

Blended finance

Mobilising resources for sustainable development
and climate action in developing countries

POLICY PERSPECTIVES



« WE NEED TO MOVE BEYOND ANALYSING AND TALKING. IT'S TIME FOR MORE CONCERTED ACTION TO ENHANCE OUR MECHANISMS OF DEVELOPMENT FINANCE AND CREATE INNOVATIVE PATHWAYS OF CHANNELING INVESTMENT FOR SUSTAINABLE DEVELOPMENT. »»

CHARLOTTE PETRI GORNITZKA, CHAIR, DEVELOPMENT ASSISTANCE COMMITTEE

« THE DEVELOPMENT CHALLENGES TODAY THAT CONNECT DIVERSE SOCIETIES IN NEW WAYS – INCLUDING THE REFUGEE CRISIS PENETRATING DEVELOPING AND DEVELOPED COUNTRIES AND CLIMATE-RELATED DISASTERS LIKE HURRICANE IRMA – EXTEND BEYOND CURRENT FINANCING LEVELS AND BEG FOR MODERN APPROACHES. »»

JORGE MOREIRA DA SILVA, DIRECTOR, OECD DEVELOPMENT CO-OPERATION DIRECTORATE



The global community has spoken loud and clear: more resources must be mobilised to end extreme poverty and mitigate the effects of climate change. Blended finance - an approach to mix different forms of capital in support of development - is emerging as an important solution to help meet the 'billions to trillions' agenda. For development co-operation providers, the scaling up of this approach needs to be based on a good understanding of its potential in supporting developing countries meet the SDGs and Paris Agreement.

This Policy Perspectives draws on recent OECD work, including the upcoming 2018 report *Making Blended Finance Work for the SDGs*, the draft *OECD DAC Principles on Blended Finance* and work under the OECD Development Assistance Committee (DAC) on measuring the amounts mobilised by official development finance interventions.



THE CHALLENGE: SCALING UP FINANCING FOR THE SDGS AND PARIS AGREEMENT

Blended finance can help bridge the estimated USD 2.5 trillion per year annual investment gap for delivering the SDGs in developing countries.



Two years after the Addis Ababa Action Agenda, there is still a clear gap in investment required for developing countries to meet the Sustainable Development Goals (SDGs) and commitments made under the Paris Agreement. In developing countries, this is estimated at USD 2.5 trillion per year (UNCTAD, 2014). Public development finance - from governments and donors - will not be sufficient to fill this investment gap.

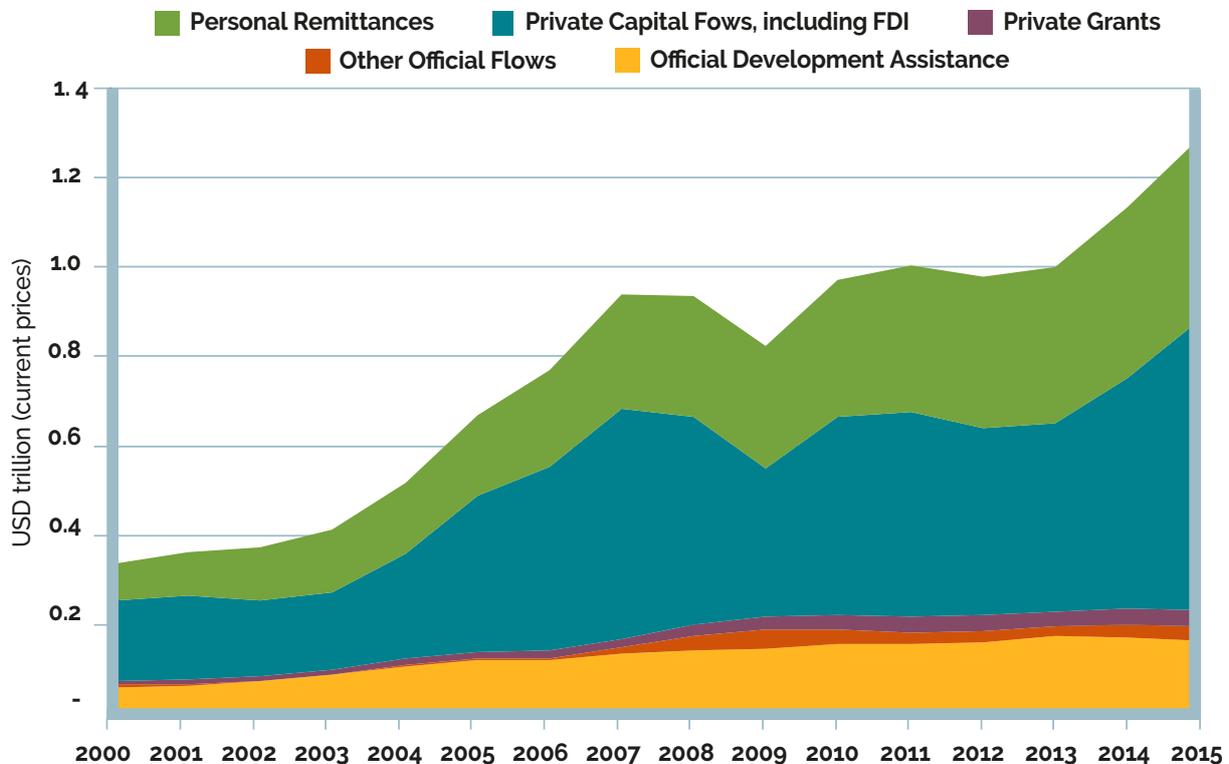
At the same time, the landscape for development finance is changing rapidly with private flows - foreign

direct investment, private philanthropic funding, and remittances - dwarfing other sources of external finance to developing countries (Figure 1). While Official Development Assistance (ODA) remains an important support for development outcomes, it needs to increasingly catalyse additional finance and channel existing resources towards the SDGs and Paris Agreement. Blended finance is emerging as one solution with significant potential to help meet the investment gap by using public support to mobilise commercial finance



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FIGURE 1:
EXTERNAL FINANCE TO DEVELOPING COUNTRIES, 2000 - 2015



Source: Estimates based on OECD statistics and World Bank data.

Note: The figures shown are in net disbursements at USD current prices (in trillions). Remittances are in gross disbursements. Official Development Assistance includes bilateral official development assistance and multilateral official development assistance (capital subscriptions are included with grants). Other Official Flows were negative in 2003, 2004, and 2006, and were given a null value in the graph. Total private flows at market terms include bilateral private flows (direct investments and other securities and claims) as well as multilateral private flows.

However, commercial investors are wary of investing in developing countries, even on projects backed by a sound business case, due to high risks or uncertain returns. There are several barriers to unlocking private finance for development and climate action (McKinsey, 2016; OECD 2017a):

- A lack of transparent and bankable pipelines for projects supporting the SDGs, coupled with high development and transaction costs for projects.
- A lack of viable funding models and inadequate risk-adjusted returns for projects, especially related to

sustainable infrastructure in low income countries, or in areas where the poorest or most vulnerable populations are located.

- Unfavorable and uncertain regulations and policies, coupled with a lack of institutional capacity and weak governance, which make up the enabling environment for private investment.
- Impediments in the global financial regulatory system that hamper investors from investing in emerging markets due to the associated risks.

Official Development Assistance (ODA) reached record levels in 2016 totalling

USD **142.6** billion



In developing countries, the annual investment gap is estimated at

USD **2.5** trillion



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WHAT IS BLENDED FINANCE?

Using public finance in catalytic ways
to attract commercial investors



Official development finance must increasingly be used to mobilise other sources of financing for sustainable development and climate action, with a focus on resources - such as commercial, private investment - that do not currently target development.

Blended finance approaches make use of development finance sources, such as development assistance from donor governments and funds provided by philanthropic foundations, to mobilise additional finance - primarily from private and commercial sources - in order to address the SDGs and promote climate action in developing countries. The logic behind the approach is simple. Private investors, businesses and project developers respond to and are constrained by risks and returns associated with

investments. As a result, investments in developing countries with important public good dimensions may be backed by a sound business case but cannot necessarily be financed by commercial investors due to high risks associated with projects or uncertainty related to returns. In these cases, public support can be used strategically through blended finance to improve the 'risk-return' profile of investments in developing countries and make them more attractive to private investors.

FIGURE 2:
ILLUSTRATION OF HOW BLENDED FINANCE WORKS



Source: OECD (forthcoming)

Development actors are finding increasingly innovative ways to blend finance through a range of instruments so as to attract commercial, private finance towards the SDGs and climate action.

A range of instruments are being used for blending, going beyond the more traditional loans and grants to the use of guarantees, securitisation, currency hedging, political risk insurance, etc. In this context, greater diversification of instruments could support better targeting of different risks and result in more commercial resources being targeted towards sustainable development outcomes. Amongst the different models, collective vehicles, such as funds, bring investors together to pool financing and offer opportunities for scaling up blended finance. In particular, structured

funds allow donor governments to use concessional finance in a first loss position to provide a risk cushion for commercial investors. Blending can also occur through equity or debt investments in projects and companies in developing countries. For example, development finance providers and private actors invest in impact funds with the aim of generating financial returns and measurable environmental and / or social impact. OECD (forthcoming) shows that there is increasing interest in blended finance funds, with at least 189 such funds being launched between 2000 and 2016.

BOX 1.

ENABLING MUNICIPALITIES TO TAP CAPITAL MARKETS TO FUND INFRASTRUCTURE DEVELOPMENT

Since municipalities in Tamil Nadu lack access to finance to undertake local infrastructure investments, the government created Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL), an asset manager jointly owned by the Government and private financial institutions. Nevertheless, tapping capital markets to fund infrastructure projects remained challenging. Consequently, a EUR 10 million concessional loan was disbursed by KfW to the government of India to fund the subordinated tranche (35%) of an existing Special Purpose Vehicle, the Water and Sanitation Pooled Fund (WSPF), managed by TNUIFSL, and designed to disburse loans to urban local bodies. This was combined to the Government of Tamil Nadu's equity support as cash collateral (10%) to provide an additional cushion against potential losses. The combination of the KfW concessional loan and interest on the bonds (the first bond issued at 10.6%) permitted on-lending on a revolving basis to municipal projects at a sustainable level.

In turn, the intervention is expected to achieve meaningful outcomes, with the ex-ante assessment showing a strong development impact of local infrastructure projects funded with loans from WSPF. Likewise, on the long-term, the issuance of bonds via SPV enhanced the local market. In a nutshell, the project contributed to SDG 9 (Industry, Innovation and Infrastructure) and SDG 8 (Decent work and economic growth) by providing access to finance to municipalities.

Source: OECD (forthcoming)



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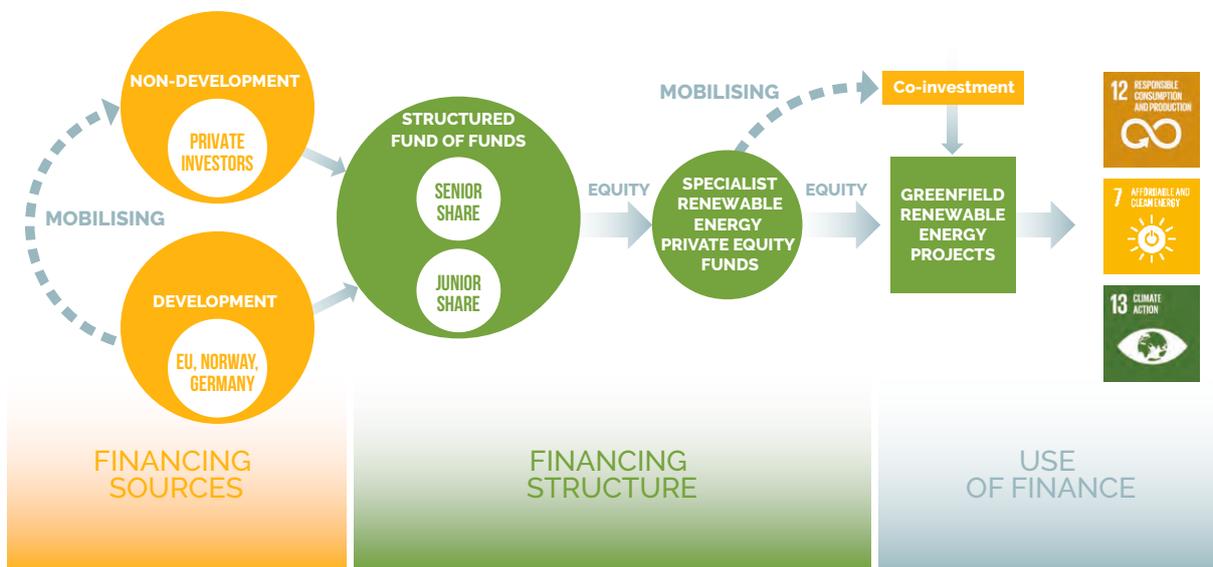
BOX 2.
MOBILISING INVESTORS AT SEVERAL LEVELS - GLOBAL ENERGY EFFICIENCY AND RENEWABLE ENERGY FUND (GEEREF)

The EIB-managed Global Energy Efficiency and Renewable Energy Fund (GEEREF) was initiated by the European Commission in 2006 and has EUR 222 million in assets under management. It supports the deployment of clean and renewable energy technologies in developing countries by investing in specialised private equity funds. These funds, in turn, invest in a broad mix of small to medium sized projects (through equity and mezzanine instruments) in renewable energy - such as solar, biomass and wind farms - and energy efficiency, focussing on the riskier, early-stage development phase.

GEEREF has a blended structure where public seed funding from governments (EUR 112 million) has been used to attract an additional EUR 110 million from private sector investors. The “fund-of-funds” approach enables further leverage on the public contribution when commercial investors are engaged in the private equity funds in which GEEREF invests. As of August 2017, GEEREF's portfolio comprises 12 such funds. Following the success of this model EIB is in the process of fundraising for a successor to GEEREF, (GEEREF Next) which aims for a larger amount of assets under management from commercial investors.

Source: OECD (forthcoming)

FIGURE 3:
HOW GEEREF MOBILISES PRIVATE INVESTMENT AT MULTIPLE LEVELS



Source: OECD (forthcoming)

Insights on the potential mobilisation impact of selected instruments are emerging from OECD analyses

An OECD assessment of five instruments - guarantees, syndicated loans, credit lines, direct investment in companies and shares in common investment vehicles - highlights that these are not only mobilising different magnitudes of finance, but they are also applied in different country contexts and sectors (Benn et al., 2017) - Figure 4. In total, USD 81.1 billion were mobilised from the private sector by official development finance interventions in 2012-15. Of this, 26% of the amount mobilised targeted climate change, with the majority of finance mobilised by guarantees, syndicated loans and

collective investment vehicles (i.e. funds). Mobilisation took place mainly in Africa (30% of amounts mobilised), followed by Asia (26%), with the majority of financing mobilised in middle income countries (43% in Upper Middle Income Countries and 34% in Lower Middle Income Countries. Banking and finance, energy and industry were the main sectors where finance was mobilised. Guarantees mobilised the largest share of finance across the three years (USD 35.9 billion), followed by syndicated loans (USD 15.9 billion) and credit lines (USD 15.2 billion).

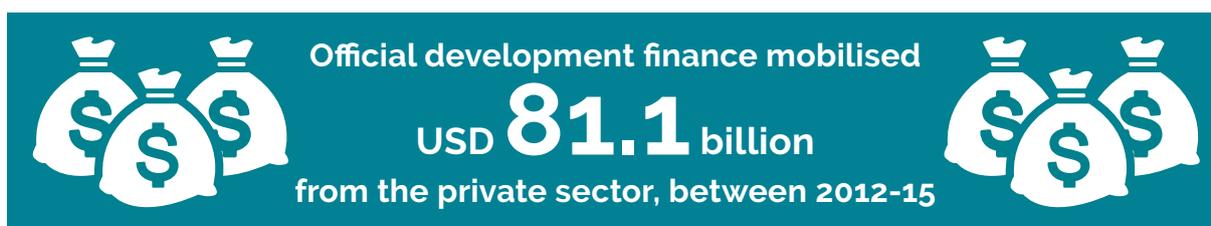
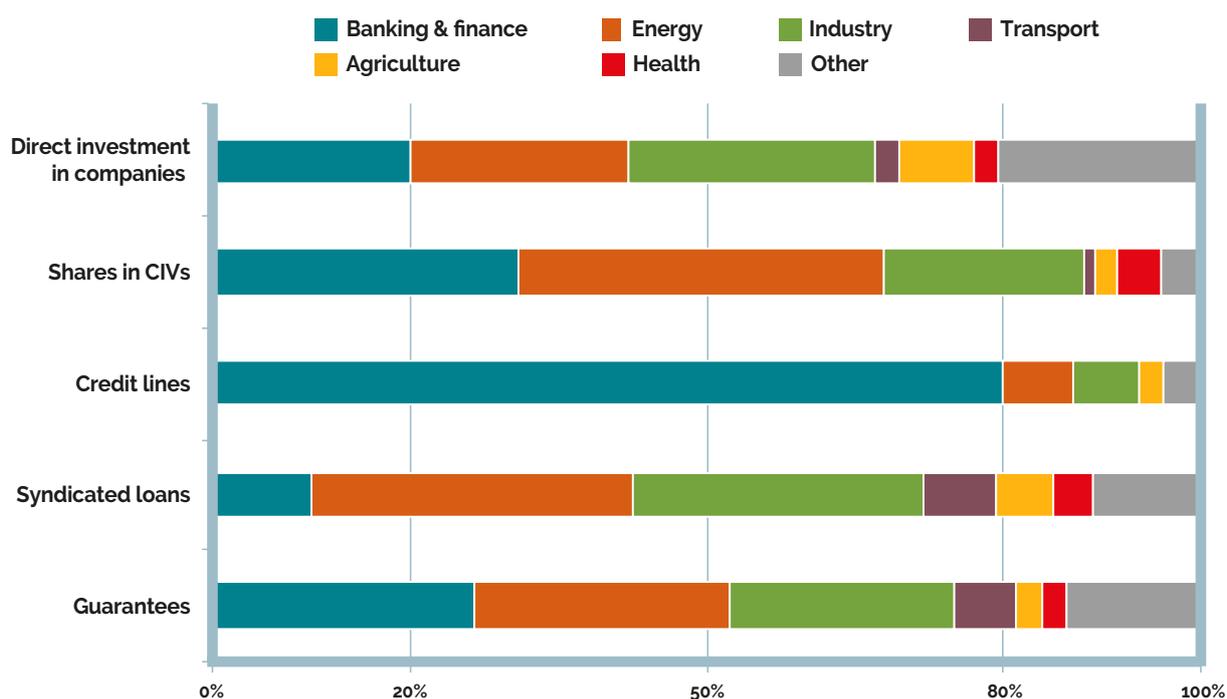


FIGURE 4:
 AMOUNTS MOBILISED FROM THE PRIVATE SECTOR
 BY OFFICIAL DEVELOPMENT FINANCE INSTRUMENTS,
 BY SECTOR, 2012-2015



WHO IS INVOLVED IN BLENDED?

Partnerships between development and commercial actors are at the heart of blended finance approaches.



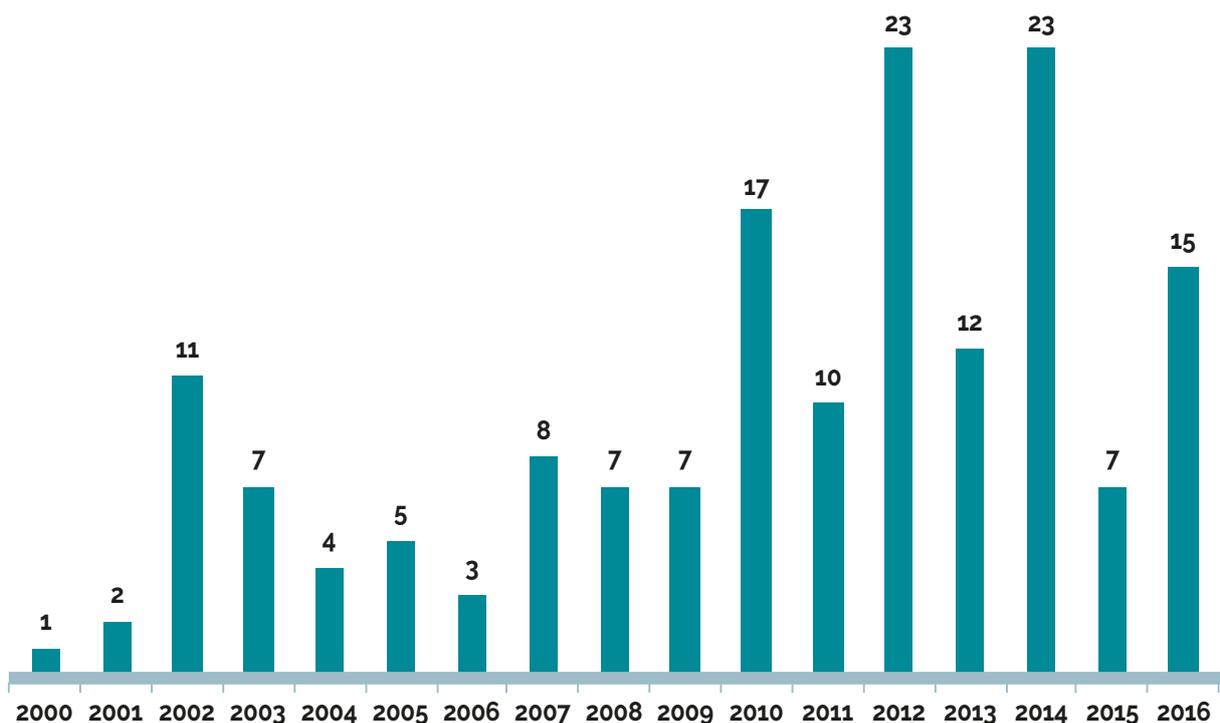
Development co-operation providers are increasingly using private sector engagement approaches to address environmental issues, especially climate change. In 2013, around 22% of climate-related development finance recorded by the OECD Development Assistance Committee (DAC) supported activities to engage the private sector, including through blended finance (Crishna Morgado and Lasfargues, 2017). The majority of OECD DAC members already engage in blended finance, although countries are at very different stages of maturity with respect to the range of instruments

used and how blending is carried out. The increasing interest in blending is also evidenced by the growing number of dedicated 'facilities' that have emerged in recent years. According to surveys by OECD and the European DFI Association (EDFI) presented in OECD (forthcoming), 167 facilities have been set up between 2000 and 2016, with a total of USD 31 billion in commitments. The number of facilities launched has increased steadily, as almost three times more facilities were established between 2009 and 2016 than over the previous 8 years (Figure 5).



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FIGURE 5:
NUMBER OF NEW BLENDED FINANCE FACILITIES LAUNCHED PER YEAR,
2000 TO 2016



Source: OECD and EDFI surveys in OECD (forthcoming)

«DFIs PLAY A CRITICAL ROLE IN BLENDED FINANCE, STRUCTURING THE TRANSACTION, BRINGING TOGETHER ACTORS AND MONITORING THE INVESTMENT.»»

NANNO KLEITERP, CHAIRMAN OF EDFI

Multilateral development banks (MDBs) and **bilateral DFIs** also engage in blending, both as facilitators of blended transactions and also with their own finance. MDBs, in particular, are beginning to integrate blended finance into their overarching service offering to development countries. For example, the World Bank Group's 'Cascade Approach' prioritises commercial sources of investment for a project, supported by efforts from governments and MDBs to improve the investment environment and correct market failures (WBG, 2017). When this is not viable, public resources from developing countries and development finance providers should be used for blending and risk mitigation instruments. Only if neither of the first two options is feasible, should public resources be used to cover the costs of the project in its entirety.

There are also a variety of private actors engaging in blending, ranging from institutional to philanthropy investors. **Institutional investors**, such as pension funds or sovereign wealth funds, generally have a huge amount of capital at their disposal and their investment practices thus significantly shape the investment climate. **Banks** can provide debt financing in the blended finance framework. **Corporates** can contribute to blending not only by investments, e.g. an equity financed expansion of their services in infrastructure, education or health, but also with the development of innovative products and services that address sustainable development issues. **Private philanthropy** also plays a role in development finance, particularly as a result of their relatively low level of risk-averseness and their willingness to invest in innovative business concepts and financing models.



167 donor facilities have been launched between 2000 and 2016 to pool financing for blending with a total of **USD 31** billion in commitments

A **fifth** of climate-related development finance in 2013 went towards engaging the private sector for green growth and climate action.



«THE PRIVATE SECTOR STANDS READY TO PROMOTE DEVELOPMENT AND FACILITATE THE REDUCTION OF POVERTY. DEVELOPMENT FINANCE PROVIDERS CAN PLAY A KEY AND CRITICAL ROLE IN BLENDED FINANCE, PROVIDING THE ENHANCEMENT THAT INCENTIVISES THE PRIVATE SECTOR TO ENGAGE.»»

JULIA PRESCOTT, CHIEF STRATEGY OFFICER, MERIDIAM:



BLENDED FINANCE FOR THE SDGS - IMPLICATIONS FOR POLICYMAKERS

While blended finance has significant potential to boost financing for development, development actors must ensure it meets the needs of the SDGs and Paris Agreement.



Initial evidence points to four areas of action for development actors:

1. BROADENING THE USE OF BLENDED FINANCE

To date, blended finance has been used in a relatively limited set of countries. Between 2012 and 2015, the majority of private financing mobilised through official development finance interventions was in middle income countries (43% in Upper Middle Income Countries), with a minority being mobilised in Least Developed Countries and other low income countries (Benn et al, 2017). In addition, the mobilisation of private capital is most pronounced in the finance and energy sectors. Within finance mobilised for climate change, there is a need to scale up support for adaptation - in 2012-15, 81% of finance mobilised targeted climate change mitigation only, compared with 3% for climate change adaptation only, and 16% targeting both mitigation and adaptation.

2. A STRONGER FOCUS ON MOBILISING COMMERCIAL FINANCE

In order to meet the SDGs, mobilisation must focus on those financial resources that are not already deployed for development priorities. While this is the overarching goal of most blended finance today, participation of commercial investors needs to be scaled up. This shift is already evident among some development finance providers - a recent example is the European Commission's External Investment Plan which emphasises the need to move forward from blending amongst public sources, to a stronger focus on mobilising private finance through the use of guarantees.

3. BETTER DONOR POLICY AND GUIDANCE ON BLENDED FINANCE

Despite widespread interest, the maturity of policies and practices guiding blending operations is still very uneven among donor governments. OECD (forthcoming) shows that only a few DAC members have dedicated strategies or guidance in place. In this context, the OECD is preparing 'Blended Finance Principles' which outline five broad policy guidelines to support public engagement in this area:

1. Deploy blended finance on the basis of its effectiveness and relevance for achieving a development impact or outcome.
2. Increase efforts to mobilise additional commercial finance within blended finance mechanisms and instruments.
3. Ensure blended finance supports the development of local markets.
4. Balance risks, returns and impact for blended finance.
5. Invest in the evidence base for blended finance.

4. BUILDING THE EVIDENCE BASE FOR BLENDED FINANCE

The scaling up of blended finance must be based on a thorough review of what works and what doesn't. However, there is a general lack of evidence on blended finance, both in terms of financial flows going towards blending as well as non-financial performance of blended instruments and models. While there have been various efforts to map the blending landscape, a consistent and comparable estimate of the blended finance 'market', that covers the entirety of flows, is lacking. As OECD (forthcoming) demonstrates, gaps in the evidence base are exacerbated by shortcomings in existing monitoring and evaluation (M&E) systems. M&E for blended finance is particularly challenging because it must cater to the needs of diverse stakeholders. Furthermore, it remains a critical step to ensure the credibility and effectiveness of blended finance approaches.

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The OECD's work on Blended Finance



Blended Finance is part of the OECD Development Assistance Committee's wider work on Private Financing for Sustainable Development. The overarching objective of this work is to mobilise additional resources to address the most pressing environmental and social challenges in developing countries. In addition to analysing blended models to de-risk and unlock private investment towards the SDGs, the OECD is also looking into efforts to promote investment with measurable social and environment impact in developing countries through its **Social Impact Investment Initiative**. Another cross-cutting theme is **green finance and investment**, which is critical to ensure that future growth follows low-carbon and climate resilient pathways, and is carried out in collaboration with the OECD Centre on Green Finance and Investment.

<http://oe.cd/blended>

<http://oe.cd/social-impact>

Beyond analytical work in support of policy issues, the OECD is developing an **international standard for measuring the amounts mobilised by official development finance** interventions (including guarantee schemes). So far, methodologies have been elaborated to measure the amounts mobilised through guarantees, syndicated loans, shares in collective investment vehicles, credit lines and direct investment in companies. Future work will cover a broader range of mechanisms such as standard grants or loans in co-financing with private investment as well as more complex financing schemes (e.g. PPPs, project finance).

<http://oe.cd/privfin>



OECD Centre on Green Finance and Investment

The main mission of the Centre on Green Finance and Investment is to catalyse and support the transition to a green, low-emissions and climate-resilient global economy, through the development of effective policies, institutions and instruments for green finance and investment.

www.oecd.org/cgfi/



Blended Finance

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