UNCDF
Unlocking Public and Private Finance for the Poor

BLENDED FINANCE in the LEAST DEVELOPED COUNTRIES

EXECUTIVE SUMMARY AND ACTION AGENDA

in collaboration with

OECD
BETTER POLICIES FOR BETTER LIVES

Southern Voice
2015 On Post-MDG International Development Goals

CONVERGENCE
BLENDING GLOBAL FINANCE

UNITED NATIONS FOUNDATION

KEY MESSAGES FROM THE REPORT

More resources—public and private, domestic and international—need to work together effectively to help all developing countries meet the Sustainable Development Goals (SDGs) and support inclusive and sustainable growth. **Increases in SDG finance must benefit and include the world's 47 least developed countries (LDCs)** at risk of being left behind.

While official development assistance (ODA) and domestic public finance remain essential, they will not be enough for LDCs to meet the SDGs. **Private investment, including foreign direct investment (FDI), often bypasses LDCs.** It is, therefore, important to understand how these countries can best benefit from the full range of financing options, including blended approaches. This report examines the opportunities and challenges for deploying blended strategies in LDCs, and how to pursue them effectively.

Blended finance is receiving increasing attention for its potential to amplify the impact of concessional resources by sharing risks or lowering costs to adjust risk–return profiles for private investors, thereby crowding in private finance for SDG investments that would otherwise be overlooked. In addition, blended finance in LDCs can create demonstration effects that support commercial replication over time, inform government-led policy improvements and potentially support the development of local markets. Still, blended projects are not without their limitations and risks.

Data from the Organisation for Economic Co-operation and Development (OECD) compiled for this report show that official development finance has mobilized much less private capital in LDCs than in other developing countries: **of US$81 billion mobilized in 2012–2015 for all developing countries, $5.5 billion (some 7 percent) was for LDCs**, though the trend is one of growth. This is not necessarily an 'underweighting' relative to the size of LDC economies, though it is small relative to the ODA that LDCs receive. Average amounts mobilized per transaction in LDCs are less than one third of those in developing countries overall. Credit and risk guarantees generated the largest absolute mobilization of private capital.

Barriers to private capital are typically more prevalent and severe in LDCs than in middle-income countries (MICs). At the enabling environment level, these stem from macroeconomic, governance, regulatory, infrastructure, market and other perceived risks. At the project level, these include operational and contract risks, costly and time-consuming pipeline origination and project preparation, small deal size (in absolute terms and relative to transaction costs), untested business models, and information and data gaps.

The difficulty of blended finance in LDCs may reflect objective challenges in attracting private capital to riskier, smaller and less-tested markets— even when concessional resources are deployed to share risks. Some providers of concessional capital may also shy away from such markets, for several reasons: low risk appetite given the need to preserve their triple-A credit ratings; a lack of awareness of investable projects; institutional incentives to close deals, leading to a focus on 'easier' markets or projects; or mandates that favour commercial returns.

Blended approaches must be deployed carefully in line with established principles on effective development cooperation related to the use of ODA more generally. Two critical principles are:

- **sustainable development additionality**, meaning that the intervention has direct development impact and alignment with the SDGs, with the goal of leaving no one behind. Development additionality entails incorporating social equity considerations into project design and execution, including pricing products and services with public good features at affordable levels. These affordability constraints imply that when it comes to providing many public services, domestic public finance, supported by ODA as necessary, might be the best option; and
- **financial additionality**, meaning that the project would not be funded by commercial sources alone without concessional support. Ensuring the minimum amount of concessionality is critical to avoid over-subsidizing the private sector while also not crowding out private investors or unduly distorting local markets. Determining the amount and structure of concessionality in LDCs can be complicated by differences in risk perception and the scarcity of market data and pricing references, among other factors.

Providers of concessional finance should also ensure that blended transactions:

- comply with high standards of **transparency and accountability**;

- promote the fair allocation of risks and rewards between private investors and project beneficiaries; and
- apply rigorous economic, social and governance (ESG) standards, promote local participation and ensure a focus on the empowerment of women.

While blended approaches seek to increase overall financing for the SDGs, absent an increase in the overall level of aid, using more ODA for blending may result in a decrease in its use for such purposes as helping to fund basic infrastructure or social services in LDCs—sectors not usually suitable for blending. Given concerns about LDC governments not being fully involved in decisions about the allocation of concessional resources, or blended finance being a back door to tied aid, concessional finance providers and donors should ensure that blended transactions **align with national priorities and respect national ownership**.

To improve the effectiveness and efficiency of blended operations, principles related to blended finance have been articulated in recent years. For instance, embedded in the Addis Ababa Action Agenda, Member States agreed on a set of overarching principles for blended finance and public–private partnerships (PPPs). In October 2017, the OECD Development Assistance Committee approved a set of blended finance principles for unlocking commercial finance for the SDGs.

Many blended finance projects tend to fall into two categories: infrastructure projects and corporate investments. This report maintains a particular focus on the 'missing middle' segment of the corporate sector. While the support required will vary by project type and sector, a flexible and hands-on approach is necessary in blended finance transactions in LDCs throughout the project life cycle:

- During pipeline and project preparation, concessional finance providers typically need to spend more time and resources providing technical assistance and capacity-building support to project stakeholders. More broadly, providers of concessional capital and donors should also help strengthen national capacities in LDCs to engage effectively on blended transactions.
- During deal design and execution, greater concessionality may have to be deployed in LDCs. This may come in the form of a larger amount of concessional finance, more generous terms and pricing and/or the use of multiple concessional instruments. In corporate deals, especially in the 'missing middle' segment, this results from risks related to the small scale of the opportunity, the early stage of business development, project sponsors lacking a strong record, or the novelty of business models or technologies adopted. In addition to some of these factors, in infrastructure deals higher concessionality may be required to mitigate tariff affordability issues and regulatory risks.
- During the transition to commercial solutions, the phasing-out of concessional support, with the ultimate goal of reaching commercial sustainability, may take longer in LDCs than in other developing countries. Some concessionality may still be needed in subsequent deals—for instance, in infrastructure projects where tariff affordability and social equity issues persist. The government may replace ODA with domestic public resources to keep a project viable, while needing carefully to assess potential fiscal and sovereign debt repercussions.

Given the limited track record of, and evidence on, blended finance impact in LDCs, **monitoring and evaluation (M&E) and knowledge-sharing** are very important—in all three stages of the investment life cycle. M&E can contribute to the formation of best practices and identification of similar blended opportunities in new sectors or geographies.

Given concerns around indebtedness, LDC governments should institute **sound fiscal risk management frameworks that account for contingent liabilities** arising from blended finance projects.

Blended finance in LDCs is an evolving concept. The report examines several open questions, including:

- *Should blended finance be expanded to more sectors?* The report argues that blended finance may not be well suited to all sectors, especially those with limited revenue-generating potential. In some cases, the cost of blending may be too high, and pure public financing might be a better option. In other cases, blended transactions are important to create demonstration effects that narrow the gap between real and perceived risks of investing in LDCs.
- *Should blended finance focus on attracting domestic or foreign investors?* This report argues that any source of private capital should be opportunistically targeted. While FDI can also bring benefits in the form of know-how, technology and expertise to LDCs, proactively focusing on domestic investors can have positive side effects on local market development.
- *Is blended finance better suited to countries with stronger enabling environments?* While some enabling environment barriers can only be fixed by policy interventions, demonstration effects from blended projects (especially when they are of national importance) can inform government-led

policy reforms. This underlines the need for coordination between blended finance and other interventions aimed at supporting long-term private-sector development.

- *Should providers of concessional finance set hard targets for mobilizing private finance?* This report argues that while higher leverage ratios can play an important role in bridging SDG financing gaps, setting hard mobilization targets for providers of concessional finance raises concerns. Careful analysis is necessary to consider the impact of mobilization targets on development finance envelopes and allocations for LDCs and other vulnerable countries. More broadly, if blended finance becomes an increasingly important modality of development cooperation, development partners will need to ensure that this does not come at the expense of support for LDCs and other vulnerable countries—those where blending has been more challenging.

Blended approaches can help mobilize much-needed additional capital for LDCs. But they need to be considered carefully and should be applied as part of a broader SDG financing strategy. Ultimately, **project and country characteristics, macroeconomic conditions and national policy priorities should determine which financing model—public, private or blended—is best suited for which SDG investment.**

AN ACTION AGENDA

Recognizing the complementary roles of public and private finance, UNCDF proposes five areas where action is needed from all stakeholders—private and commercial investors, civil society, development partners, LDC national and subnational governments, and think tanks. These five areas seek to improve the practice of blended finance and help ensure that its application can support LDCs to achieve the SDGs:

1. ENCOURAGE RISK-TAKING AND EXPERIMENTATION, AS APPROPRIATE

As part of broader efforts to get more private resources flowing to LDCs, providers of concessional finance should engage with their boards, donors and LDC governments to find innovative ways to take more risk and experiment with new solutions. With the aim of generating demonstration effects that can inform subsequent scale-up and replication, this could include the following in relation to blending:

- Determining, first, when blended approaches may be the right ones for leveraging private finance and for providing public services. In some cases, a project may simply not be ripe for blending, and pure public financing might be a better option. However, there may be other cases in which blended transactions are important to create demonstration effects that can narrow the gap between actual and perceived risks in LDCs.
- For those cases where blended finance is appropriate, establishing and/or sufficiently resourcing existing dedicated funds, facilities, entities or special purpose vehicles that will support blended projects in LDCs throughout their life cycle. At the same time, providers of concessional finance should be given the headroom and incentives to take risks while preserving their credit ratings and financial sustainability.
- In LDCs where providers are not physically represented, working with those providers which do have boots on the ground—including United Nations entities—to source, develop, structure, finance and/or scale up SDG-aligned projects, and engage local communities in decisions which affect them.
- Better coordinating provider and donor activities so that the right set of instruments can be designed, tailored to the specific deal context and applied at the right time both to develop investable projects and to attract private finance to them.

2. BRING LDCs TO THE DECISION-MAKING TABLE

Expand LDC involvement in blended finance policy discussions

To bring more voices and perspectives to the table, with a view to improving best practice, global policymaking discussions on blended finance should purposefully engage LDCs and other developing countries as active participants. The same applies to engaging providers of concessional capital from the South that may support blended transactions. It would be important to convene these discussions in universal forums, such as the Financing for Development and Development Cooperation Forums held at the United Nations.

Strengthen national capacities

To strengthen national capacities in LDCs, providers of concessional finance and donors should support national and local government officials and national development banks with targeted capacity-building and training to:

- identify and develop a pipeline of SDG-aligned projects;
- ensure robust metrics are in place for assessing and monitoring development and financial additionality;
- involve impacted communities in decisions;
- negotiate deal structures that share risks and rewards fairly;
- put robust mechanisms in place to ensure transparency and accountability; and
- apply rigorous ESG standards, promote local participation and support the empowerment of women.

3. DEPLOY BLENDED STRATEGIES TO SUPPORT SUSTAINABLE OUTCOMES

Leverage domestic investors and support local industry

Providers and other development partners in LDCs should, where appropriate:

- actively seek out suitable domestic investors—many of whom may be more willing to invest in local projects than external investors—and support blended transactions in local currencies; and
- ensure that linkages are built with local suppliers and entrepreneurs, so that blended transactions can help strengthen domestic industries.

Coordinate blended interventions with complementary approaches

- In line with the principle of national ownership, providers should proactively engage at a strategic level with LDC governments so that they can determine which financing model—public, private or blended—is best suited for which investment; and
- LDC governments, concessional providers and donors should coordinate closely at the country level to introduce new blended finance vehicles and to ensure that blended finance transactions are complementary to interventions by other development partners aimed at supporting long-term private-sector development and promoting a sound enabling environment.

Increase facilitation of currency hedging

While currency risks are not specific to blending, blended approaches can help mitigate one of the most frequent barriers to investment in LDCs—local currency volatility. Providers should, therefore, increase facilitation of currency hedging for projects in LDCs.

4. IMPROVE IMPACT MEASUREMENT AND TRANSPARENCY

Strengthen impact measurement of blended transactions

Strengthening SDG impact measurement means that providers should:

- ensure that *ex ante* SDG and ESG impact assessments are undertaken, along with analysis to minimize market distortions caused by their interventions; and
- conduct or support *ex post* evaluations and consider providing additional grant capital for such impact evaluations. These evaluations should be made publicly available and should focus not just on project-specific impacts but, to the extent possible, also on broader impacts on market development and enabling environments.

Improve transparency of blended operations

To improve transparency concerning the use of blended finance in LDCs and help coordination with other interventions, it is important that concessional providers:

- make publicly available information such as how much ODA is going into blended transactions, any non-commercially sensitive information on deals and portfolios, performance, eligibility criteria and impact metrics;
- create appropriate data standards that support better monitoring, measurement and cross-comparison of blended finance interventions; and
- work with LDC governments to run fair tendering processes to select the most competitive project sponsors.

5. INCREASE KNOWLEDGE-SHARING AND EVIDENCE TO INFORM BLENDED FINANCE BEST PRACTICE

Increase blended finance knowledge-sharing

Providers should work with all stakeholders to maximize the sharing and transfer of knowledge on blended finance in LDCs. This could mean:

- at the country level, creating regular policy dialogues to share lessons from blended finance successes and failures;
- at the global level, promoting and scaling up existing data efforts by making them available to a larger group of stakeholders, including the private sector;
- at the global level, actively supporting North–South and South–South exchanges on blended finance—including through Financing for Development and Development Cooperation Forums held at the United Nations, expert meetings, conferences and field visits; and
- within concessional providers, disseminating evidence and past experiences more effectively between different functional and geographical units.

Generate additional evidence

All stakeholders should continue generating additional evidence as to how blended finance can work in LDCs. Topics that deserve further research include:

- how blended finance should be applied across different countries and sectors and using different instruments;
- how to assess and measure development and financial additionality;
- how much blending is taking place thanks to concessional providers from the South;
- the impact of increased blending and mobilization ratios on development financing envelopes overall, and for LDCs in particular;
- how blended finance can help build capital markets in LDCs so that increased financing can be sourced domestically, and what role local entities can play in supporting this goal; and
- how to increase standardization in blended transactions and achieve scalability.

ABOUT UNCDF

The United Nations Capital Development Fund (UNCDF) makes public and private finance work for the poor in the world's 47 least developed countries. With its capital mandate and instruments, UNCDF offers 'last mile' finance models that unlock public and private resources, especially at the domestic level, to reduce poverty and support local economic development.

UNCDF's financing models work through two channels: savings-led financial inclusion that expands the opportunities for individuals, households and small businesses to participate in the local economy, providing them with the tools they need to climb out of poverty and manage their financial lives; and by showing how localized investments—through fiscal decentralization, innovative municipal finance and structured project finance—can drive public and private funding that underpins local economic expansion and sustainable development.

By strengthening how finance works for poor people at the household, small enterprise, and local infrastructure levels, UNCDF contributes to SDG 1 on eradicating poverty and SDG 17 on the means of implementation. By identifying those market segments where innovative financing models can have transformational impact in helping to reach the last mile and address exclusion and inequalities of access, UNCDF contributes to a number of different SDGs.

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