariff from approximately $9.60 to $7.30 (in local currency) per unit, limiting potential returns for commercial investors in solar. There is currently no commercial on-grid solar. Besides the lower solar tariff, other bottlenecks to attracting private investment include untested solar regulations as well as risks related to currency, sovereign credit (Nepal does not have a sovereign rating) and general project delays.

In such a context, blended finance can be an effective approach to sharing risks in ways that encourage private investors to invest in much-needed renewables projects while meeting their risk–return mandates. Instruments such as early-stage project development equity, first-loss guarantees, political risk insurance, currency hedging and concessional loans can all play a role in attracting more private capital.

As a recent example, the UK Department for International Development, together with the Dolma group, has been working on the Dolma Himalayan Climate Fund. The project seeks to catalyse private finance into photovoltaic and battery storage projects in Nepal that can address peak-energy deficits in the dry season, thereby reversing electricity imports. To this end, the project will feature political risk insurance and currency hedging as part of its strategy to ensure risk-adjusted market returns for equity investors.

**Project-specific barriers**

Blended finance plays a direct role in sharing risks that help overcome project-specific barriers—for instance, by plugging holes in certain layers of a project’s capital structure required to make it attractive to private or commercial investors, or by issuing guarantees that incentivize local financial institutions to lend to SMEs.

Understanding the project-specific barriers to private capital in LDCs highlights the most critical ‘pain points’ for blended finance to address and allows better targeting and tailoring of blended finance solutions to specific contexts. Table 5 summarizes the most common project-specific barriers in LDCs.94

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94 The list and commentary draw from the scoping studies, the synthesis paper, informal interviews as well as from evidence from the case studies presented in Part II.
Project-specific barriers vary over time and with investor experience. In many cases, private capital providers lack the in-depth understanding of LDC markets or sector expertise (particularly related to the SDGs) to accurately assess risk and make informed investment decisions. There are limited private-sector investors actively looking at LDCs; this pool of capital will be looking for greater returns due to the risks of investing in LDCs. However, as they become more accustomed to the LDCs and their opportunities and challenges, private investors should be able to engage more efficiently and perhaps perceive risks differently. This highlights the importance of sharing knowledge—of lessons, markets and past performance—as a way both to improve blended finance practices and to reveal opportunities to wider pools of investors.

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**TABLE 5.** Most common project-specific barriers in LDCs

<table>
<thead>
<tr>
<th>Barriers</th>
<th>Relevance in LDCs</th>
</tr>
</thead>
</table>
| Costly and time-consuming pipeline origination | • In untested markets, supporting pipeline development or identifying pipeline opportunities (both for infrastructure and corporate investments) requires a presence on the ground and significant time committed by an investment team.  
  • When good opportunities are identified, much work may still be required to prepare projects for investment—for instance, by improving accounting and budgeting practices or conducting the necessary feasibility assessments. |
| High transaction costs relative to project size | • Small projects, especially one-off, require high transaction costs and investors’ staff time (due diligence, negotiation etc.) compared to the returns achievable (in absolute terms and relative to the size of an investor’s overall portfolio).  
  • The cost of procuring all the services required by project preparation can be higher in smaller and more remote markets. |
| Limited credit histories         | • Even if their businesses are solid, many entrepreneurs (especially SMEs) may find it difficult to attract lenders and investors because of a lack of credit history or audited financial statements.  
  • There may also be a dearth of qualified project sponsors with an investable track record. |
| ESG compliance                   | • Some investors may not be well equipped to ensure ESG compliance, crucial to qualify for most sources of concessional finance.  
  • For DFIs and impact investors, ensuring ESG compliance may limit the pool of investment opportunities. |
| Service/tariff affordability issues | • When tariffs for a certain service are capped by social equity and affordability constraints, projects likely cannot be financed entirely on a commercial basis.  
  • Absent any concessiality, equity and/or debt providers would likely reject the deal. |
| Untested business models         | • The pursuit of some SDGs through the involvement of private capital might require testing new financing or business models.  
  • In LDCs, the financial sustainability of projects is often untested, even when they are adapted from other countries. Investors must often be willing and able to commit extra time and resources to project preparation and accept the risk that the project may not take off. |
| Lack of market data              | • In some LDCs and some business sectors within LDCs, there may be limited market data on which to base investment decisions. |

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96 Ibid.
BOX 4. Mobilizing domestic resources for an agribusiness in Benin

In the Azove region of Benin, food security is a big challenge. CIPTA is a limited liability company in the area focusing mainly on processing groundnuts and peanuts. When UNCDF first got involved, the sponsor had made significant investments in machinery, but the factory was not operating at its full capacity and needed $400,000 in working capital to purchase nuts in bulk. The project had potential to create rural jobs, increase food security and reduce malnutrition among vulnerable households, while developing local value chains.

The project sponsor had been unsuccessfully seeking financing, in large part because CIPTA was viewed as high risk by creditors. Banks in Benin typically do not invest in agribusinesses, with financing options for such businesses usually limited to short-term credit in small amounts (such as through microfinance) and subject to high interest rates. The lack of affordable financing was hampering the company’s ability to negotiate sales agreements with prospective clients, preventing it from fully exploiting its productive potential.

After conducting due diligence and assessing the project’s development impact, UNCDF believed that this was a financially viable project and that, with some support, it could become an attractive investment for domestic banks. UNCDF, therefore, initially provided technical support to help the sponsor improve the business plans and operations, strengthen the marketing strategy, prepare loan documentation and connect to potential sources of financing.

In the financing phase, UNCDF provided a seed grant of $30,000 to help the sponsor meet the equity contribution required by an external lender, and a 50 percent partial loan guarantee up to $185,000 in a risk-sharing agreement with Diamond Bank, a local bank, which intends to provide a $370,000 working capital loan. To mitigate risk, the loan facility is structured so that disbursements will be made in tranches, with the maximum amount per tranche limited to around 10 percent of the total facility.

UNCDF continues to provide both business advice to the developer to ensure loan repayment as well as technical support to ensure that the project is achieving its intended development impact.

Source: UNCDF (Abdul-Rahman Lediju and Armel Djengue).
This chapter analyses blended finance transactions and the role of the main stakeholders—private investors, concessional finance providers and governments—in three stages of the investment life cycle: pipeline and project preparation; deal design and execution; and transition to commercial replicability. It also discusses the importance of M&E and knowledge-sharing to inform and improve the work of concessional finance providers and government stakeholders throughout the life cycle. The analysis emphasizes aspects that are more critical in LDCs than in other developing markets. The tables at the end of each stage provide a checklist of relevant activities for private investors, concessional finance providers and governments, highlighting also possible risks in the process.

**Stage 1: Pipeline and project preparation**

The identification of bankable projects in LDCs can be challenging. Interviews conducted for this report as well as the scoping studies suggest that this is true in both the corporate sector (and the missing middle in particular) and the infrastructure sector.\(^97\) While infrastructure needs are typically identified in national development plans, national authorities may find that structuring infrastructure projects in an investable format, entailing some level of cost recovery via user tariffs, can be politically sensitive and technically complicated. These pipeline constraints can deter the engagement even of those investors searching for opportunities in new frontiers.

In this first stage, the role of development stakeholders is twofold: identifying opportunities, including leveraging their presence on the ground, and supporting project preparation to bring these opportunities to the point of bankability.

Interviews conducted for this report and UNCDF’s own experience suggest that deal origination generally occurs in a multitude of ways. Private investors or country offices of concessional finance providers may identify, during their normal course of business and/or interactions with government officials or other concessional finance providers, a transaction suitable to blending and initiate the contacts necessary for that transaction to happen.

In the case of infrastructure projects, government officials typically approach concessional providers for support; they may benefit from capacity-building to help them identify transactions with revenue-generating potential and engage with the different sources of private and concessional finance that could facilitate their coming to fruition. In the case of missing-middle projects, a concessional finance provider may solicit proposals from project sponsors or entrepreneurs, through competitive processes such as calls for proposal or challenge funds. In some cases, individual deals—usually infrastructure ones—emerge as part of broader policy work initiated by the government at central or local level (possibly with the support of a donor or a concessional provider).

**BOX 5. An example of a two-pronged approach to pipeline development**

The Sahel Irrigation Initiative Support Project for Western Africa is a new World Bank and IFC programme covering six LDCs across the Sahel (Mali, Niger, Mauritania, Senegal, Niger and Chad).

The Sahel region faces significant security and climatic challenges that will detrimentally impact its growing population. Significant coordination is required across borders to ensure water resource management, goods and service transfers, and a united approach to combat climate change and desertification. This initiative aims to help improve stakeholders’ capacity to develop and manage irrigation and to increase irrigated areas using a regional ‘solutions’ approach in the six countries by 2024.

The World Bank will work with public institutions to modernize the institutional framework to strengthen countries’ capacities to scale up irrigation solutions. This component of the initiative will finance assessments of land and water resources and of local production systems. It will help strengthen national organizations to drive sustainable irrigation development. It will also finance irrigation investment solutions in the participating countries through: (i) the preparation or updating of bankable investment proposals, including carrying out feasibility studies and environmental and social assessments for medium or large irrigation schemes, and assistance in mobilizing extra financing; and (ii) designing and implementing irrigation solutions for the revitalization and modernization of existing schemes and the construction of new small-scale irrigation schemes and related infrastructure.

In addition, through private-sector support dialogues, funded by the World Bank, IFC is identifying specific opportunities to support commercial private-sector engagement in the Sahel. These dialogues have convened government institutions, development partners and private-sector leaders to identify and address challenges and promote investment opportunities.

The project includes strong knowledge management and coordination elements. It seeks to collect, produce and disseminate useful knowledge and allow irrigation stakeholders to communicate with one another around solutions, while supporting efficient coordination of the project’s activities.


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**Upfront start-up and project preparation costs can be significant, especially in relation to deal size.** In LDCs, prospective investments are generally smaller than in other developing countries; this is particularly the case for missing-middle projects. Preparation activities include support to companies and entrepreneurs to upgrade their budget and accounting processes, set up corporate governance structures suitable to the injection of equity or debt capital, improve tax compliance and establish ESG procedures (among other activities). The Uganda scoping study noted that project sponsors tend to receive support limited to business development services, whereas other support measures are often also required.

High project preparation costs are compounded by the lower likelihood of a deal reaching financial close inherent in riskier markets such as the LDCs. In infrastructure deals, costs can be even higher if an LDC does not have a sufficiently developed regulatory environment; for instance, the project sponsor will need to invest significant time and resources (such as legal advice) to negotiate with the host government or regulator a suitable tariff arrangement and implementation framework. Risk assessments and technical feasibility studies produced by competent advisory firms are also necessary in infrastructure projects involving new capital investments.

Concessional finance providers can step in to support pipeline and project preparation work with a range of instruments, including grants, concessional loans (including reimbursable grants, which are, in essence, highly concessional loans), guarantees or technical assistance lines to cover, at least in part, the cost of some of the activities described above.

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The sample of transactions from the Convergence database confirms the importance of technical assistance funds (i.e., grants provided alongside investment capital) in LDCs. About 53 percent of the 38 blended finance transactions focused exclusively on the LDCs in the database used technical assistance.\(^9^9\) Technical assistance funds are most commonly deployed for pre-investment support, and legal and/or technical support required to structure the transaction. There is a growing number of technical assistance funds that provide post-investment support, particularly alongside investment into SMEs. Most of the case studies in Part II underline the importance of technical assistance coupled with a strong presence on the ground of both investors and concessional finance providers.

\(^9^9\) This is 6 percentage points higher than the figure for all (95) blended finance transactions that include LDCs, and 11 percentage points higher than the figure for the entire data set of 320 blended finance transactions captured by Convergence.

The role of technical assistance in blended projects can be seen in Uganda. There, AFD, KfW and the European Investment Bank (EIB) support the National Water and Sewerage Corporation to improve water and sanitation services in Kampala through a combination of physical interventions and capacity-building. The project started in 2011 and benefited from grants from the EU–Africa Infrastructure Trust Fund. The grants covered technical assistance and feasibility studies for a full ‘supply chain’ approach to water provision for households in Kampala. Grants from KfW made it possible for the project to expand to low-income areas and informal settlements.

**BOX 6. UNCDF’s CleanStart programme: Expanding decentralized energy access**

CleanStart is a UNCDF programme focused on expanding energy access and use for households and SMEs in LDCs, especially in remote areas requiring decentralized sources of electricity, such as solar panels.

The programme operates through a challenge fund approach, soliciting investment proposals by early-stage businesses with innovative solutions to energy access problems. Particular attention is paid to proposals that embed an innovative financing mechanism for the users of the decentralized solutions (e.g., households or businesses that need to source the capital to purchase a solar panel). Proposals are evaluated by an independent investment committee, comprising energy industry and financial experts and one UNCDF representative.

All businesses funded by CleanStart are seed/early-stage, operate in new geographic locations, or deploy new business models in a conscious effort to provide capital to entrepreneurs that, because of their untested business model and lack of track record, are not yet suitable for equity investments, let alone debt. Instead, CleanStart’s capital comes in the form of performance-based grant funding, and always as a complement to other funding identified by the promoter. The aim is to enable businesses to move up the investment curve, by lowering risk and, therefore, attracting different types of capital as businesses expand and scale up.

CleanStart also provides technical assistance to help its grant recipients move closer to becoming investable, including through business plan support, measurement of key performance indicators, preparation of investor pitches and introductions to investors and lenders.

CleanStart began deploying capital in 2015. It has since funded over 20 early-stage businesses in Cambodia, Myanmar, Nepal and Uganda.

Source: UNCDF (Vincent Wierda).
Despite the vast potential for solar power in Africa, many countries find it difficult to develop utility-scale solar power plants because of: limited institutional capacity to manage, structure and negotiate private power concessions; limited competition for tendering; and a lack of scale and, consequently, high transaction costs. Scaling Solar, a World Bank Group programme, aims to resolve such problems and help countries attract investors through a competitive selection process.

Scaling Solar focuses on the project preparation stage, offering a clearly defined process for public institutions and investors to work together by ensuring simple and rapid tendering, and providing templates of documents, transaction structuring advice, and technical expertise on the size and location of the power plant. According to the World Bank Group, this simple and transparent process helps open up regional opportunities for qualified developers looking for new markets.

Scaling Solar took off in Zambia in 2015 by supporting a government-owned company to issue a tender for solar power plants. The resulting investment has added 76MW of power to the energy network and is being scaled up to a second round. This has boosted the renewable energy market in Zambia in line with the government’s priorities to procure 200MW of renewable energy projects before 2020. The programme is now being replicated in Ethiopia, Madagascar and Senegal.

Source: Scaling Solar website (https://www.scalingsolar.org/).
### IN FOCUS: Pipeline and project preparation for blended finance in LDCs

<table>
<thead>
<tr>
<th>Goal</th>
<th>• Early-stage identification of pipeline deals that: (i) are consistent with the country’s development priorities; (ii) have strong SDG impact; (iii) offer potential for private capital involvement; and (iv) have a meaningful likelihood of coming to fruition.</th>
</tr>
</thead>
</table>
| Concessional instruments | • *Ex ante* SDG impact assessments.  
• Technical assistance as well as grants, loans (including reimbursable grants) and potentially guarantees.  
• Technical assistance and capacity-building provided directly by the concessional entity (own staff time and resources) for free or with some form of remuneration (e.g. equity participation in deal).  
• Concessional provider’s data, information, research and contacts. |
| Role of concessional provider | • *Ex ante* SDG impact assessments.  
• Engage proactively with private investors and government entities that may have pipeline opportunities (e.g. through country offices or sector programmes).  
• Assess project preparation needs and identify risks and challenges, including based on lessons learned from previous project engagement.  
• Assess the required concessional support—modality, budget, likelihood of success—and, if needed, finance it or provide it directly.  
• Facilitate government and stakeholder engagement, including to support ownership and ensure alignment with national priorities, and uphold ESG and other relevant standards.  
• Coordinate project preparation facilities with other providers of concessional resources. |
| Role of private capital | • Identification of potential opportunities.  
• Engagement of concessional finance providers that can support preparation work.  
• Constructive relationship-building with government and public stakeholders.  
• Lead project preparation work (especially in the case of direct investors).  
• Ensure from an early stage compliance with ESG requirements of concessional providers, and establish appropriate monitoring and reporting processes. |
| Role of government institutions | • Identify pipeline opportunities, especially infrastructure projects, in the context of broader policy programmes and national priorities.  
• Alert sources of private and concessional finance and expertise instrumental in getting deal off the ground.  
• Support engagement of relevant local stakeholders, including subnational government entities and project beneficiaries.  
• Identify necessary regulatory interventions, process and timing. |
| Points of concern | • Pipelines are sourced in an *ad hoc* manner skewed to ‘easier’ projects from a financial standpoint, even if development additivity is limited.  
• Too many concessional resources and time dedicated to a project that is too small, not easily replicable or highly unlikely to get to financial close.  
• Lack of alignment with national priorities.  
• Concessional providers, driven by institutional incentives, are eager to close the deal even if that means compromising on the principles of blended finance (e.g. minimum concessionality). |
**Stage 2: Deal design and execution**

In this stage of a blended finance transaction, investors conduct due diligence and valuation work and negotiate the most advantageous terms to bring the project to financial close. Concessional finance providers work alongside them to identify the most effective and efficient capital structure and use of concessionality to get the specific deal off the ground.

In almost all cases, blended finance solutions will be tailored to the specific deal context and investor; it is very rare that off-the-shelf solutions apply to different deals. The complexity and specificity of blended finance transactions often requires concessional providers to play a multifaceted role.

First, the type and quantity of concessional finance required to achieve financial close can vary significantly from one project to the next, with greater concessionality required on average in LDCs. This may come in the form of a larger portion of concessional finance, more generous terms and pricing and/or the use of multiple concessional instruments in tandem. As highlighted in the case studies in Part II, it is not unusual for deals in LDCs to require technical assistance, investment-stage grants as part of the capital structure, guarantees and concessional loans all in one package.

The OECD data show that the three sectors with the greatest volume of private finance mobilized in LDCs benefited from the most diverse mix of financial instruments. For industry, mining and construction, for instance, 66 percent of reported private finance mobilized in LDCs used guarantees, followed by 14 percent using syndicated loans and 11 percent using common shares in collective investment vehicles. The energy sector similarly used guarantees and syndicated loans, but 9 percent of private finance mobilized was done through direct investment in companies.

Second, concessional finance providers play an important role in identifying, managing and measuring the social and environmental impacts of private-sector deals in LDCs. Especially in the case of infrastructure projects, providers should use their influence so that blended deals not only ‘do no harm’ but also include a focus on the SDGs.

A recent evaluation of blending by the European Commission recommends that concessional finance providers: (i) analyse the poverty and employment profile in the project area, considering explicitly the needs of poor people and related protective measures; (ii) ensure that projects with infrastructure or macroeconomic development goals maximize downstream employment prospects (e.g. improved electricity supply can expand SME activity); and (iii) select partners such as MFIs, if possible, which will be effective in reaching poor people.

Third, concessional finance providers are often required to be flexible and innovative, which can be critical to achieving financial close on deals in LDCs. For instance, providers may have to: work with project sponsors or fund managers new to a country or without a long track record; focus on pre-operational greenfield infrastructure; support the application of new technologies or new business models, or adapt proven technologies or business models, to new contexts; operate in the framework of new and untested policy and regulatory frameworks; or work in a sector or subnational region with little track record of private finance flows. In the case of Bangladesh, there are suggestions that entrepreneurs who were part of blended finance deals supported by DFIs were subsequently able to leverage their track record to mobilize additional funds.

Providers can also use non-financial instruments to attract private investment, including access to information and research, direct technical assistance, networking and policy dialogue. Experimentation can also come in the form of developing new tools and instruments to alter risk–return ratios. The guest piece from Roots of Impact showcases the organization’s development of an approach to mobilizing private finance by rewarding market-based social enterprises with premium payments for achieving social impact.

Fourth, concessional finance providers could leverage partnerships and expertise from their large networks. In LDCs, intermediaries can play an important role, especially in sectors with a large number of beneficiaries and small individual financing tickets. Microfinance is an example. As the Myanmar case study shows, facilitating $86 million worth of wholesale borrowing by local MFIs through subsidized foreign exchange hedging resulted, downstream, in the issuance of loans to over 337,000 people.

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92 See the guest piece by Jonny Gill, ‘Paving the way: Creating a track record for mobilizing private capital in risky markets’.

**BOX 8. The African Guarantee Fund: Six years on**

The African Guarantee Fund for Small and Medium-sized Enterprises (AGF) was established in 2012 to improve access to finance for SMEs in Africa. AGF was formed through a joint effort by the Danish International Development Agency (DANIDA), the Spanish Agency for International Development Cooperation and the African Development Bank (AfDB). Since then, AGF has attracted other partners such as AFD and the Nordic Development Fund, as well as a re-guarantee line from the Swedish International Development Cooperation Agency (Sida). AGF received a rating of AA- by Fitch International in 2017. This is the highest rating issued to a non-bank financial institution in Africa.

AGF operates in 25 LDCs and has a twofold mandate: ensure financial sustainability of SMEs and contribute to social impacts in the form of jobs, financial inclusion for women and youth and positive environmental impacts. It provides a partial guarantee cover that is generally 50 percent of a total loan facility. This is designed to increase the appetite of partner financial institutions, such as domestic commercial banks, to provide financing to SMEs they typically otherwise find too risky to support.

AGF complements its guarantee products with capacity development grants, which help partner financial institutions and SMEs enhance the technical competence of their staff and improve their internal operational capabilities focusing on systems, policies, and information and technology support.

In the last six years, AGF has issued guarantees worth $780 million to 125 partner financial institutions, leveraging about $1.5 billion in financing available for SME lending. Because of the guarantees provided, partner financial institutions have to date disbursed about $1 billion in loan facilities to over 20,000 SMEs, of which 30 percent are owned by women.

AGF data show that the average SME portfolio among partner financial institutions has increased from 25 percent of the total loan portfolio in 2011 to 31 percent in 2017. In AGF’s view, guarantees will remain important to cover the risk associated with the growing number of new SMEs in Africa, in particular in sectors considered riskier by lenders, such as agriculture and commodity trading.

Source: African Guarantee Fund (Emmanuel Rutsimba).

Five points of concern are worth highlighting when it comes to deal design and execution:

First, a lack of effective coordination between various stakeholders can result in deals not coming to fruition, or excessive (or insufficient) use of concessionality—though it is often not clear until later, if at all, whether concessionality was deployed optimally. There is a related concern about ensuring that risks and rewards are fairly shared, since blending involves transferring risks to the public sector to improve returns for the private sector.

The synthesis paper produced by Southern Voice suggests that LDC officials are often unaware of blended finance approaches and the full spectrum of financiers for infrastructure or missing-middle projects. Investors, for their part, may also not know the full suite of blended finance tools and providers in the country, have access to relevant government stakeholders, or have the expertise to incorporate ESG considerations in their projects (as required by concessional finance providers).

Awareness-building initiatives—such as existing or specially created blended finance forums, expert group meetings and wider broadcasting of blended project evaluations—can help address these issues. These initiatives should also seek to share lessons and information among countries from the South, so that LDCs can learn from MICs and vice versa.
Second, some concessional finance providers or LDC government officials may lack private transaction expertise or experience, resulting in cumbersome relationships with private investors during deal design and execution; sometimes this can itself be a deterrent to private capital. In addition, some domestic DFIs lack the human capital and internal capabilities to fulfil their mandates or live up to their potential when it comes to blending.

Third, institutional mandates and incentives may result in the application of one blended toolset even if it is not the most efficient for a certain transaction. Concessional finance providers sometimes focus on a limited range of those tools at their disposal which they have an inherent incentive to deploy. This may lead to missed opportunities for innovation or for cooperation with other concessional finance providers that have a complementary toolset, perhaps one more appropriate to the deal under consideration.

Fourth, a lack of local participation can mean that projects are designed and structured in ways that negatively impact communities. This also speaks to the importance of ensuring that projects have robust accountability and transparency mechanisms attached to them.

Fifth, because of the project specificity of blended finance, transaction costs to get a deal to financial close can be high, especially in relation to ticket size. This problem is compounded by the complexity to access, and fragmentation of, some concessional funds and facilities; this complexity requires time and effort to navigate by project sponsors and private investors alike.

Knowledge transfer within organizations (e.g. different country offices of the same concessional provider) or among organizations (e.g. different providers in the same country, region or sector) can generate important synergies in the deal design and execution phase. Similarly, creating pooled approaches, facilities or platforms to replicate blended finance deals (to the extent possible) could accelerate deal execution, help avoid common mistakes, enhance benchmarking of results achieved and support scalability.

105 See, for example, the guest piece by Aniket Shah, ‘Policy consistency, capability traps, and development finance institutions: An important nexus’.

Five points of concern in relation to deal design and execution:

1. Lack of effective coordination between stakeholders; risks and rewards need to be fairly shared
2. Limited private transaction expertise of concessional finance providers or LDC government officials
3. Institutional mandates may limit tools or instruments applied
4. Lack of local participation; accountability and transparency
5. Transaction costs can be high in relation to ticket size
### IN FOCUS:
### Design and execution of blended finance deals in LDCs

<table>
<thead>
<tr>
<th>Goal</th>
<th>• Achieve financial closing of a blended transaction with the minimum use of concessionality and the most appropriate mix of concessional instruments to the project at hand.</th>
</tr>
</thead>
</table>
| Concessional instruments | • Concessional tools tailored to the specific transaction, local context, sector (e.g. infrastructure vs. missing middle), project or company size and stage of business development.  
  • These typically include grants, guarantees, concessional loans, technical assistance and first-loss equity tranches. |
| Role of concessional provider | • Convene private capital, government stakeholders and other concessional providers around a promising transaction.  
  • Analyse the barriers that give rise to the need for concessional finance.  
  • Design and negotiate a blended finance package that addresses the barriers identified and complies with the minimum concessionality principle.  
  • Liaise between private capital and government when the transaction has a regulatory angle.  
  • Require and agree impact metrics and M&E procedures with private investors.  
  • Require investors to undertake regular ESG monitoring and reporting.  
  • Provide technical assistance to ensure competitive tendering and bidding processes.  
  • Plan for a possible exit when concessionality comes to an end.  
  • Share, at a minimum, non-commercially sensitive information to boost transparency and knowledge-sharing. |
| Role of private capital | • Engage in standard investment activities (due diligence, valuation, negotiation etc.).  
  • Identify barriers to full commercial return and possible concessional solutions suitable to making the transaction profitable on a risk-adjusted basis.  
  • Contact concessional finance providers, if known.  
  • Agree impact metrics and ESG standards and undertake associated monitoring and reporting to providers. |
| Role of government institutions | • Convene and reach out to private capital and concessional finance providers about a promising transaction (a role more likely to be required in infrastructure deals).  
  • Promote public stakeholder engagement.  
  • Facilitate project approval process, if relevant to the transaction, and set tariffs for services from infrastructure in compliance with social equity considerations.  
  • Ensure the transaction’s fit with national priorities.  
  • Ensure that blended transactions (for infrastructure projects in particular) have clear accountability mechanisms attached to them. |
| Points of concern | • Concessional resources are over- or underused.  
  • Effective coordination between private investors, concessional finance providers and government stakeholders is lacking, leading to project failure, delay or poor design.  
  • Concessional finance providers and government stakeholders do not have sufficient private transaction expertise.  
  • Complexity of navigating concessional funds and facilities acting as a deterrent for private investors.  
  • Concessional finance providers prioritize the application of blended instruments available in-house, even if not ideal for the transaction.  
  • Governments build up unsustainable contingent liabilities or take on risks they cannot manage. |
**Stage 3: Transition to commercial solutions**

In most cases, blended finance solutions should be time-bound, temporary fixes designed to contribute to commercial replicability and long-term sustainability of the sector or project in question, especially where ODA is involved. Having a plan for credibly phasing out concessional support can avoid creating a permanent dependency on long-term concessional finance.

Concessional finance providers should actively work towards this goal, even in LDCs where market development needs are more pronounced and concessional support may be most in need to get deals done. In the case of SMEs, or sectors such as telecommunications where there may be more limited social equity considerations around the provision of services, concessional finance providers should get involved when there is a realistic expectation that a blended deal could trigger future investments in similar projects and will gradually require less concessionality. Boxes 9, 10 and 11 discuss examples of such transitions.

**BOX 9. From demonstration effects to replication: Rural banking in Malawi**

In 2012–2016, UNCDF supported NBS Bank in Malawi and Women’s World Banking, a technical assistance provider, via a performance-based grant. The aim was to incentivize the bank to develop a tailored savings account to expand access for poor, unbanked people in rural areas, especially women. Called the Pafupi Savings account, it relies on agency banking, mobile technology and community-based marketing to reach rural women where they are and mobilize domestic savings. As an institution, NBS Bank gained new client insights, developed new product delivery channels and tapped into a new market as a result of the introduction of Pafupi Savings.

Two factors were key to introducing the new product successfully:

First, Malawi’s regulatory environment allowed for the introduction of Pafupi Savings. The Reserve Bank of Malawi had existing regulations in place for a simplified ‘know your customer’ account with small balance limits. NBS Bank engaged the regulator to increase the balance limit to better align with the savings capacity of the target market.

Second, Women’s World Banking hosted a learning exchange for NBS Bank’s product and executive leadership team. The group visited Kenya to learn about the opportunities and challenges in developing agent networks. Through this exchange, NBS Bank gained new energy to explore mobile-based solutions and a better understanding of how to organize its agency banking team, leading them to advocate successfully for regulatory support.

Pafupi Savings not only demonstrated the value of investing in digital financial services to serve new client segments, but it also paved the way for regulatory changes in Malawi that have led to other institutions designing products that bring underserved communities into the formal financial sector.

Source: UNCDF (Pamela Eser).
**BOX 10. bKash: From innovation to scale**

bKash is a mobile financial services platform focused on providing affordable and easy ways for both the unbanked and underbanked populations of Bangladesh to store limited funds, transfer and receive money and make payments via basic mobile phones. bKash did not pilot-test; rather, it aimed to scale up from launch and took a ‘learn as you do’ approach. Today, it has a network of more than 180,000 agents throughout urban and rural areas, serving over 30 million registered accounts.

bKash was launched in 2010 through a joint venture between the US company Money in Motion and a leading private commercial bank in Bangladesh, BRAC Bank, with the intention to expand financial services to poor segments of the population. To get the idea off the ground, a $10 million grant from the Bill and Melinda Gates Foundation which supported bKash’s development, including technical assistance linking bKash to mobile financial services expertise from Kenya, was key in complementing Money in Motion’s $5 million in seed capital. In 2014, the Bill and Melinda Gates Foundation also became a minority equity investor, preceded by IFC in 2013.

bKash has played a major role in building Bangladesh’s mobile financial services market and remains a market leader in this sector, also propelled by a flexible and clear regulatory environment that crowded in investors. In early 2018, the Chinese firm Alipay, one of the world’s top third-party mobile and online payment platforms, became an additional investor with a view to improving bKash’s technological capabilities.


**BOX 11. Supporting local bond market development in Cambodia**

With the support of the IDA18 Private Sector Window, IFC is investing the equivalent of up to $20 million to participate in Cambodia’s first-ever local currency bond. The bond will be issued by Hattha Kaksekar Limited in an amount of up to the equivalent of $30 million in Khmer Riel and will have a three-year tenor. Hattha Kaksekar Limited is the third largest deposit-taking MFI in Cambodia.

The Private Sector Window Local Currency Facility provides an open foreign exchange swap with IFC of up to $20 million to cover the currency risk to enable IFC to subscribe to the bond in the local currency as an anchor investor. Without this support, this transaction would not be feasible. Swap rates from alternative providers would translate to end consumer loan pricing levels that are too high.

The project’s goal is to increase lending to rural micro and small enterprises, including women entrepreneurs, who have limited access to loans in local currency and are, therefore, exposed to foreign exchange risk. It is projected that the financing will translate into a 60 percent increase in outstanding Khmer Riel-based loans by 2020, with a strong focus on increasing loans to women, and that the project will deepen the local currency funding pool and create a replicable model.

The development of a local bond market, coupled with incentives to promote the use of local currency, is a key step to help foster domestic savings and progressively attain exchange rate flexibility. A successful transaction could demonstrate that the legal and infrastructural frameworks for local bond issuance are in place and are feasible.

Source: Factsheet on approved projects provided to authors by IDA18 Private Sector Window.
It is important from the outset that concessional finance providers plan for what happens after a particular blended finance project has come to fruition. This planning will depend on the kind of project in question and its profitability. In the case of infrastructure, if a country is growing and GNI per capita increasing, this could entail recommending gradual tariff increases for a utility’s services. This could help a project become profitable over time, reducing or obviating the need for public support. Similarly, missing-middle projects would usually be expected to be profitable. In both these cases, concessional finance providers supporting further rounds of projects in that sector or country may be able to phase out or reduce concessionality over time. This is a very ambitious agenda, but, nevertheless, one that many concessional finance providers seek to pursue to make the most out of their concessional resources.

In such instances, in this transition stage, concessional finance providers may: start to provide financial support on increasingly commercial terms; use their networks to seek out additional investors willing to participate; and share best practices from previous deals that could help lower deal evaluation and execution costs for prospective new investors.

The transition from blended to fully commercial finance, however, may not always be smooth for three main reasons:

First, in some infrastructure projects, overall social and macroeconomic conditions in the country may not have improved to a level that allows full market pricing of the services provided by a project. Sometimes, even in developed countries, there may be a continued subsidization of services for social reasons. The result is that public support may still be necessary. Especially as LDCs graduate and risk losing access to concessional finance, the goal may be for governments to take over and provide such support from their domestic budget, rather than relying on ODA.

Second, some enabling environment barriers may persist, such as regulatory bottlenecks and currency volatility. In these cases, there may be a need for concessional support for the foreseeable future, though this needs to be provided in a way that does not substitute for, delay or, worse, disincentivize required policy changes.

Third, where enabling environment barriers are larger, there may be a higher risk of blending only having a temporary impact, benefiting mostly those directly involved in a specific deal. This could limit broader market development impacts.

Nonetheless, even in these cases, exit strategies for phasing out concessional finance should still be considered, though this may mean adopting a longer-term time-frame.

Figure 20 provides a stylized illustration of how the transition to commercial sustainability may occur in a given sector over time. The amount of capital invested in the sector increases over time, as its commercial potential becomes more evident. At the same time, concessionality decreases. It should be noted that this is a simplification that ignores, for instance, macroeconomic developments that could have a much bigger impact—positively or negatively—than the deployment of concessional resources in the sector.

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**FIGURE 20. Stylized market development and source of capital**

*Note: The ‘sweat equity’ would mostly be the developer’s or entrepreneur’s equity, though occasionally a provider of technical assistance may also be remunerated in equity.*

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106 See, for instance, ‘Case Study 3: Myanmar. Currency hedging to support lending to MFIs’.
**IN FOCUS:**

**Transition to commercial solutions in LDCs**

| Goal | • For concessional finance providers: weaning the project off concessionality in the future, if possible and appropriate to the project in question, depending on the circumstances, the goal may include broader market development.  
• For commercial or private investors: realization of target returns. |
| Concessional instruments | • Evaluation of a possible reduction in the concessionality package for the next deal; this may be more appropriate for the corporate sector than for infrastructure deals, where there may be a need for continued public support (for tariff affordability reasons) for a longer period. |
| Role of concessional provider | • Assess potential and structure of its involvement with the project in a subsequent blended deal, as appropriate and relevant.  
• Extract lessons learned to facilitate replication and support innovation.  
• Conduct ex post evaluations on project results and impacts, and publicize findings.  
• Evaluate how to scale up similar future interventions through platforms (e.g. to address SME finance gaps). |
| Role of private capital | • For equity investments, identify exit options that maximize returns.  
• For debt investments, obtain repayment of principal at maturity, in compliance with loan agreement.  
• FDI and direct domestic investors may continue to be involved for the foreseeable future as long as they are able to make risk-adjusted returns, even when concessionality decreases.  
• Investors may be searching for new opportunities in the same sector or country, perhaps without the need for concessional resources. |
| Role of government institutions | • Create a supportive enabling environment, through policy actions sometimes prompted or informed by the blended finance project itself.  
• If needed and where applicable, provide continued public support once external concessional resources decrease (especially in the case of infrastructure projects where there are social equity considerations). |
| Points of concern | • Concessional finance providers and government fail to capture lessons learned or use the transaction to inform policy or regulatory reform.  
• Stakeholder engagement is lacking, and project implementation is not well managed or delayed; especially in the case of public services delivered through PPPs, this could lead to negative public perception, reducing any chance of scalability or commercial replicability.  
• Governments and concessional finance providers fail to assess potential risks as they pertain to a country’s debt sustainability, if governments take on financing that is less concessional in order to support a project’s continuation. |

**In parallel: Monitoring, evaluation and knowledge-sharing**

It is critical that blended finance deals are held to the same level of scrutiny as other activities supported by ODA, and report on similar metrics. Transparency and results measurement are of importance throughout the project life cycle, as is the need to capture lessons and share knowledge and experiences.

Ensuring development additionality has been one of the main points of concern in blended projects, in part because of the limited availability of reliable evidence on the sustainable development impact of such operations. \(^{107}\)

An evaluation of blended finance activities commissioned by the European Commission found that blending projects under review had often been of high quality and had mobilized additional finance, but that they generally had had a modest impact on poverty. \(^{108}\) As is the case for many private-sector development interventions, most evaluations also reveal the difficulty in attributing observed results to the blending operation or measuring its net contribution. \(^{109}\)

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Project-level M&E must feed into broader knowledge transfer and stakeholder engagement. While established practices are typically in place for M&E during the deal execution phase, concessional finance providers should nonetheless play a more proactive role in defining impact metrics and goals ex ante, already in the deal preparation phase. Conducting ex ante impact assessments may not always be a condition for a project to go ahead. The evidence from the scoping studies suggests that some projects may not perform such assessments, focusing in some cases more narrowly on ESG assessments. A related challenge is that there are no universally standardized approaches or benchmarks that can be used in conducting such impact assessments. Concessional finance providers have significant influence on the decision of investors to monitor impact and should use that leverage from the early stages of blended deal-making.

Many blending projects have not monitored development impacts, and evaluations are not routinely made publicly available. Ex post evaluations have yet to become a common practice. This is perhaps a natural consequence of the investment cycle: investors and concessional finance providers exit a deal and focus their resources on the next one. For those blended funds and facilities that are newly established, it is too early to expect a meaningful evaluation. Another challenge is that different providers adopt different standards and frameworks for measuring impact.

Nonetheless, donor governments should work towards ensuring that blended finance funds and facilities support strengthen the quality of their M&E with sustainable development impact in mind. It is also important that ex post evaluations not only focus on project-specific impacts but, to the extent possible, also adopt a wider perspective to examine broader impacts on market development and enabling environments. For their part, LDC governments can also support more M&E. In Uganda, for instance, the government has established a national coordination framework for monitoring and evaluating all government programmes for impact.

**BOX 12. Evidence of M&E in blended finance funds and facilities worldwide**

The OECD survey on blended finance funds and facilities found that:

- Blended finance facilities are effective in pushing for M&E: evaluations were performed out of contractual obligations by 65 percent of blended finance facilities.
- More than 88 percent of facilities and 74 percent of funds responding to the OECD survey have a formalized M&E function.
- However, the M&E effort is fragmented, and the quality and completeness of information collected need to be improved. For instance, monitoring of economic, social and environmental indicators is more frequent than that of governance indicators.
- In blended finance, as in most development cooperation, monitoring rarely continues after the end of project implementation.
- External accountability of blended finance vehicles is weak. More than half of survey respondents do not make evaluation reports public.
- Blended finance M&E captures deal-specific performance indicators well, but it does not usually extend the analysis to impact at the project beneficiary level. The focus is often on financial indicators such as private capital mobilization ratios.


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In addition to M&E, it is also important that deliberate efforts are made to capture and share knowledge of what works and what does not.

First, sharing findings from evaluations boosts transparency. Second, sharing knowledge can help other concessional providers adapt their strategy, activities and toolset, especially in difficult markets. It can support relevant South–South exchanges among governments and other national stakeholders and demonstrate to investors the potential opportunities in underserved markets. Third, the lessons captured through M&E or programme reviews by donors and providers can also be instrumental for engaging in policy dialogue with governments and provide the evidence base for government-led reforms. Fourth, showcasing successful blended transactions can contribute to the establishment of an investor’s track record (which in turn facilitates future fundraising, if the investor is a fund manager), highlight investment opportunities and perhaps bring risk perceptions closer to the actual risks of investing in a country or sector. All these factors should be conducive to increased investor interest and, possibly, private capital flow to a country or sector.

**BOX 13. Challenges of measuring blended finance in LDCs**

Designing blended finance interventions with M&E in mind is an essential step to ensuring accountability and value for money for public resources channelled to the private sector in developing countries, and for learning what works and in which development context. It also helps build evidence around the financial performance of blended finance with a view to mobilizing additional commercial capital.

M&E can be especially challenging in the context of LDCs, some of which are affected by crises or face constraints holding back their sustainable development, such as weak state policies and institutions. There may also be challenges with the availability and quality of data which can hamper robust measurement of the development and financial results of investments.

The OECD DAC principles for measuring the results of blended finance remain relevant:115

- Agree on performance and result metrics.
- Track financial flows, commercial performance and development results.
- Dedicate appropriate resources to M&E.
- Ensure public transparency and accountability on blended finance operations.

In LDCs, providers might need to make special efforts to employ further measures, such as:

- Promoting flexible and innovative M&E approaches to ensure continued appropriateness to what can be fast-changing contexts;
- Using and strengthening M&E country systems where possible, while addressing data availability and reliability issues;
- Monitoring risk factors especially closely, such as institutional weakness, operation- and management-related challenges or lack of technical skills;
- Dedicating greater resources to M&E (taking into account, for example, security and logistics costs); and
- Ensuring that M&E practices ‘do no harm’ (e.g. that providers consider the conflict sensitivity of interventions while implementing M&E, maintain flexibility during M&E etc.).

Source: Aide à la Décision Economique S.A. (Vincent Coppens and Virginie Morillon).

CHAPTER 5

BLENDED FINANCE AND DEVELOPMENT EFFECTIVENESS

ODA is a scarce resource, which needs to be spent as effectively as possible to help countries achieve the SDGs. There are long-standing principles of development effectiveness related to the use of ODA. Where ODA is involved, blended transactions should meet those same standards.

A number of principles related to blended finance have been articulated in recent years. Embedded in the Addis Ababa Action Agenda, for instance, Member States agreed on a set of overarching principles for blended finance and PPPs. In October 2017, the OECD DAC approved a set of blended finance principles for unlocking commercial finance for the SDGs. These were also referred to in the June 2018 G7 commitment on innovative financing for development agreed in Canada. Also in October 2017, a working group of DFIs proposed five principles, enhanced with detailed guidelines, on blended concessional finance for private-sector projects.

These sets of principles share many common elements that are of relevance to the use of ODA in blended transactions in LDCs. As already discussed in Chapter 1, the overarching goal of blended transactions should be to mobilize additional private or commercial finance in support of the SDGs. Four other sets of issues are also important:

**Blended finance should support alignment with, and ownership of, the national development agenda**

Blended finance should reinforce, and not undermine, broader development efforts being made by national authorities. Having concessional providers align their support to a blended project with national plans is critical, so that national authorities can deliver on their own priorities. This takes on added importance in the case of LDCs; many governments already have their capacities stretched thin by having to coordinate a multitude of partners and their aid programmes in different sectors. Adding blended transactions to the mix can make that task more complex. Moreover, projects that are aligned with national priorities and plans and that involve local and national actors should be better able to progress from individual projects towards improving the enabling environment.

Blended finance, especially when ODA is involved, should also reinforce broader development efforts being made by LDCs. That is, blended finance should support local ownership and national development agendas.

In interviews for this report, some DFIs emphasized the importance they place on supporting alignment and ownership in their operations, noting that blended finance projects (especially infrastructure) are usually initiated and designed in response to requests by national authorities and that their boards do not approve projects that are not based on close consultation with the government. Fully involving not only national and local authorities but also domestic civil society, the private sector and communities affected by a project can help ensure the delivery of more sustainable results suited to local needs, including a pro-poor focus. Supporting ownership also means working towards local value retention, ensuring that linkages are built with local suppliers and entrepreneurs and strengthening domestic industry.

Still, there is some evidence that suggests the involvement of recipient countries in decision-making is fairly low in blended finance. Understanding more about recipient-country and community involvement in decision-making is a topic that requires further research. It would also be important to understand better how issues of alignment and ownership feature in the operations of Southern providers of concessionality.

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118 The nine DFIs in the working group are: EBRD, IFC, ADB, IDB, ADB, EIB, ICD, AIIB and EDFI. The principles can be found in the working group’s Summary Report. [https://www.ifc.org/wps/wcm/connect/506330ce-1c81-42a9-97b6-25514a9626c8/DFIs+Blended+Concessional+Finance+for+Private+Sector+Operations_Summary+Report.pdf](https://www.ifc.org/wps/wcm/connect/506330ce-1c81-42a9-97b6-25514a9626c8/DFIs+Blended+Concessional+Finance+for+Private+Sector+Operations_Summary+Report.pdf)


121 Ibid.


Reconciling blended finance with ownership can be challenging, for several reasons:

First, many LDCs are heavily dependent on ODA to fund the provision of basic infrastructure and social services or to strengthen systems and institutions—and this need for ODA will continue to be essential to their development prospects. These sectors are often not suitable for blended finance. Without an increase in the overall level of aid, if donors decide to deploy more ODA for blending, this may result in a decrease in its use for traditional purposes and its diversion towards projects which generate returns. This is against a backdrop in which the share of budget support for LDCs has declined in recent years, despite being an aid modality particularly well aligned with national ownership.

Second, blended finance may become a back door to increased use of tied aid. It is very difficult to quantify precisely how much aid is tied in practice, but data confirm that domestic firms in donor countries are the biggest beneficiaries of donors’ aid contracts. In 2014, donors reported to the OECD on individual aid contracts within the scope of the DAC recommendation on untying aid: 46 percent of the value of these contracts was awarded to firms in donor countries, and 38 percent to developing countries, of which some 4 percent went to firms in LDCs or Highly Indebted Poor Countries. Whereas the overall average contract size awarded in 2014 was $3.7 million, the average volume for contracts awarded to LDCs was $0.5 million. Some concessional providers involved in blended finance may be mandated to secure aid contracts for companies from the donor country. This has led to calls for ODA that is used to support the private sector directly (as in blending) to benefit domestic companies in the programme country.

Third, lots of government involvement may be a deterrent to private investors seeking swift deal execution. Government involvement will vary by country, sector, and project. Some projects, especially those targeting the missing middle, may not require the involvement of national authorities, at least at the central government level, though local governments might need to be engaged. On the other hand, other blended finance projects—especially those involving infrastructure for the provision of basic services—require close collaboration with governments and regulators.

Fourth, blended finance may not feature in LDCs’ financing strategies or planning frameworks. The scoping studies note that there is hardly any reference to the concept of blended finance in national policy documents.

Fifth, when regulatory capacities and supervision are weak, it can be more difficult for national authorities to take ownership of blended finance projects. Evidence from the scoping studies suggests that the institutions and regulations that are currently in place to accommodate the leveraging of private capital towards national development priorities are usually in the context of PPPs; these institutions and regulations may, therefore, need to be amended to cover also blended transactions.

Concessional finance providers engaged in blended finance can play a role in addressing some of these challenges. For instance, and as some already do, they can engage more systematically with LDC governments—and other key national stakeholders, including civil society, local governments and impacted communities—at a strategic level to ensure that their overall project portfolios support national development goals.

They can also contribute to strengthening the capacities of both national and subnational authorities to engage in identifying, analysing and structuring blended finance deals in ways that share risks and rewards fairly. Local governments, for example, can potentially play a greater role in identifying revenue-generating projects with transformational impact on local economies and seeking concessional resources to get them off the ground.

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124 Ibid.


131 Ibid.


134 Development Initiatives (2016b). ‘Aligning blended finance with the Busan principles of development effectiveness’. This report highlights how the concept of national ownership has evolved and broadened to include the concept of democratic accountability and consultations with civil society, the private sector and citizens.
BOX 14. Electrification in the Atlantic province of Benin

In Benin, the Société Béninoise d’Energie Electrique (SBEE) cooperates closely with AFD and the EIB to provide reliable electricity to Abomey Calavi, a major commuter town near Cotonou, and the surrounding rural areas in the Atlantic province. This project, which started in 2015, was conceived by the SBEE and designed through close consultations between AFD, the EIB and the SBEE. Energy is a key development priority in Benin, and every six months a sectoral review takes place during which the government discusses its plans and policies in the field of energy with development partners.

The total project was just under EUR66 million. The EU–Africa Infrastructure Trust Fund contributed EUR20 million in grants; this provided a sufficient level of concessionality for the project to reach 82 rural localities in line with the SBEE’s focus to provide energy services in rural and poor areas. In addition, AFD and the EIB contributed EUR20 million and EUR18 million, respectively, in concessional loans, and the SBEE provided EUR7.4 million to support, inter alia, operations.

This project is characterized by a high level of coordination among the parties. To simplify the interactions between the SBEE and the concessional capital providers, AFD acts as a chef de file (lead financier) for the project. A steering committee also meets every six months to review the implementation of the project.


BOX 15. Ownership and domestic DFIs

Many LDCs have national development banks or other domestic financial institutions that are set up to help fund national development plans and could potentially play a much greater role in crowding in private investors. By blending concessional resources with their own, more expensive sources of finance from capital markets, national DFIs can potentially reduce the cost of capital for projects.

Supporting such institutions may require donors and providers not only to channel concessional resources through them, but also to help build their capacities to source, structure, implement, manage and monitor deals. For instance, the Uganda Development Bank is mandated to mobilize capital in line with the national development strategy, but in practice has played a very limited role in blended finance transactions, in part because of lack of capacity and limited resources.135

Examples of domestic DFIs captured in the scoping papers include the following institutions:

• The Senegalese Strategic Investment Fund (FONSIS) was launched to help facilitate private-sector investments in strategic sectors aligned with the national development plan.136

• The Uganda Development Bank is mandated to finance enterprises in important growth sectors of the economy, and is a key partner supporting the government to deliver on its national development plan.

• The Bangladesh Infrastructure Finance Fund Limited seeks to attract private investment for infrastructure projects.137 Other domestic institutions in Bangladesh that support private-sector investment include the Infrastructure Development Company Limited and the Investment Promotion and Financing Facility II.138

• In Nepal, the Town Development Fund provides long-term financing to local governments as well as support to municipalities to identify and implement urban development projects. The Hydroelectricity Investment and Development Company Limited was set up by the government as a special purpose vehicle to address the country’s energy needs through the development of hydropower.139

135 See the guest piece by Patricia Ojangole, ‘National Development Banks: The view from Kampala’.
137 See the guest piece by Formanul Islam, ‘Financing infrastructure in Bangladesh: Ways forward’.
**BOX 16. Blended finance and integrated financing frameworks**

The United Nations Development Programme (UNDP) Development Finance Assessment tool is an example of an effort to support governments and their partners in identifying and building consensus around solutions to address development financing challenges. Lessons from early assessments, such as Mozambique, indicate the importance of different financing modalities, including blending, while also ensuring that transparency and accountability systems are in place to maintain country ownership and alignment of all flows—public and private—to national priorities.

Mozambique’s National Development Strategy, 2015–2035, recognizes private-sector contributions to development as vital to achieving its aims. Specifically, it names mobilizing increased foreign investment and fostering the growth of the domestic business sector as key catalysts for achieving overall development. As such, the Mozambique Development Finance Assessment, completed in July 2017, commits substantial analysis to private-sector engagement issues.

In addition to providing an overview of current private and public inflows, the Assessment highlights the need for robust national systems to measure SDG additionality and for strengthened monitoring systems to track project impacts. With regards to the development of an integrated national financing framework for the country, the Assessment notes the need to consider how to harness effectively private flows to finance national development priorities.

Source: UNDP (Yuko Suzuki and Piper Hart).

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**Blended finance must comply with high standards of transparency and accountability**

Promoting greater accountability and transparency is necessary to ensure that ODA goes where it is most needed and has the greatest development impact, and so that affected LDCs and communities are fully informed and consulted about activities that affect them. In all deals, every stakeholder should be accountable for its role in delivering results, with clear accountability mechanisms in place. Concessional finance providers must adhere to best practice, as many indeed already do, when it comes to disclosure of their blended finance portfolios, concessional resources committed and success or failure in achieving the desired development impact without disproportionately distorting markets.

Another reason why transparency is important is related to sovereign debt sustainability. As noted in Case Study 4: Rwanda, for example, the government is the guarantor of a project. Contingent liabilities such as these—created by some blending strategies, including PPPs and other mechanisms—need to be carefully managed. They are often poorly understood and not captured in available data, and can exacerbate debt crises if the risks are realized.

One of the challenges with ensuring transparency, however, is that it is not clear how much ODA is currently being used for blending. Sharing detailed information on ODA deployment as well as on implementation and performance can inform the public on how ODA is being spent, and help dispel concerns that risks and rewards are not shared fairly and that the private sector is over-subsidized. Better information-sharing can improve the pricing of future blended deals where references are otherwise limited. It can also improve market information by alerting investors to the blended finance opportunities in LDCs and help improve blended finance practices. Another challenge is that independent complaints mechanisms, for example, do not always exist in blended operations.

More transparency and stronger competition in tenders for blended finance transactions and associated public procurement contracts can help ensure the best financing option is found, including domestic sources of capital that may not be used to international tendering standards and are crucial to building local markets and capacities.

Promoting transparency and accountability can, however, be complicated in blended finance for three reasons.

First, private investors and some DFIs are keen to maintain confidentiality over precise investment terms and pricing, for competitive reasons. In addition, some concessional providers note that revealing pricing structures could undercut the minimum concessionality principle in the future, by creating the expectation that subsequent deals should enjoy the same concessionality as the first, even if markets have evolved. Both the Bangladesh and Senegal scoping studies point to the difficulty in accessing data and information on projects, especially when deals have already closed.

Balancing the needs for confidentiality with the imperative to be transparent warrants further discussion. Still, at a minimum, non-commercially sensitive information could and should be made publicly available and more easily accessible, reflecting transparency standards applied to other forms of development finance. This could mean

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141 Pereira, Javier (2017). ‘Blended Finance. What it is, how it works and how it is used?’
sharing information on where and how much ODA is used to support blended deals; what type of support is made available and to which investors; the identity of the main parties involved in the project; and agreements on results frameworks and ESG standards.144

Second, especially where there are multiple domestic DFIs or ministries involved in blended transactions, LDCs may need clear regulations and a dedicated institution, or clearly identified lead institution, to coordinate and manage blended investments effectively. This could speed up decision-making processes and make them more predictable and transparent. Absent clear guidelines or legal and regulatory frameworks, and without sufficient capacities to analyse the impacts and finance structure of projects, LDC officials may not want to take the risk of giving their approval, especially when large infrastructure projects are concerned.145

Third, the transparency and accountability requirements that LDC governments place in relation to private investments are often limited. This means that investors can be in compliance with national legislation without making publicly available much project-specific information.

**Blended finance should promote the fair allocation of risks and rewards between private investors and project beneficiaries**

Blended finance requires effective partnerships. If more blending takes place in LDCs, it would be important for donors to work with providers of concessional finance to help build local capacity to negotiate, structure and deploy appropriate financing arrangements. The Uganda scoping study, for instance, highlighted the difficulties governments can face in negotiating PPP terms that are in the public interest and ensuring that regulations are fully implemented in practice.146 Some stakeholders have raised similar concerns about PPPs more generally, especially in countries where regulations and capacities to oversee such projects are more limited.147

Information or capacity asymmetries between national authorities and international investors can sometimes lead to outcomes that favour private investors at the expense of LDCs. This is particularly true in the infrastructure sector; blended deals in the corporate sector usually hinge on contracts negotiated bilaterally between the parties involved, with little government involvement.

For their part, LDC governments should, therefore: (i) carefully select infrastructure projects and assess the best financing options, including any blended instruments that will be used, on the basis of costs and benefits over the lifetime of the project; (ii) institute sound fiscal risk management frameworks that account for contingent liabilities;148 and (iii) ensure that blended finance transactions take place in the context of integrated financing frameworks for the SDGs and are anchored in existing institutions.

**Blended finance should apply high ESG standards and promote local participation**

There is growing interest in investing in ways that support achievement of the SDGs.149 Although data are limited, existing sources indicate that more than 80 percent of millennials and more than three quarters of women are interested in ESG investing.150 An increasing number of asset managers and owners have committed to integrate ESG criteria in their capital allocation process. Impact investors, who intend to generate ESG impacts alongside financial returns in their decision-making process, hold assets under management of around $22 billion.151

However, it is unclear how SDG targets convert into private investment criteria, and there is a lack of clear definitions, standardization and adequate measurement and reporting mechanisms in relation to ESG standards.152 Some private investors may not be well equipped or incentivized to measure ESG impacts meaningfully and/or could demand a greater return to offset the costs of ESG compliance and impact measurement.

This is an issue that requires further consideration. One solution in the case of blended finance could be for providers to require that investors (domestic and international) and/or project sponsors undertake ESG assessments and regular monitoring and reporting, even as providers remain ultimately responsible for oversight and development effectiveness. In Bangladesh, for example, DFIs have provided technical support to power plant projects to ensure ESG compliance.153 Such efforts could help strengthen ESG reporting overall. If more standardized approaches to ESG and impact reporting emerge, and large institutional investors use these in their investment decision-making, SDG investing could gain ground and become more institutionalized.154 These benchmarks could in turn be applied also in blended transactions.

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144 Development Initiatives (2016b). ‘Aligning blended finance with the Busan principles of development effectiveness.’
It is also important that projects, especially large infrastructure ones, do not widen disparities—gender, income or regional—within a country. Providers operating in conflict-affected countries should pay attention to conducting thorough conflict sensitivity analysis. This would include conducting ex ante conflict risk assessments.

As part of ESG best practice, concessional finance providers should actively ensure that blended and other projects reflect the importance of empowering women, as indeed many already do. UNCDF, for example, makes a concerted effort to identify missing-middle projects that do so. The focus on women’s empowerment and the promotion of gender equality looks set to get a further boost with the establishment of a Canadian DFI that will be aligned with Canada’s feminist international assistance policy.

Related, it is also important that providers ensure meaningful participation of all key stakeholders, including beneficiaries, civil society and the domestic private sector. Communities should be fully informed and engaged in decisions that affect their lives and livelihoods. This will be especially relevant in the case of infrastructure projects, where negative outcomes will be difficult to undo. Such practices could also extend to corporate projects, if they have transformative impacts on local economies. Local governments could play a big role in consulting with communities about private investments being made in their jurisdiction.

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157 Development Initiatives (2016b). ‘Aligning blended finance with the Busan principles of development effectiveness’.
Blended finance is an evolving concept, in general and particularly in LDCs, where its application has been limited so far. This chapter discusses four open issues raised in the Expert Group Meeting and in interviews and other research for this report, namely: (i) whether blended finance should expand its targeted sectors in LDCs; (ii) whether blended finance should focus on mobilizing domestic or foreign capital in LDCs; (iii) blended finance’s ability to influence the broader enabling environment; and (iv) the weight that blended finance should place on mobilization ratios in LDCs.

Should blended finance expand its targeted sectors in LDCs?

Getting blended finance to work in LDCs can be difficult enough. Still, casting the net wide when it comes to selecting target sectors—outside the exclusion lists applied by most concessional providers—could see a broader pipeline of bankable projects coming to the fore.

In addition to using blended finance in SDG sectors prone to revenue generation, such as infrastructure, water or clean energy, investments in such sectors as consumer goods and retail sectors, for instance, could also qualify for blended finance. These sectors can have SDG-related impacts, as on job creation or supporting economic growth (related to SDG 8), even if the SDG impacts may at times be less immediately apparent. They may serve well as early proofs of concept that blended finance can work in attracting private capital, especially in countries with challenging macroeconomic conditions and poor enabling environments.

All the same, it may be easier to overestimate the need for blending—many of these sectors may be suitable for pure private capital financing solutions—and institutional pressure for concessional providers to show success may lead to crowding out or over-subsidizing the private sector.

Some participants at the Expert Group Meeting made a case for providers to develop specific blended strategies for high-impact sectors such as education, health and conservation, or on priorities such as leaving no one behind, a core feature of the 2030 Agenda. The greatest difficulty, however, is that projects in these sectors very often do not generate (sufficient) revenue to make them commercially investable, which may not make them the best candidates for blended finance.

Take the case of conservation. Projects in this sector tend not to generate enough sizeable revenues in the short-to medium-term. Environmental benefits are often externalities for the investors involved, and the monetary and conservation benefits of such projects are not sufficiently well identified and standardized. Interventions are therefore largely publicly financed owing to the public good nature of the sector, although there is growing interest in mobilizing financing through development banks and impact investors.

This speaks to the potential role blended finance can play in improving risk-return profiles in this sector. For example, UNCDF is working with the Commonland Foundation to support local and regional governments and the local private sector in mobilizing private finance for land restoration projects, starting in Tanzania. Providing an economic incentive to preserve natural resources through conservation contributes to the long-term sustainability of the interventions.

Nonetheless, structuring blended solutions in such sectors where revenue streams are weak or uncertain, and in countries with high levels of poverty and weak regulation for the use of natural resources, can be challenging. These difficulties are compounded by what can be unpredictable and long time-frames linked to ecosystems development, as well as issues related to land rights and tenures and small project size.

Operating in such sectors requires a higher tolerance for failure and patience among concessional providers and private investors. There are also important value-for-money questions: with enough risk-sharing, it should be possible to get a deal off the ground, but is that an appropriate

158 Development agencies and concessional providers are typically forbidden from financing sectors such as weapons, gambling and tobacco, among others.

159 Interventions are therefore largely publicly financed owing to the public good nature of the sector, although there is growing interest in mobilizing financing through development banks and impact investors. 

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162 Operating in such sectors requires a higher tolerance for failure and patience among concessional providers and private investors. There are also important value-for-money questions: with enough risk-sharing, it should be possible to get a deal off the ground, but is that an appropriate...
use of scarce concessional resources if the outcome is to support one deal only? In some cases, the cost of blending may be too high, and pure public financing might be a better option. There may, however, be other cases in LDCs where blended transactions are important to create demonstration effects that narrow the gap between real and perceived risks of investing in LDCs.

Beyond expanding blended finance to alternative and less common sectors, one question is whether blended finance can be applied to address the development challenges of the most vulnerable and poorest parts of the population. Low income levels constrain the potential for revenue generation. If projects are able to generate returns, especially infrastructure projects, there could be serious risks of exacerbating inequalities by limiting access to goods or services only to those who could afford market rates; addressing social equity considerations may require further concessionality. In some of these sectors, there may be no pricing references to determine minimum concessionality.

Ultimately, blended finance may not be well suited to all sectors, especially those with limited revenue-generating potential. This speaks to the importance of: (i) deploying public, private and blended finance in complementary ways, recognizing the different objectives of each; (ii) governments developing financing frameworks for meeting the SDGs that take all financing sources and options into account; and (iii) deploying concessional resources to support national ownership and ensuring projects are aligned with national priorities.

At the same time, the imperative to leave no one behind calls for fresh thinking and a proactive effort to explore how new solutions can change the status quo. The case for purposefully using blended finance to correct market inefficiencies and mobilize funds for under-resourced sectors can be especially powerful if projects have broader market development impacts.164

Should blended finance prioritize domestic over foreign investors in LDCs?

The project-specific nature of blended finance calls, in principle, for a flexible approach to the sources of private capital. The objective is not only to source the necessary amount of private capital, but also to achieve minimum concessionality, bearing in mind that getting the levels of concessionality right can be tricky in LDCs.

There can be instances where either domestic or foreign private capital might provide the best financing option for a particular deal. Both have advantages and issues (summarized in Table 6) that need to be assessed on a deal basis.

Nonetheless, there is a strong case for providers of concessional finance to reach out proactively to mobilize domestic investors where possible, even if satisfactory international sources exist. This can not only improve competition for deals but could also have positive side effects on local capital market development. Conversely, blended finance should avoid approaches that discriminate against the local financial sector.165 Increased availability of domestic savings and sources of finance, a broader offering of financial products and the development of local financial expertise are all essential contributors to the broader development of an LDC.

However, domestic investors in LDCs can represent a relatively small capital pool, may be new to some concessional providers and their ESG criteria and may not have extensive sector track records. Their involvement might be limited in some cases to missing-middle rather than large-scale infrastructure projects. Yet they have significant country expertise, presence and a concrete understanding of local conditions and uncertainties, and they do not typically face currency risks. Anecdotal evidence from UNCDF’s work backs this up, with domestic banks more willing to take on the risk of supporting early-stage or smaller-sized domestic businesses or projects in LDCs than international banks and investors. The involvement of domestic investors can also send a signal to international investors that local markets have commercially viable opportunities.166

Importantly, while domestic capital in LDCs is small relative to international markets, it is expected to grow significantly, in tandem with the local economies. Pension funds in Africa, for example, could play a meaningful role in infrastructure financing given pension funds’ longer-term investment horizons.167

International investors represent a larger pool of capital, may have a more established reputation with concessional providers, and may have significant expertise in the sector. Foreign direct investors often bring with them additional benefits beyond just resources. Exposing domestic markets to FDI could provide important know-how, technology and expertise to LDC stakeholders. FDI can sometimes lead to the promotion of higher standards (such as ESG standards), as well as better production and management practices, improved corporate governance and more competitive domestic markets, as well as formal and informal training through subcontracting.

Still, foreign investors may not have the necessary country expertise or physical presence to identify opportunities or make investment decisions—particularly relevant when a hands-on approach to project development is needed—and will have to price in their terms additional risks such as currency volatility and capital controls where they exist. Foreign investors can sometimes emphasize domestic risks more than local investors.168


165 This was the finding also in Rahman, Mustafizur, Towfiqul Islam Khan and Sherajum Monira Farin (2018, forthcoming). ‘Blended Finance in Bangladesh: A scoping paper.


167 This was the finding also in Rahman, Mustafizur, Towfiqul Islam Khan and Sherajum Monira Farin (2018, forthcoming). ‘Blended Finance in Bangladesh: A scoping paper.

Foreign financial investors are also generally subject to the regulation in force in their countries of domiciliation, such as Solvency II for European Union insurance companies and Basel III for commercial banks. The latter are subject to tight capital requirements, especially after the global economic and financial crisis, which may prevent them from increasing exposure to risky markets, either by direct lending or by owning subsidiaries there. Pension funds and insurance asset managers, even those focusing on the emerging markets, may be subject to restrictions linked to the liquidity or credit rating of the securities purchased. These limits may prevent their activities where there are sub-investment-grade ratings (or absence of a rating altogether) or a lack of listed securities. For financial investors, compensation tied to short-term performance measures and benchmarks can incentivize short-term investment outlooks.169

Finally, in the effort to identify appropriate funding sources, it is important to weigh investor search and preparation costs. Especially in small and not very replicable transactions, these transaction costs must be carefully considered.

### TABLE 6. Advantages and disadvantages of mobilizing international or domestic capital

<table>
<thead>
<tr>
<th><strong>International capital</strong></th>
<th><strong>Advantages</strong></th>
<th><strong>Disadvantages</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Overall, a larger capital pool</td>
<td>More limited country knowledge</td>
</tr>
<tr>
<td></td>
<td>More extensive track record in the sector and strategy</td>
<td>Harder to attract to high-risk, untested LDCs</td>
</tr>
<tr>
<td></td>
<td>More established reputation with concessional providers</td>
<td>If a fund, may struggle to attract local institutional investors because of regulatory restrictions affecting them</td>
</tr>
<tr>
<td></td>
<td>Must comply with international governance standards</td>
<td>Currency risk is a big issue</td>
</tr>
<tr>
<td></td>
<td>FDI can bring not just resources, but know-how and technology</td>
<td>Capital controls (if in force)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Subject to regulatory limits originating in domicile countries</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Domestic capital</strong></th>
<th><strong>Advantages</strong></th>
<th><strong>Disadvantages</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Country, sector and perhaps even direct sponsor knowledge</td>
<td>A smaller capital pool with established track record or expertise in particular sectors</td>
</tr>
<tr>
<td></td>
<td>Better at assessing local risk, and may be more prone to support domestic businesses</td>
<td>Corporate governance may be sub-par</td>
</tr>
<tr>
<td></td>
<td>If a fund, more likely to attract local institutional capital</td>
<td>Less familiarity with concessional providers and ESG standards</td>
</tr>
<tr>
<td></td>
<td>No currency risk if domestic investor invests in local currency (as is often the case) and project revenues are also in local currency</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Not subject to FDI controls</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Might be politically important to have domestic capital in projects</td>
<td></td>
</tr>
</tbody>
</table>

169 Ibid.
Should blended finance wait for a better enabling environment in LDCs?

In informal interviews for this report, some stakeholders argued that, as a priority, development cooperation should focus on assisting countries to build a supportive enabling environment. Only once markets have matured should the focus gradually shift towards more direct support for private projects and programmes. Thus, strengthened policy frameworks and reduced risks will help make private investments more competitive and ensure that benefits and risks of partnerships are distributed fairly and that local market distortions are lessened.\(^\text{170}\)

Blended transactions can, however, be about more than simply getting one-off deals done, as important as those may be. Improving the enabling environment and capital market reforms take time and are part of the development process; blended deals might help capital markets develop and perhaps provide the demonstration effects that can help speed up that process. In the best-case scenario, if the right policies and regulatory reforms accompany the project, blended finance can help build local businesses and markets that could in due course be more attractive to private investors. Blended finance investments in large infrastructure, in particular, can also help strengthen the enabling environment, especially if those investments serve to demonstrate the viability and benefits of policy reforms.\(^\text{171}\) Blended transactions can also create the space for experimentation and learning and establish a track record of investment in underserved markets, showcasing to wider pools of investors what is possible in high-risk countries or sectors.

Still, blended solutions are not a panacea. There are situations in which they can only play at best a marginal role in improving the investment climate, at least in the short term. Moreover, unless it has strategic national importance, it is unlikely that a single deal (or a few deals) will alone help improve the enabling environment. In fact, as noted above, there is a risk that blended transactions—by bringing deals to life in the face of enabling environment challenges—could even delay or disincentivize required reforms.

ODA remains important to support development in a range of areas, including helping to develop the enabling environment and to support the growth of local capital markets. As the guest piece from Development Initiatives highlights, there is an opportunity for donors to improve targeting of more systemic support in LDCs. In 2015, $9.9 billion worth of ODA (5.7 percent of the total) was spent on strengthening the enabling environment. However, most went to MICs.\(^\text{172, 173}\)

Waiting until the right moment when the enabling environment is deemed ready may mean that opportunities to leverage additional private finance are missed. Further, supporting both projects and country-led reforms at the same time should be possible and could potentially create virtuous circles, with demonstration effects from blended finance helping to inform work aimed at improving policies, and improved enabling environments making countries more attractive for private-sector investments.

This calls for blended finance to complement and support reform efforts as relevant, and for much greater coordination between blended finance and other interventions aimed at supporting long-term private-sector development. As the IFC put it in a recent report, ”blended finance solutions must never be seen in isolation from the market context, and there should also be consideration of complementary tools other than blended finance—advisory services, regulatory reform, or public sector-financed infrastructure improvements—that may be sufficient to make projects commercially viable without the need to provide concessionality.”\(^\text{174}\)

In the end, the decision of how and whether to use limited ODA to support specific deals or support other interventions should involve LDC governments and be aligned with their priorities. This underscores once again the importance of national ownership of the development agenda.

Mobilization ratios: hard targets or a flexible approach in LDCs?

Given the need to mobilize larger amounts of finance to meet the SDGs, MDBs and DFIs are looking to make optimal use of their balance sheets and strengthen the catalytic role of their interventions. A question some stakeholders have raised in policy debates on blended finance is whether setting hard mobilization targets is the best way to achieve this goal.

\(^\text{170}\) As one recent article suggested “…supporting country-led programmes of policy reform, local capital market development and capacity building—may have a greater development impact and be more financially sustainable than ad hoc blended finance project investment in the poorest countries” (Attridge, Samanita (2018). ‘Can blended finance work for the poorest countries?. London: Overseas Development Institute, 1 June 2018. \([\text{https://www oggi.org/comment/ij0503-can-blended-finance-work-poorest-countries}\)\).


Increasing the ratio of private capital mobilized to concessional finance deployed—variously referred to as ‘mobilization ratio’, ‘leverage ratio’ or ‘multiplier’—is an important measure of success of a blended finance transaction, but not the only one. Setting explicit mobilization targets, while intended to help mobilize more resources, raises five concerns:

First, mobilization ratios can (further) skew resources towards MICs, because they will tend to be higher in these countries than in LDCs, owing to the lower perceived risks and larger scale of investment opportunities. During the Expert Group Meeting and informal interviews, concessional finance providers argued that the mobilization agenda in LDCs needs to be different because of the lower mobilization ratios in these countries.

Second, setting mobilization targets may also further lead providers to engage in projects that would have gone ahead without them even in riskier settings such as LDCs. A high leverage ratio can be generated by providing a small amount of money to a large private project that requires no concessionality in the first place. To address these challenges, providers may in some cases need to modify institutional incentives, so that they avoid supporting blended deals when there is a realistic chance that private capital could do the job on its own or predominantly so—rather than measuring success based on the number and size of deals closed or amount of private finance mobilized.

Third, hard ratios can lead to a focus on meeting quantitative targets, as opposed to focusing on quality or the impact on sustainable development. They can also push providers of concessional finance to have private-sector investment even where it does not make sense—such as in sectors where there are no returns—ultimately over-subsidizing the private sector.

Fourth, some industry sectors are more prone to higher mobilization ratios. Infrastructure projects are the classic example. Because of their potential to generate stable cash flows through user tariffs, these projects can support a meaningful amount of debt in addition to the equity provided by the infrastructure developer and other investors. Depending on specific project features, tariff affordability in primis, a relatively small grant may be sufficient to attract significant equity and even more significant debt from commercial sources. In contrast, blended finance projects that support fast-growing missing-middle projects do not benefit from the same cash flow predictability and may be unsuitable for highly leveraged capital structures, even if their development impact is potentially very important in LDCs.

Last, some stakeholders suggest that, even if more blended operations take place in MICs in a response to the setting of high mobilization targets, this could free up additional development finance that could be allocated to higher-risk countries, such as LDCs. Yet greater amounts of concessional finance will still be needed to get more deals off the ground, wherever they take place; if there are more deals happening in MICs, then there is a risk that ODA might gravitate there too.

Meeting the SDGs requires that development actors raise their ambitions around mobilizing additional public and private finance. Higher leverage ratios can play an important role in helping to bridge SDG financing gaps. Blended finance can help increase the resources available overall for development by mobilizing additional private capital. Setting hard targets for providers, however, should be accompanied by a careful analysis that considers the impact of targets on development finance envelopes and allocations for LDCs and other vulnerable countries.

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