



Unlocking Public and Private
Finance for the Poor

BLENDING FINANCE

in the LEAST DEVELOPED COUNTRIES



in collaboration with



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.

Three years after the adoption of the Addis Ababa Action Agenda and the 2030 Agenda for Sustainable Development, there is a consensus that public and private finance will both be needed—at scale—to meet the Sustainable Development Goals (SDGs). There is also a recognition that development finance can and should play a role in accelerating sustainable development and catalysing additional resources for development.

In this context, more development partners are focusing on blended approaches at the same time as more private investors are looking for opportunities to invest not only to generate profit, but to create positive SDG outcomes that help tackle poverty, empower women and safeguard our environment.

That led UNCDF to ask: what do we really know about how blended finance is working for the least developed countries (LDCs)? What are the quantities of those flows? Which sectors are they supporting? What development impact are they having?

Answering these questions is increasingly important. While turning the 'billions into trillions' is essential, it should not just be about quantity, but also about quality and geography. LDCs typically find it much more difficult to attract private investment seeking risk-adjusted returns. If we are to live up to the SDG commitment of leaving no one behind, then increased public and private financial flows must be made to work also for the world's most vulnerable countries, for underserved markets and localities, and for smaller-sized projects in the so-called 'missing middle' that can transform local communities.

Official development assistance (ODA) and domestic public resources will continue to be essential for the development prospects of LDCs, supporting essential infrastructure, services, institutions, policies and capacities. To catalyse additional private-sector investment for the SDGs on the scale needed, we must also consider how best to harness a broad range of options in the financing for development toolbox in ways that can benefit LDCs.

Some of the questions this report seeks to address therefore include: Can blended finance be part of the solution in getting more finance to where it is needed most? What challenges and risks should be considered and mitigated? How can blended finance be effectively and efficiently deployed, so that projects support national ownership and generate additionality? Can blended operations in LDCs crowd in investors, especially domestic investors, while also creating demonstration effects that support commercial replication?

The aim of this report was not to settle these questions definitively, but to paint a better picture of what is happening, analyse how blended finance is being applied, and spark a discussion on what more could or should be done. Based on the research and case studies, UNCDF proposes an action agenda that, we hope, speaks to a wide readership in a position to make decisions about blended finance approaches.

Getting SDG finance right is essential for LDCs to meet their development goals. This means we, as the development community, need to experiment more and adopt more flexible approaches. We also need to see blending for what it is—not as a cure-all, but as a complement to purely public or purely private financing options that, deployed under the right circumstances, help catalyse much-needed additional resources for the SDGs.

UNCDF and UNDP have for decades worked side-by-side in LDCs, empowering poor families, local governments, and small and medium enterprises (SMEs) to access the financial resources they need to build a better future. Now, if all of us working together can get more resources going to where they are most needed, we will have mobilized much greater force behind our collective efforts to put the world's most vulnerable countries on an upward path towards sustainable development.



Achim Steiner
UNDP Administrator



Judith Karl
UNCDF Executive Secretary

This report has been prepared at a critical juncture, when financing the implementation of the SDGs in LDCs is being discussed rigorously to ensure the success of these globally accepted goals. Many LDCs are taking important strides towards graduation and structural transformation, especially where the availability of financing can leverage their sincere efforts in human development and empowerment and poverty reduction to build a better future. Yet progress in many cases is slow, and not uniform between and within LDCs.

To successfully deliver on the SDGs, countries need strong and visionary leadership and necessary institutions and capacities to implement that vision. They also need the financial resources to transform plans into actions. As this report highlights, many LDCs are facing the steepest paths to achieve the SDGs and to mobilize much-needed private finance. Against this backdrop, it is very important that innovations in financing for development focus on mobilization of the trillions of dollars required for the realization of the SDGs, and that LDCs and other vulnerable countries are able to benefit from these resources too.

Blended finance has generated increased interest for its potential to put ODA to catalytic effect and leverage additional private investments into LDCs. Blended transactions can also create important demonstration effects that could support commercial replication and informed national policy choices. At the same time, blended finance needs to be deployed effectively to support national ownership and to ensure that risks and rewards are shared fairly between public and private partners. Moreover, international public finance will continue to remain essential for LDCs. This highlights once again the importance of donors meeting their ODA commitments and providing other support measures to LDCs.

We are already three years into the implementation of the 2030 Agenda, and so much remains to be done. Now is the time to get more financing invested in those people and places that need it the most. We should not assume that this will happen on its own, nor can we afford to wait patiently as spectators. The opportunity cost of inaction is likely to be very high. The importance of analytical reports on blended finance is timely. They can help us understand better how to implement such approaches effectively in LDCs, and can also stimulate the risk-taking and experimentation required to extend the frontiers of finance for development. I am sure this report will provide LDCs with necessary information on financing options which will help them meet their national priorities in realizing the universal 2030 Agenda.



Masud Bin Momen
Ambassador and Permanent Representative of Bangladesh to the United Nations,
and Chair of the Global Coordination Bureau of the Least Developed Countries

The lead authors of this report are: Samuel Choritz (UNCDF), Gianni Lorenzato (UNCDF consultant) and Simona Santoro (UNCDF). Irene Basile (Organisation for Economic Co-operation and Development, or OECD) is the lead author of Chapter 2. She undertook extensive data analysis to map blended finance in LDCs.

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1 Southern Voice is a network of 50 think tanks from Asia, Africa and Latin America.

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ADB	Asian Development Bank
AFD	Agence Française de Développement
AfDB	African Development Bank
ARF	African Rivers Fund
BIFFL	Bangladesh Infrastructure Finance Fund Limited
BIO	Belgian Investment Company for Developing Countries
CAR	Central African Republic
CASF	Central Africa SME Fund
CPI	Climate Policy Initiative
DAC	Development Assistance Committee
DFI	Development finance institution
DRC	Democratic Republic of the Congo
EAIF	Emerging Africa Infrastructure Fund
EBRD	European Bank for Reconstruction and Development
EDFI	Association of European Development Finance Institutions
EIB	European Investment Bank
EIP	External Investment Plan
ESG	Environmental, social and governance
EU	European Union
EUR	Euro
EVI	Economic Vulnerability Index
FDI	Foreign direct investment
FMO	Financierings-Maatschappij voor Ontwikkelingslanden (Netherlands Development Finance Agency)
GDP	Gross domestic product
GNI	Gross national income
HAI	Human Assets Index
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation

KfW	Kreditanstalt für Wiederaufbau (German Development Bank)
kWh	Kilowatt hour
LDC	Least developed country
LIFT	Livelihoods and Food Security Trust Fund
M&E	Monitoring and evaluation
MDB	Multilateral development bank
MFI	Microfinance institution
MIC	Middle-income country
MIGA	Multilateral Investment Guarantee Agency
MSME	Micro, small and medium enterprises
MW	Megawatt
ODA	Official development assistance
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
OPIC	Overseas Private Investment Corporation
PIDG	Private Infrastructure Development Group
PPA	Power purchase agreement
PPP	Public-private partnership
SDG	Sustainable Development Goal
Sida	Swedish International Development Cooperation Agency
SME	Small and medium enterprise
TCX	The Currency Exchange Fund
UN	United Nations
UNCDF	United Nations Capital Development Fund
UNCTAD	United Nations Conference on Trade and Development
UN-DESA	United Nations Department for Economic and Social Affairs
UNDP	United Nations Development Programme
USAID	United States Agency for International Development

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

FOR BLENDED FINANCE IN LDCs

UNCDF proposes five areas where action is needed to improve the practice of blended finance and help ensure that its application can support LDCs to achieve the SDGs. These five areas are summarized below and spelled out in more detail in Part IV.



1. Encourage risk-taking and experimentation, as appropriate

Providers of concessional finance should engage with their boards, donors and LDC governments to find innovative ways to take more risks and experiment with new solutions, as part of broader efforts to get more private resources flowing to LDCs. This could include: determining, first, when blended finance may be the right approach for leveraging private finance and for providing public services; for those cases where it 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; 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 better coordinating provider and donor activities so that the right set of instruments can be designed 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

Global policymaking discussions on blended finance should purposefully engage LDCs and other developing countries as active participants. 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. 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.



3. Deploy blended strategies to support sustainable outcomes

Providers and other development partners in LDCs should, where appropriate, actively seek out suitable domestic investors; support blended transactions in local currencies; and ensure that linkages are built with local suppliers and entrepreneurs. 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 is best suited for a given investment; and ensure that blended finance transactions are complementary to other interventions aimed at supporting private-sector development. Providers should increase facilitation of currency hedging for projects in LDCs.



4. Improve impact measurement and transparency

Strengthening SDG impact measurement means that providers should ensure that *ex ante* SDG impact assessments and *ex post* evaluations are undertaken and made publicly available. To improve transparency, it is important that concessional providers make publicly available such information as how much ODA is going into blended transactions; create appropriate data standards that support better monitoring, measurement and cross-comparison of interventions; and work with LDC governments to run fair tendering processes to select the most competitive project sponsors.

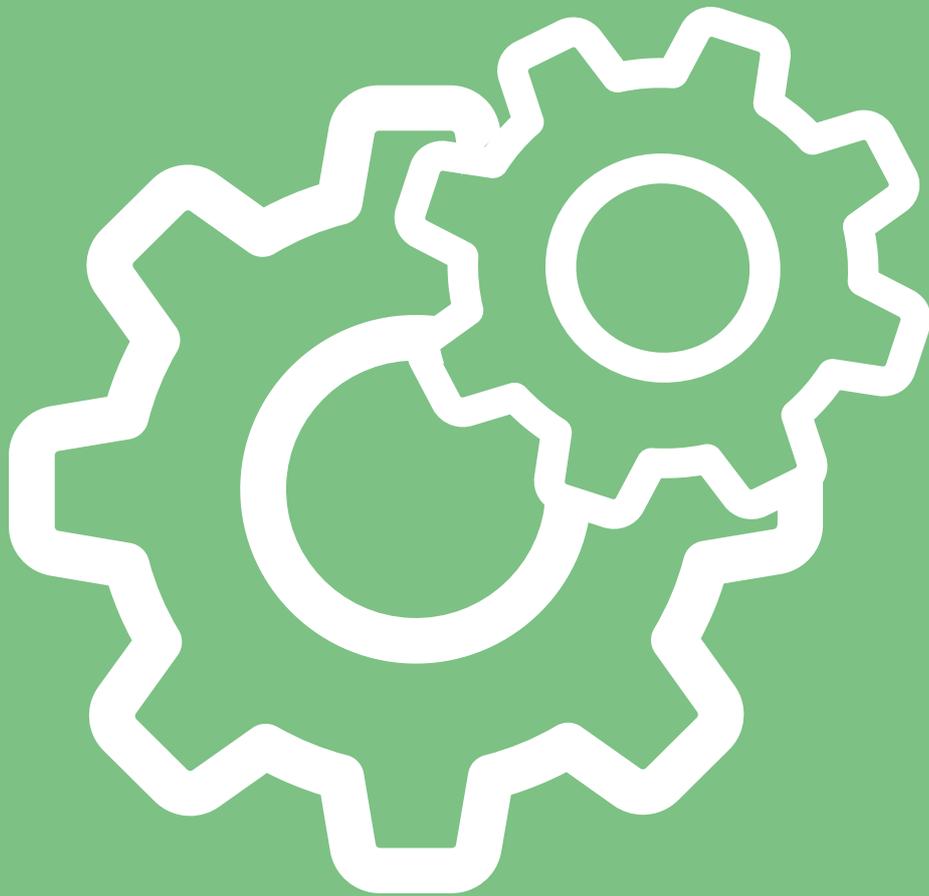


5. Increase knowledge-sharing and evidence to inform blended finance best practice

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; at the global level, promoting and scaling up existing data efforts by making them available to a larger group of stakeholders; supporting North–South and South–South exchanges; and within concessional providers, disseminating evidence and past experiences more effectively between different functional and geographical units. All stakeholders should also continue generating additional evidence as to how blended finance can work in LDCs and riskier markets.

INTRODUCTION

Why a focus on blended
finance in LDCs?



WHY A FOCUS ON BLENDED FINANCE IN THE LEAST DEVELOPED COUNTRIES?

The world's 47 least developed countries (LDCs) face a substantial challenge to mobilize the resources they need to achieve the Sustainable Development Goals (SDGs). While a comprehensive estimate is not available, various data points confirm the extent of the financing gap for achieving the SDGs in LDCs. For instance, the cost to achieve universal access to electricity in LDCs alone is estimated at \$20–30 billion per year.² The overall infrastructure funding gap, including the water, communication³ and transportation sectors, is most likely a multiple of that figure. It is estimated that micro, small and medium enterprises (MSMEs) need hundreds of billions of dollars to grow.⁴

LDCs are a diverse group of countries, with different levels of growth, vulnerability, demographics, geography, and size of the economy.⁵ Some are on a fast track to middle-income country (MIC) status, and others are affected by crises. LDCs are home to 1 billion people, one third of whom live on less than \$1.90 per day.⁶ Despite many LDCs recording impressive improvements in human development, long-term growth projections point to 35 percent of the population in LDCs remaining in extreme poverty by 2030.⁷ Gross domestic product (GDP) growth in LDCs, estimated to reach 5.4 percent in 2018⁸, is higher than projected global growth,⁹ but still below the 7 percent annual rate called for by SDG 8. Individual country performances vary: 5 LDCs achieved the 7 percent target in 2017, down from 14 in 2012; at the same time, 9 of the LDCs for which data are available have

experienced gradual deteriorations in GDP per capita.¹⁰ Life expectancy, years of schooling and percentage of the population living in urban areas are all lower in LDCs than in developing countries as a whole. Just over half (54 percent) of people without access to electricity globally live in LDCs.¹¹



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\$1.90 per day



GDP growth in LDCs,
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for by the SDGs

² United Nations Conference on Trade and Development (2017a). 'The Least Developed Countries Report 2017—Transformational Energy Access'. Geneva: UNCTAD. http://unctad.org/en/PublicationChapters/ldcr2017_ch5_en.pdf.

³ For instance, in 2016, the proportion of the population covered by a 3G mobile network stood at 61 percent in LDCs, compared to 84 percent globally. (United Nations (2018c). 'The Sustainable Development Goals Report 2018'. New York: United Nations. <https://unstats.un.org/sdgs/files/report/2018/TheSustainableDevelopmentGoalsReport2018.pdf>).

⁴ Calculations performed by UNCDF for 39 of the 47 LDCs for which data are available, based on the SME Finance Forum's MSME Finance Gap Database (2017). SME Finance Forum, MSME Finance Gap Database. <http://smefinanceforum.org/data-sites/msme-finance-gap>. (Accessed July 2018.)

⁵ There are 33 LDCs in Africa, 13 in Asia and the Pacific, and 1 in Latin America. Of the 47 LDCs, 17 are also a Landlocked Developing Country, and 9 are also a Small Island Developing State. For more information, see <http://unohrls.org/about-ldcs/>.

⁶ United Nations (2018a). 'Report of the Secretary General. Implementation of the Programme of Action for the Least Developed Countries for the Decade 2011–2020, 27 July 2017 to 26 July 2018'. A/73/80. New York: United Nations. <http://undocs.org/en/A/73/80>.

⁷ United Nations (2018c). 'World Economic Situation and Prospects 2018, Update as of mid-2018'. New York: United Nations. https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/WESP_2018_Mid-year_Update.pdf.

⁸ United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018'. Geneva: UNCTAD. https://unctad.org/en/PublicationsLibrary/aldc2018d1_en.pdf.

⁹ International Monetary Fund (2018). 'World Economic Outlook Update, July 2018'. Washington, DC: IMF. <https://www.imf.org/en/Publications/WEO/Issues/2018/07/02/world-economic-outlook-update-july-2018>.

¹⁰ The five LDCs meeting the 7 percent GDP growth target in 2017 were: Bangladesh, Djibouti, Ethiopia, Myanmar and Nepal. Seven LDCs posted real GDP growth in excess of 6 percent: Burkina Faso, Cambodia, Guinea, Lao People's Democratic Republic, Rwanda, Senegal and Sierra Leone. (United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018').

¹¹ United Nations Conference on Trade and Development (2017a). 'The Least Developed Countries Report 2017—Transformational Energy Access'.

TABLE 1. Key socio-economic data for LDCs vs. all developing countries

	LDCs	All developing countries (incl. LDCs)
Population, total (millions)	1,002	6,259
Urban population (%)	33	49.7
Average annual population growth (2010–2015, %)	2.3	1.3
GDP (total, 2011 purchasing power parity, \$ billions)	2,483	62,657
GDP per capita (purchasing power parity \$)	2,536	10,199
Gross fixed capital formation (% of GDP, 2010–2015)	25.9	30.9
Internet users (% of population)	15.7	38.5
Foreign direct investment, net inflows (% of GDP)	3.3	1.9
Net ODA received (% of GNI)	4.5	0.4
Remittance inflows (% of GDP)	3.87	1.46
Life expectancy at birth (years)	64.8	70.7
Expected years of schooling (years)	9.84	12.2
Domestic credit provided by financial sector (% of GDP, 2010–2015)	38.4	133.2
Renewable energy consumption (% of total final energy consumption)	73.2	23.5

Source: UNDP (2018). 'Human Development Indices and Indicators. 2018 Statistical Update'. New York: UNDP.

As LDCs and their development partners explore all potential sources of finance to achieve the SDGs, there is growing interest in the role of blended finance to complement existing sources that, on their own, are not sufficient to bridge the financing gap.

First, many LDC governments have limited fiscal space and a heightened reliance on external sources of funding. Tax revenues are lowest in LDCs as a whole; few manage levels above 15 percent of GDP (compared with the Organisation for Economic Co-operation and Development (OECD) average of 34.4 percent in 2014), as they typically have lower levels of tax collection and a narrower tax base.¹² Approximately one third of LDC sovereigns are at high risk of debt distress or already in that situation.¹³ Debt service as a proportion of exports of goods

and services increased from a low of 3.5 percent in 2011 to 8.6 percent in 2016.¹⁴ The LDCs' share of world merchandise exports decreased from 1.1 percent to 0.9 percent between 2013 and 2016; a similar trend was seen for service exports, where the LDC share stood at 0.74 percent in 2016.¹⁵ In 38 of the LDCs for which data are available, economies are heavily reliant on the commodity sector, which accounted for more than two thirds of merchandise exports in 2013–2015;¹⁶ the cyclical nature of this sector can lead to government budgets shrinking during commodity downturns.

¹² Ibid.

¹³ United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018'.

¹⁴ United Nations (2018c). 'The Sustainable Development Goals Report 2018'.

¹⁵ Ibid.

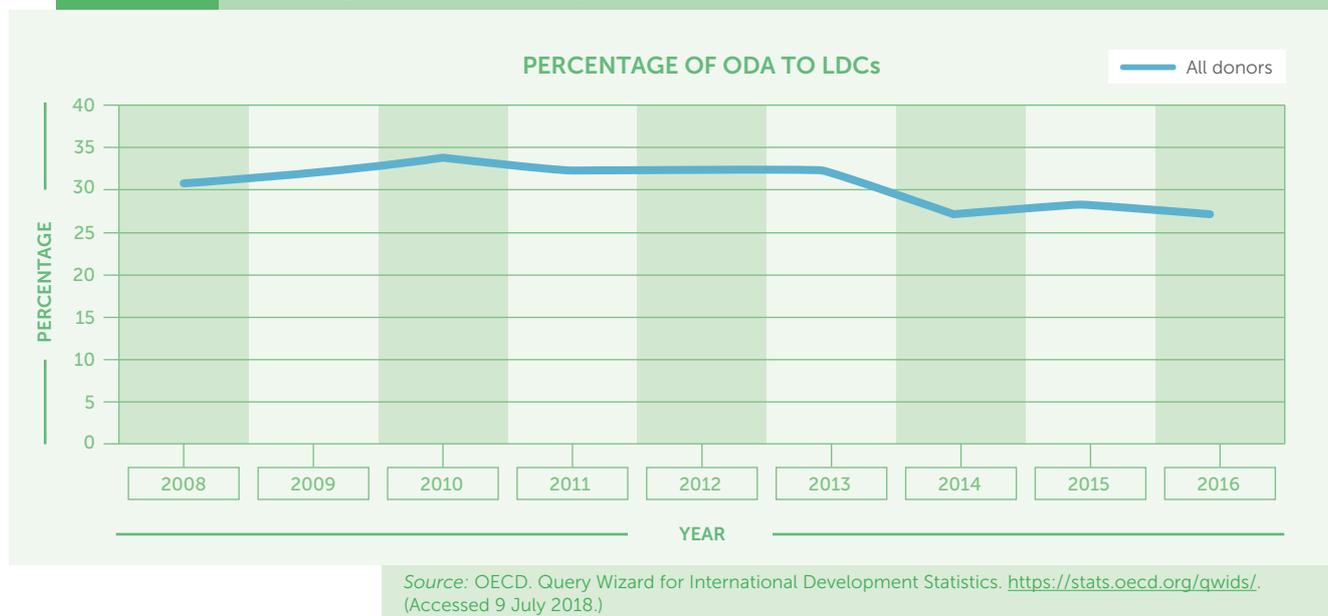
¹⁶ For more information, see United Nations Conference on Trade and Development (2016). 'The Least Developed Countries Report. The path to graduation and beyond: Making the most of the process'. Geneva: UNCTAD. http://unctad.org/en/PublicationsLibrary/ldc2016_en.pdf.

Financing shortfalls can be especially large at the subnational level. Many fast-growing cities in LDCs play an important role in delivering the SDGs, and face pressures from growing urbanization.¹⁷ The difficulty in raising debt at subnational level is reflected in the fact that there is no subnational public rating for an LDC from any of the three major ratings agencies, except for the Municipality of Dakar.¹⁸

Overall, the external resource gap—that is, the difference between the gross fixed capital formation rate and the gross domestic savings rate—of LDCs as a group averaged 6.9 percent of GDP in 2015, up from 4.9 percent in 2014.¹⁹ LDCs have traditionally financed this external resource gap through a mixture of official development financing²⁰— including ODA — and private resource flows, notably foreign direct investment (FDI) and remittances.²¹ However, none of these options is likely to bridge the SDG financing gap entirely.

Second, in LDCs, unlike in other developing countries, ODA is already the largest source of external finance; it accounts for over one third of external finance and remains essential for LDCs' development prospects. While gross ODA disbursements amount to only 1.3 percent of government revenue in all developing countries on average, this figure is much higher in LDCs, at around 15 percent.²² While there was an increase in ODA to LDCs in 2016 of less than 1 percent in real terms to \$43.1 billion, the medium-term trend is one of stagnation.²³ In addition, LDCs have received a declining percentage of total ODA flows from all donors over the past decade in real terms, as shown in Figure 1. ODA flows to LDCs are also unevenly allocated: for example, in 2015–2016, half of the gross bilateral ODA expenditures from OECD Development Assistance Committee (DAC) countries were directed at eight LDCs.²⁴

FIGURE 1. Percentage of ODA received by LDCs (2008–2016)



¹⁷ It is estimated there will be 71 cities with populations of between 0.5 million and 1 million people in LDCs by 2030, up from 30 in 2015 (Hilger, Tim, Vito Intini, Daniel Platz and Simona Santoro (2017). 'Financing Sustainable Urban Development in the Least Developed Countries'. New York: UNCDF and DESA/Financing for Development Office).

¹⁸ Ibid.

¹⁹ United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018'

²⁰ Official development finance is a term used by OECD to measure inflow of resources to recipient countries. It includes: bilateral ODA; grants and concessional and non-concessional development lending by multilateral financial institutions; and other official flows for development purposes (including refinancing loans) which have too low a grant element to qualify as ODA.

²¹ Here too individual LDCs show differences, with some oil- and mineral-rich LDCs having gross domestic savings far outstripping gross fixed capital formation (United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018').

²² United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects 2018. Report of the Inter-agency Task Force on Financing for Development'. New York: UN-DESA. https://developmentfinance.un.org/sites/developmentfinance.un.org/files/Report_IATF_2018.pdf.

²³ Ibid.

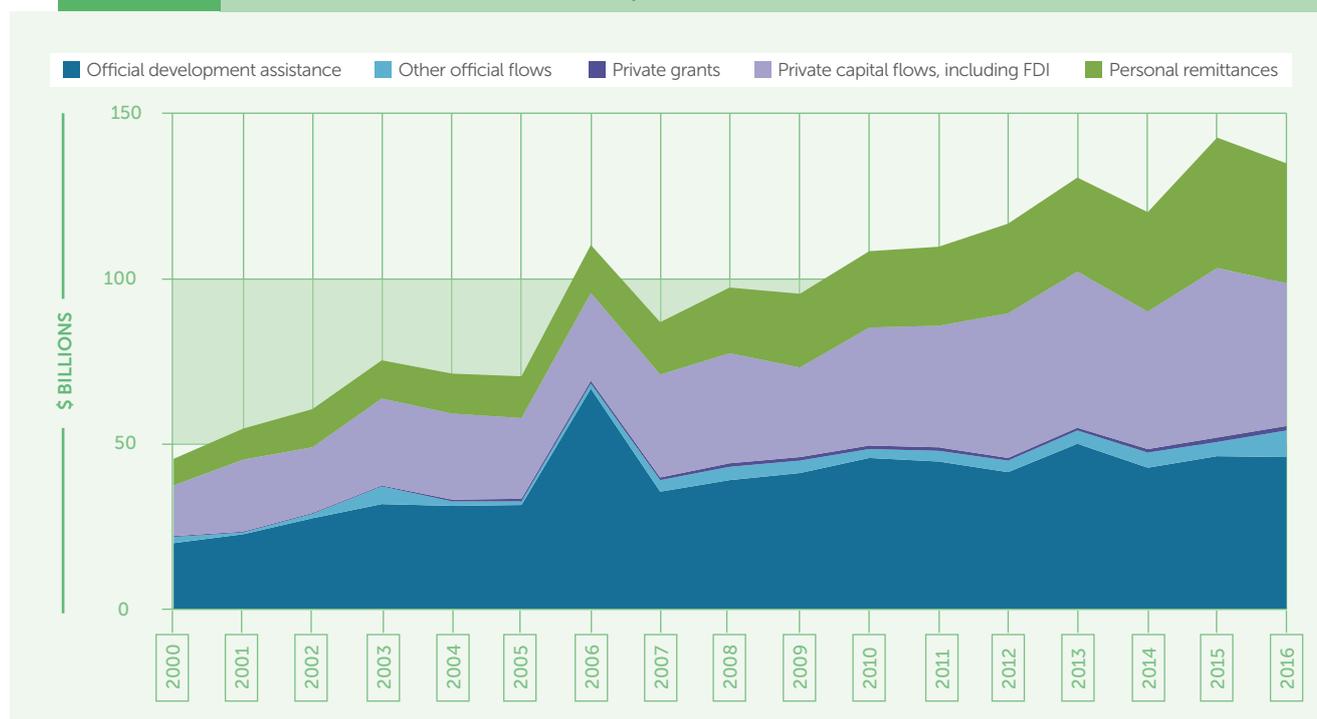
²⁴ Afghanistan, Ethiopia, Tanzania, Bangladesh, South Sudan, DRC, Mozambique and Uganda (Organisation for Economic Co-operation and Development (2018c). 'Development Co-operation Report 2018: Joining Forces to Leave No One Behind'. Paris: OECD Publishing. <https://www.oecd-ilibrary.org/docserver/dcr-2018-enpdf?expires=1539274159&id=id&accname=quest&checksum=F7B44E058615E4C52CDA3F6F9D4F3EC7>).

The Istanbul Programme of Action for LDCs seeks to enable half the LDCs to meet graduation criteria by 2020.²⁵ Even if this goal is not met, forms and modalities of ODA support might change for those LDCs²⁶ moving towards graduation.²⁷ LDCs will continue to have access to external support after graduation, and most development partners indicate that LDC status is not a main criterion for ODA allocation. However, some donors might switch from grants to concessional loans or increase interest rates for concessional loans.²⁸

Third, FDI, which has been on an upward trajectory in LDCs since 2002, remains concentrated in a small number

of economies and sectors, and can be volatile, reflecting macroeconomic and monetary conditions in both recipient and source countries. In 2017, FDI inflows to LDCs decreased for the second consecutive year, by 17 percent to \$26 billion. The value of greenfield FDI projects announced in 2017, an indicator of future FDI flows, plunged by 43 percent to a four-year low; foreign investors, mostly from other developing economies, have scaled down their capital spending plans, especially in the services sector.²⁹ It is also worth noting that remittances to LDCs as a group totalled \$36.9 billion in 2017, down by 2.6 percent compared with the 2016 peak of \$37.9 billion.³⁰

TABLE 2. External finance to LDCs, constant prices, 2000–2016



Source: Estimates based on OECD statistics and World Bank data on remittances and private capital flows.³⁰

²⁵ United Nations (2011). 'Fourth United Nations Conference on the Least Developed Countries, Programme of Action for the Least Developed Countries for the Decade 2011-2020'. A/CONF.219/3/Rev.1, 23 May 2011. New York: United Nations. <http://unohrls.org/UserFiles/File/IPoA.pdf>.

²⁶ Not all international organizations and financing institutions use the LDC category and criteria for aid and credit allocation. The list of LDCs is reviewed every three years by the Committee for Development Policy (CDP), a group of independent experts reporting to the United Nations Economic and Social Council. The CDP may recommend countries for addition to, or graduation from, the list of LDCs. At a meeting of the CDP in March 2018, four countries—Bhutan, Kiribati, São Tomé and Príncipe, and Solomon Islands—were recommended for graduation from the LDCs list. In addition, Bangladesh, Lao People's Democratic Republic and Myanmar met the graduation criteria for the first time. These three countries will be considered for graduation at the next triennial review in 2021, with a view to graduating in 2024. Nepal and Timor-Leste were found eligible for the second consecutive time but were not recommended for graduation. The Committee will consider Nepal and Timor-Leste again in 2021. See United Nations (2018d). 'Committee for Development Policy Report on the Twentieth Session (12–16 March 2018)'. E/2018/33. New York: United Nations. <http://undocs.org/en/E/2018/33>.

²⁷ As of May 2018, all LDCs except for Angola are eligible to receive IDA resources. Out of the five LDCs graduated so far, only two (Botswana and Equatorial Guinea) are also IDA graduates (United Nations (2018e). 'Implementation, Effectiveness and Added Value of Smooth Transition Measures and Graduation Support, Draft Report of the Secretary-General'. New York: United Nations).

²⁸ Ibid.

²⁹ United Nations Conference on Trade and Development (2018b). 'World Investment Report 2018. Investment and new industrial policies'. Geneva: UNCTAD. http://unctad.org/en/PublicationsLibrary/wir2018_en.pdf.

³⁰ United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018'.

³¹ Note: The figures shown are in net disbursements. Figures for ODA, other official flows (OOF) and private grants are based on OECD statistics and are net disbursements. ODA and OOF include outflows from bilateral and multilateral institutions; capital subscriptions are included in private grants. OOF flows were negative in 2000, 2001, 2004 and 2006, and are given a null value in the graph. Private grants cover gross outflows from non-governmental organizations (NGOs) and civil society minus support received from the official sector. Remittances are in gross disbursements. Private capital flows include net FDI and portfolio investments.

Institutional investors such as pension funds and insurance companies are large sources of private capital. While these investors favour liquid portfolios of bonds and equities, in some geographies they have become a meaningful source of capital for unlisted infrastructure projects.³² Such investments have largely bypassed the LDCs, however. Much of the infrastructure investment needed for the SDGs will be for sustainable infrastructure in the global South. One report estimates that at least an additional \$1 trillion a year of private-sector investment in sustainable infrastructure in emerging markets will be required.³³ Attracting long-term finance for projects in this sector, however, is very difficult. Only a few of the top 100 private institutional investors, including sovereign wealth funds, have more than 1 percent of their assets directly invested in infrastructure globally;³⁴ the figure of investments in LDCs is likely far lower. In addition, private financing for SDG investments globally can also be volatile from year to year.³⁵

All these factors underscore the fact that LDCs need access to significant additional resources—both private and public, depending on the nature of the projects to be financed—to achieve their goals. In Bangladesh, for example, the government estimates that about 42 percent of total finance for meeting the SDGs will have to come from the private sector, with another 6 percent coming in the form of public–private partnerships (PPPs).³⁶

Private and public finance have different objectives; the former is return-oriented and invests in projects or companies, such as small and medium enterprises (SMEs), that generate revenues, while the latter is concerned with providing public services and supporting sustainable development, including through public goods such as protecting ecosystems. Both types of finance are required to fill the SDG financing gap. In the case of private finance, a reallocation of even a small percentage of the \$80 trillion in assets managed by long-term institutional investors towards sustainable development in LDCs could have an enormous impact on their prospects of achieving the SDGs.³⁷

Against this backdrop, blended finance is receiving increasing attention for its potential to maximize the catalytic impact of concessional finance by sharing risks

or lowering costs to adjust risk–return profiles for private investors. This crowds in private or commercial capital for SDG-related investments that would otherwise be overlooked.³⁸ Scoping studies commissioned for this report in four LDCs suggest that interest in exploring blended finance as an additional avenue for mobilizing resources for the SDGs may be gaining momentum, though LDCs are also becoming more aware of the risks.³⁹

Beyond making an investment more attractive for private capital, blended finance can also bring other benefits. These can include sending a broader signal that a project, sector or market is investable. Through demonstration effects, lessons learned and knowledge-sharing, blended finance could support commercial replication over time, inform government-led improvements in policies and regulations, and potentially support the development of local markets, helping to make countries or sectors more attractive to private finance.⁴⁰

At the same time, blended finance is not suitable for all kinds of projects; at a minimum, projects must generate revenue streams to attract private investment. Some LDCs may not currently have the capacities, regulations or institutional arrangements to negotiate, analyse and structure blended transactions. Blended finance must also be applied effectively and efficiently. ODA should not be used in blended transactions to over-subsidize the private sector and/or provide an unfair advantage to some investors while crowding out others.

Blended transactions should comply with high standards of transparency and accountability; promote the fair allocation of risks and rewards; and apply high environmental, social and governance (ESG) standards. Given concerns around 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 providers and donors should ensure that blended transactions align with national priorities and respect national ownership.

To date, the role of blended finance in LDCs is quite limited: 7 percent (or \$5.5 billion out of \$81 billion) of the total private capital mobilized by official development finance globally over the 2012–2015 period benefited LDCs, according to OECD data (see Chapter 2). This is not necessarily an ‘underweighting’ relative to the size of their economies, though it is small relative to the amount of ODA LDCs received (see Table 3). This suggests that attracting private finance is more difficult in LDCs than elsewhere, and that providers are mobilizing much greater volumes of private finance in MICs.

³² Pension funds in some countries—notably Canada—have increased their allocation to infrastructure significantly.

³³ Blended Finance Taskforce (2018). ‘Better Finance, Better World: Consultation Paper of the Blended Finance Taskforce’. London: Blended Finance Taskforce. https://s3.amazonaws.com/aws-bsdc/BFT-BetterFinance_final_01192018.pdf.

³⁴ Ibid.

³⁵ Kharas, Homi (2018). ‘Cross-border financing flows impacting the Sustainable Development Goals’ in *Financing the UN Development System: Opening Doors*. New York: United Nations MPTF Office and Dag Hammarskjöld Foundation. https://www.daghammarskjold.se/wp-content/uploads/2018/09/financial-instr-report-2018-interactive-pdf_pj.pdf.

³⁶ Rahman, Mustafizur, Towfiqul Islam Khan and Sherajum Monira Farin (2018, forthcoming). ‘Blended Finance in Bangladesh: A scoping paper’. Southern Voice Occasional Paper, No. 46. Dhaka: Southern Voice. It is important to note that PPPs are established mechanisms to involve private parties in the provision of a public service or the building and operation of public infrastructure. Some PPPs can be structured as blended transactions.

³⁷ United Nations Department of Economic and Social Affairs (2018). ‘Financing for Development: Progress and Prospects, 2018’.

³⁸ See the guest piece by Jorge Moreira da Silva, ‘Targeting blended finance to help the poorest 20 percent’.

³⁹ Bhattacharya, Debapriya, and Sarah Sabin Khan (2018, forthcoming). ‘Is blended finance trending in LDCs? Perspectives from the ground’. Southern Voice Occasional Paper, No. 49. Dhaka: Southern Voice.

⁴⁰ Sierra-Escalante, Kruskaia, and Morten Lykke Lauridsen (2018). ‘Blended Finance—A Stepping Stone to Creating Markets’. Washington, DC: IFC. https://www.ifc.org/wps/wcm/connect/363eeaab-77da-4a9e-ad1e-9ff089402bf1/EMCompass_Note_51-BlendedFinance_FIN+April+13.pdf?MOD=AJPERES.

This reflects higher risks and perceptions of risk in LDCs, which can stem from a poor business enabling environment. Macroeconomic, governance, regulatory, infrastructure, market as well as other perceived risks can be a significant deterrent to private capital, even when risks are shared through blending. Additionally, in smaller LDCs the scale of the opportunity—overall size of the economy (notwithstanding its growth prospects) or sector—and small deal sizes relative to transaction costs may be insufficient to draw interest from international private investors. It may also reflect that there are fewer bankable opportunities in LDCs.

Some providers of concessional capital may also shy away from riskier 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.⁴¹

Blended approaches can increase overall financing available for the SDGs. While efforts to map blended finance have not necessarily painted a complete picture, they do suggest that 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 most heavily reliant on ODA and where blending has been more challenging.⁴² This underlines the importance both of donors meeting their ODA commitments to LDCs and of exploring how to deploy blending more effectively and efficiently in such countries.⁴³

Blended approaches may not always be the right ones for leveraging private finance. In some cases, a project may simply not be ripe for blending. The cost of getting a deal off the ground by deploying concessional resources may be too high; in such cases, 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 actual and perceived risks of investing in these markets.

Ultimately, meeting the SDGs will require investments of all kinds—public and private, domestic and international. Project and country characteristics, macroeconomic conditions and national policy priorities should determine which financing model—public, private or blended—is best suited for which investment.

At its heart, this report is about challenging the public and private development partners to shift the dynamics of how resources are allocated and to come up with better ways of making finance work for poor people. This report, therefore, explores how to implement and adapt blended finance approaches to LDCs to maximize their effectiveness in crowding in private capital while minimizing their risks.

⁴¹ See, for example, Lee, Nancy (2018). 'More Mobilizing, Less Lending'. Center for Global Development Brief, April 2018. Washington, DC: Center for Global Development. <https://www.cgdev.org/sites/default/files/more-mobilizing-less-lending-pragmatic-proposal-mdbs.pdf>.

⁴² Oxfam (2017). 'Private-finance blending for development: Risks and opportunities', Oxford: Oxfam, February 2017. <https://www.oxfam.org/sites/www.oxfam.org/files/bp-private-finance-blending-for-development-130217-en.pdf>.

⁴³ United Nations Department for Economic and Social Affairs (2018), 'Financing for Development: Progress and Prospects, 2018'.

STRUCTURE OF THE REPORT

In addition to briefly outlining the key concepts of blended finance used throughout the report (Chapter 1), Part I examines the current data on the application of blended finance in LDCs (Chapter 2), analyses the barriers to private capital in LDCs and how blended finance can be used to address them throughout the investment life cycle (Chapters 3 and 4), discusses blended finance and development effectiveness in LDCs (Chapter 5) and, finally, highlights open issues requiring further discussion as they pertain to blended finance in LDCs (Chapter 6). Besides the data analysis led by the OECD, this part of the report draws on the scoping studies on four LDCs—Bangladesh, Nepal, Senegal and Uganda—prepared by research centres affiliated with Southern Voice, on the related synthesis paper produced by the Southern Voice secretariat, and on informal interviews with blended finance providers. It also weaves in findings and takeaways from case studies analysed in Part II, and the guest pieces presented in Part III.

Part II presents five case studies of blended finance in LDCs produced jointly by contributors and UNCDF: a water infrastructure project in Rwanda, a solar power infrastructure project in Mali, an agricultural value chain project in Tanzania, a currency hedging programme in Myanmar, and a private equity fund in the Democratic Republic of the Congo (DRC) and the Central African Republic (CAR). Each case study discusses a specific development challenge and related barriers, the blended finance solution adopted and key takeaways, to tease out some general considerations. The case study selection was motivated by three criteria: assembling a fairly diverse geographical sample; analysing LDCs characterized by different social and macroeconomic conditions and enabling environments; and examining the application of blended finance in different sectors.

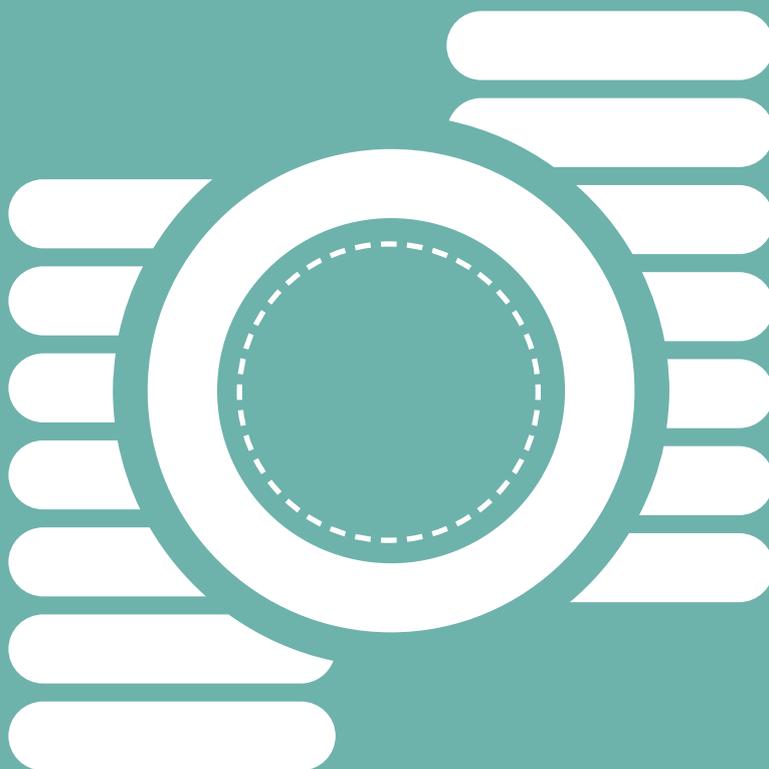
Part III introduces short opinion pieces produced by experts and practitioners covering a range of topics. This is meant to stimulate the debate on blended finance in LDCs, by providing a venue for think tanks, development finance institution (DFIs), national development banks, investors, and bilateral and multilateral development organizations to discuss specific questions emerging from their activities.

Part IV summarizes UNCDF's proposed action agenda to improve the effectiveness and efficiency of blended finance in LDCs, address risks flagged in the report, fill data and information gaps and consider some future avenues of research and analysis.

01

PART I

Applying blended finance in LDCs



CHAPTER 1

BLENDING 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. Concessional finance 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

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>.

⁴⁵ Overall, philanthropic flows are still modest in volume compared to overall ODA flows. Foundations provided \$23.9 billion for development over 2013–2015. Around 28 percent of the country-allocable funding benefited LDCs (Organisation for Economic Co-operation and Development (2018). ‘Private Philanthropy for Development, The Development Dimension’. Paris: OECD Publishing. <http://dx.doi.org/10.1787/9789264085190-en>). Foundations are engaged in blended transactions too, and their resources present an additional avenue to catalyse commercial finance for the SDGs.

⁴⁶ Organisation for Economic Co-operation and Development Development Assistance Committee (2018). ‘Blended Finance Principles for Unlocking Commercial Finance for the Sustainable Development Goals’. Paris: OECD Publishing. <https://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/OECD-Blended-Finance-Principles.pdf>. These principles are: anchor blended finance use to a development rationale; design blended finance to increase the mobilization of commercial finance; tailor blended finance to local context; focus on effective partnering for blended finance; and monitor blended finance for transparency and results.

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.

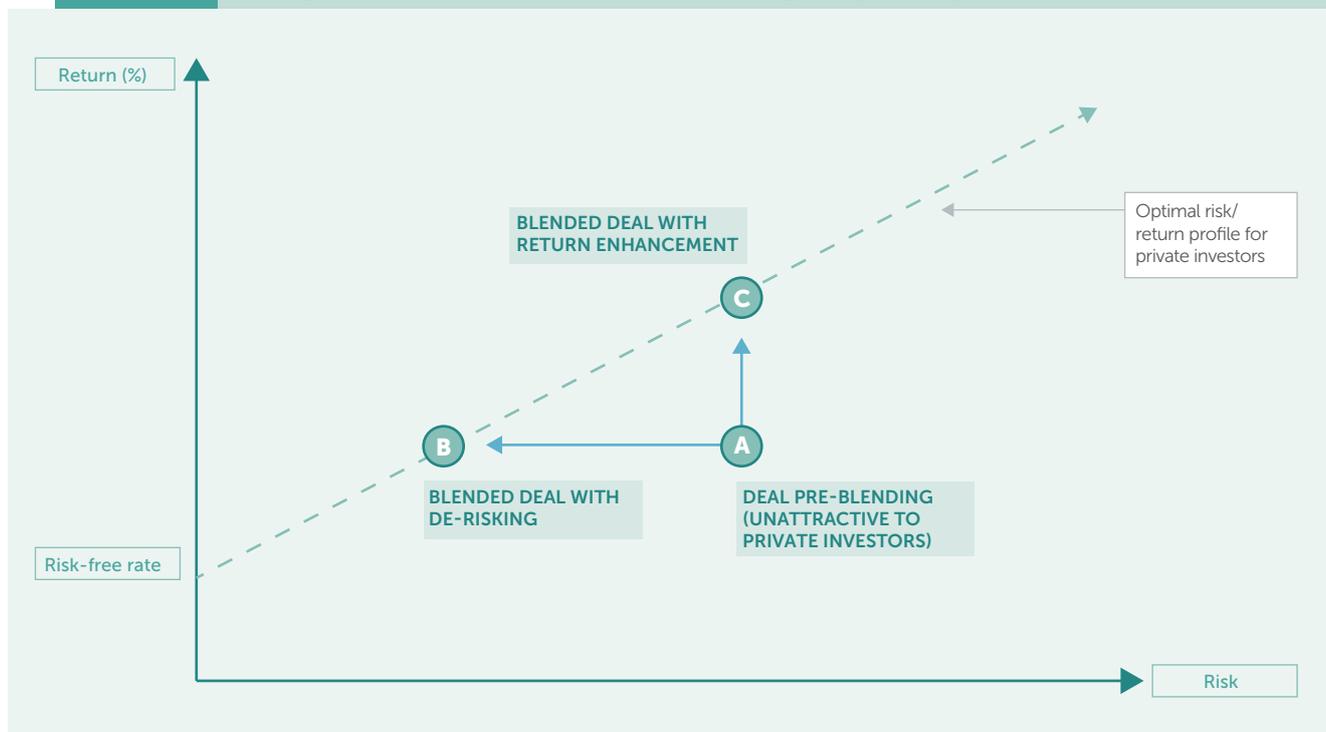
The private sector generally makes its investment decisions on the basis of risks and financial returns. Many of the poorest and most vulnerable countries in the world, or localities or smaller projects within those countries, may offer poor return prospects or may be perceived as doing so. This is partly 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.

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



⁴⁷ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

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 concessional support 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.⁴⁸ 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.⁴⁹ 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.⁵⁰ Concessional resources should, to the extent possible, help develop a market that responds to appropriate incentive structures to provide the desired goods or services.⁵¹ Ensuring development additionality, however, is not always straightforward. It can be difficult to assess exactly whether a project produces enough development additionality to justify the use of concessional resources. Metrics and methods to define and measure development differ—often widely—across organizations and may not be consistently implemented within organizations either. Development additionality is often not directly observable and may be difficult to gauge upfront, especially in the case of long-term projects or those generally aimed at wider macroeconomic development. Such uncertainty underscores the importance of *ex ante* SDG impact assessments.

Once the blended project is financed, its development additionality should be monitored regularly and benchmarked versus the original plan. Ideally, development additionality should also be monitored *ex post*, after the completion of a blended project, since development impact can take longer to achieve than the financial timeline of a project.⁵²

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.⁵³

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.⁵⁴ 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'.

⁴⁹ DANIDA (2016). 'Evaluation study: Private Capital for Sustainable Development: Concepts, Issues, and Options for Engagement in Impact Investing and Innovative Finance'. Copenhagen: DANIDA. http://um.dk/en/danida-en/results/eval/Eval_reports/?start=2.

⁵⁰ DFI Working Group on Blended Concessional Finance for Private Sector Projects (2017). 'Summary Report'. Washington, DC: DFI Working Group on Blended Concessional Finance for Private Sector Projects. https://www.ifc.org/wps/wcm/connect/30635fde-1c38-42af-97b9-2304e962fc85/DFI+Blended+Concessional+Finance+for+Private+Sector+Operations_Summary+R...pdf?MOD=AJPERES.

⁵¹ Ibid.

⁵² Heinrich, Melina (2014). 'Demonstrating additionality in private sector initiatives: A practical exploration of good practice for challenges funds and other cost-sharing mechanisms'. Cambridge: Donor Committee for Enterprise Development. https://www.enterprise-development.org/wp-content/uploads/DCED_Demonstrating-Additionality_final.pdf.

⁵³ DFI Working Group on Blended Concessional Finance for Private Sector Projects (2017). 'Summary Report'.

⁵⁴ Carter, Paddy (2018). 'The Pitfalls of Leverage Targets', Center for Global Development blog post, 9 February. <https://www.cgdev.org/blog/pitfalls-leverage-targets>.

- 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

⁵⁶ International Trade Centre (2015). 'Competitiveness Outlook 2015: Connect, Compete and Change for Inclusive Growth'. Geneva: International Trade Centre. http://www.intracen.org/uploadedFiles/intracenorg/Content/Publications/SME_Comp_2015_Jan_version_low_res.pdf.

⁵⁷ Alibhai, Salman, Simon Bell and Gillette Conner (eds) (2017). 'What's happening in the missing middle? Lessons from financing SMEs'. Washington, DC: World Bank Group. <https://openknowledge.worldbank.org/bitstream/handle/10986/26324/113906-WhatsHappeningintheMissingMiddleLessonsinSMEFinancing-29-3-2017-14-20-24.pdf?sequence=1&isAllowed=y>.

⁵⁸ International Trade Centre (2015). 'Competitiveness Outlook 2015: Connect, Compete and Change for Inclusive Growth'.

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'.

⁵⁵ See, for example, 'Case Study 4: Rwanda. Kigali bulk water supply PPP'.

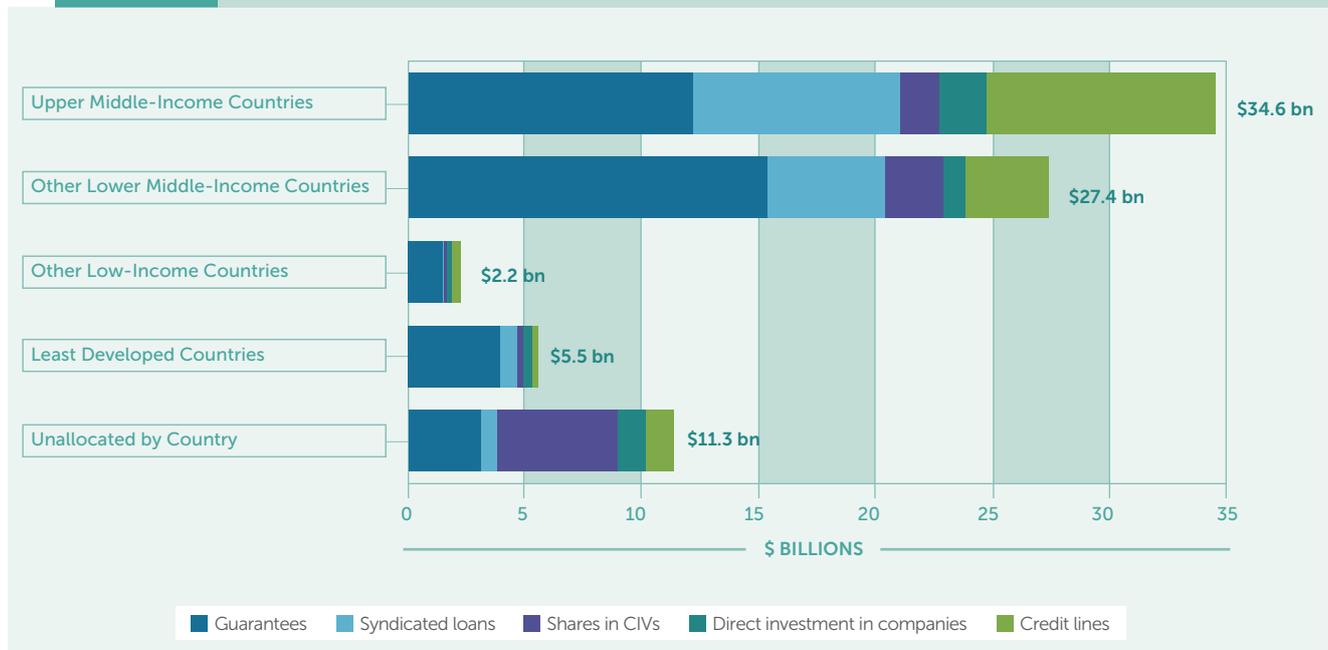
CHAPTER 2

THE APPLICATION OF BLENDED FINANCE IN LDCs: THE LATEST DATA

According to the OECD,⁶¹ in the four years from 2012 to 2015, official development finance unlocked \$81 billion in private finance for development globally.⁶² Of that amount, some \$5.5 billion of private capital—or less than 7 percent of

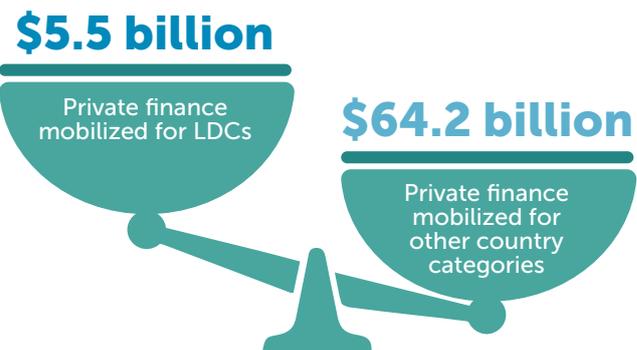
the total—was for LDCs. An additional \$11 billion in private finance was mobilized through regional operations, some of which may have included LDCs.⁶³

FIGURE 3. Private finance mobilized by official development finance instruments, \$ billions, 2012–2015



⁶¹ Unless otherwise noted, the information and data that map blended finance flows in LDCs in this report are based on additional analysis undertaken by the OECD, drawing from the 2015 DAC Survey on Amounts Mobilised from the Private Sector by Official Development Finance Interventions. The survey examined five instruments: guarantees, syndicated loans, shares in collective investment vehicles (CIVs), direct investment in companies, and credit lines. Amounts are reported in current prices. More information about that survey and its original findings can be found in Benn, Julia, Cécile Sangaré and Tomáš Hos (2017). 'Amounts Mobilised from the Private Sector by Official Development Finance Interventions: Guarantees, syndicated loans, shares in collective investment vehicles, direct investment in companies, credit lines'. OECD Development Co-operation Working Papers, No. 36. Paris: OECD Publishing. <http://dx.doi.org/10.1787/8135abde-en>.

⁶² Owing to the current boundaries of the methodologies used, estimates are likely to be conservative. It is worth noting that resources mobilized from the private sector will become an integral part of Total Official Support for Sustainable Development (TOSSD), alongside official grants and capital flows. TOSSD will capture and give donors credit for instruments such as guarantees, and may, therefore, incentivize their further use in the future.



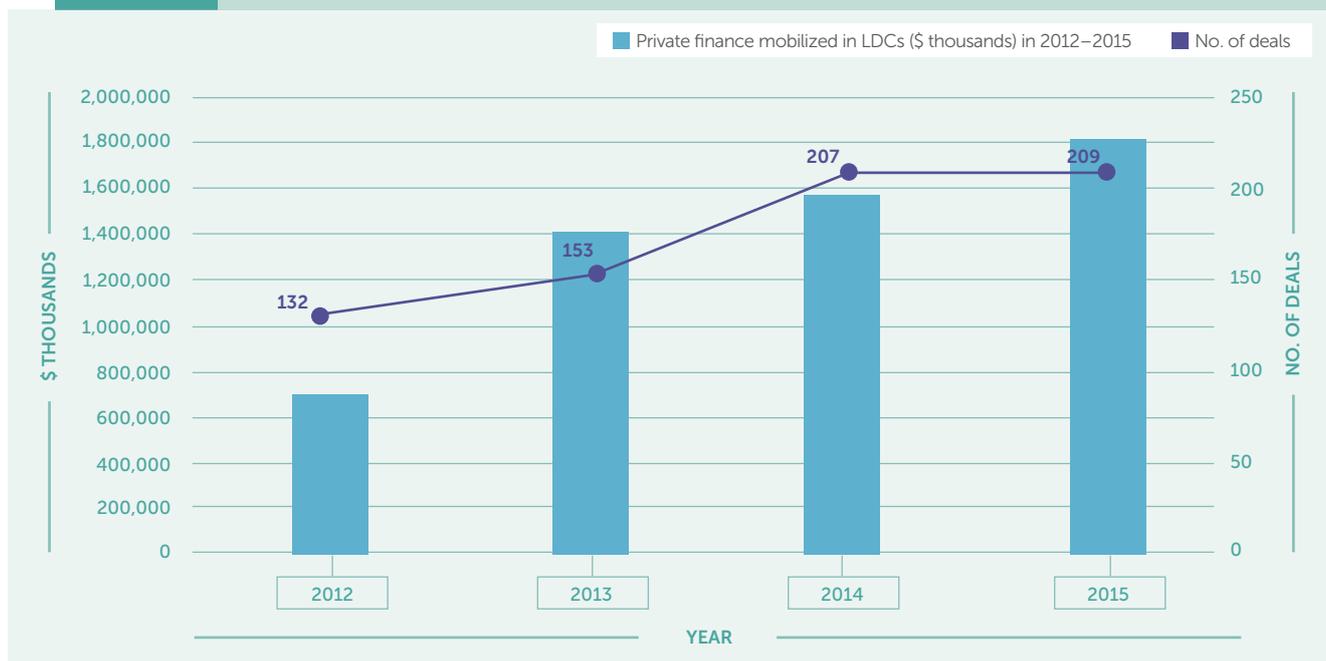
⁶³ The data currently available are only able to quantify the amount of private finance mobilized, but not how much ODA was allocated to mobilize that private finance.

The surveyed donors⁶⁴ mobilized private capital in 35 out of 48 LDCs,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)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.

FIGURE 4. Private capital mobilized for LDCs (2012–2015)



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.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.

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.

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

⁶⁶ These are Guinea-Bissau, Haiti, and São Tomé and Príncipe.

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.

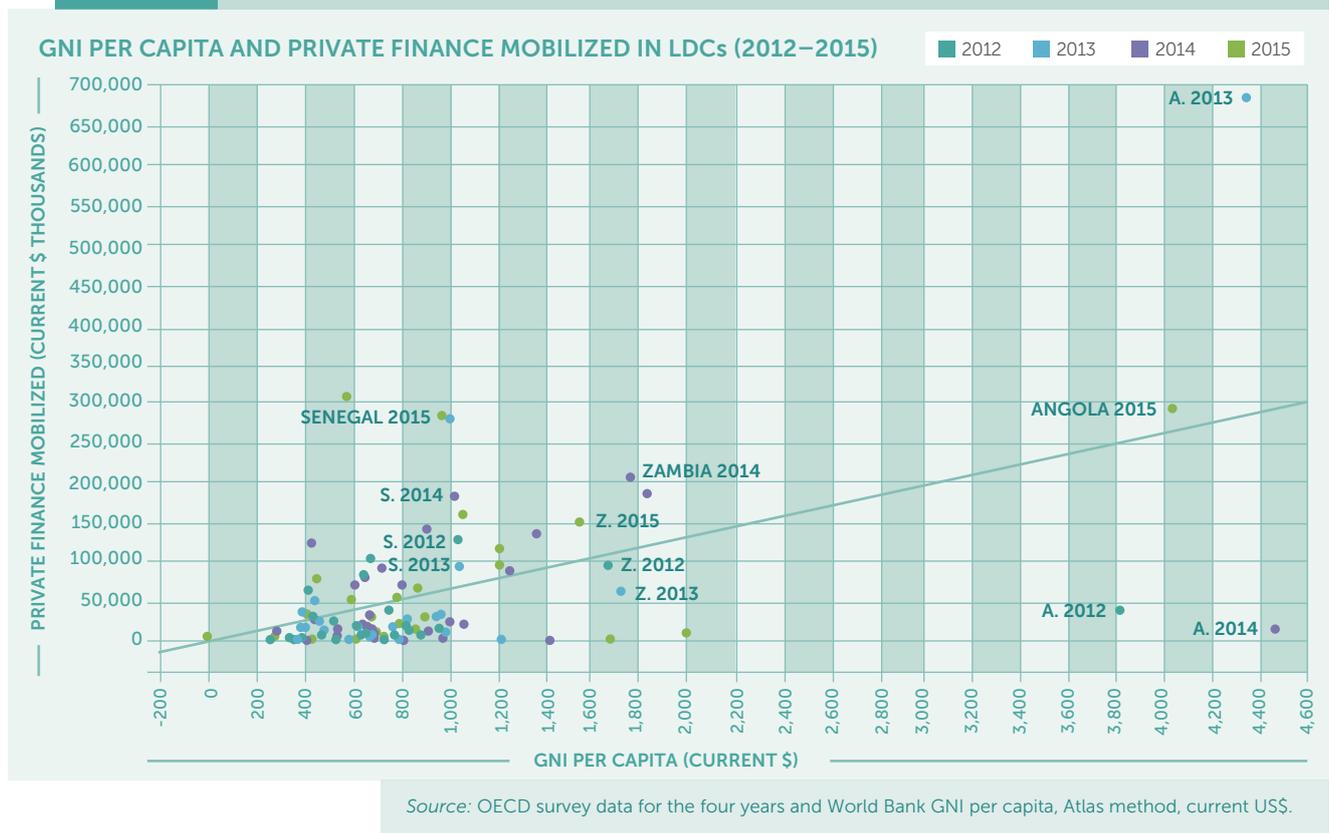
TABLE 3. Private finance mobilized in relation to GNI and ODA

Country category	Ratio of aggregate private finance mobilized/aggregate GNI (2012–2015) (current \$)	Ratio of aggregate private finance mobilized/aggregate ODA (current \$)	Aggregate ODA (2012–2015) (current \$ billions)
LDCs	0.159%	2.86%	192.43
Lower MICs	0.123%	15.76%	173.78
Upper MICs	0.043%	37.67%	91.98

Source: UNCDF calculations based on OECD survey data, OECD DAC statistics and World Bank national accounts data for GNI, Atlas method (<https://data.worldbank.org/indicator/NY.GNP.ATLS.CD>). (Accessed 6 August 2018.)

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),⁶⁸ the Human Assets Index (HAI)⁶⁹ 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.

FIGURE 5. Private finance mobilized for LDCs and GNI per capita (2012–2015)

⁶⁸ The EVI is a measure of structural vulnerability to economic and environmental shocks. High vulnerability indicates major structural impediments to sustainable development. A higher EVI represents a higher economic vulnerability.

⁶⁹ The HAI is a measure of the level of human capital. Low levels of human assets indicate major structural impediments to sustainable development. A lower HAI represents lower development of human capital.

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.⁷⁰ 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.⁷¹ 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).

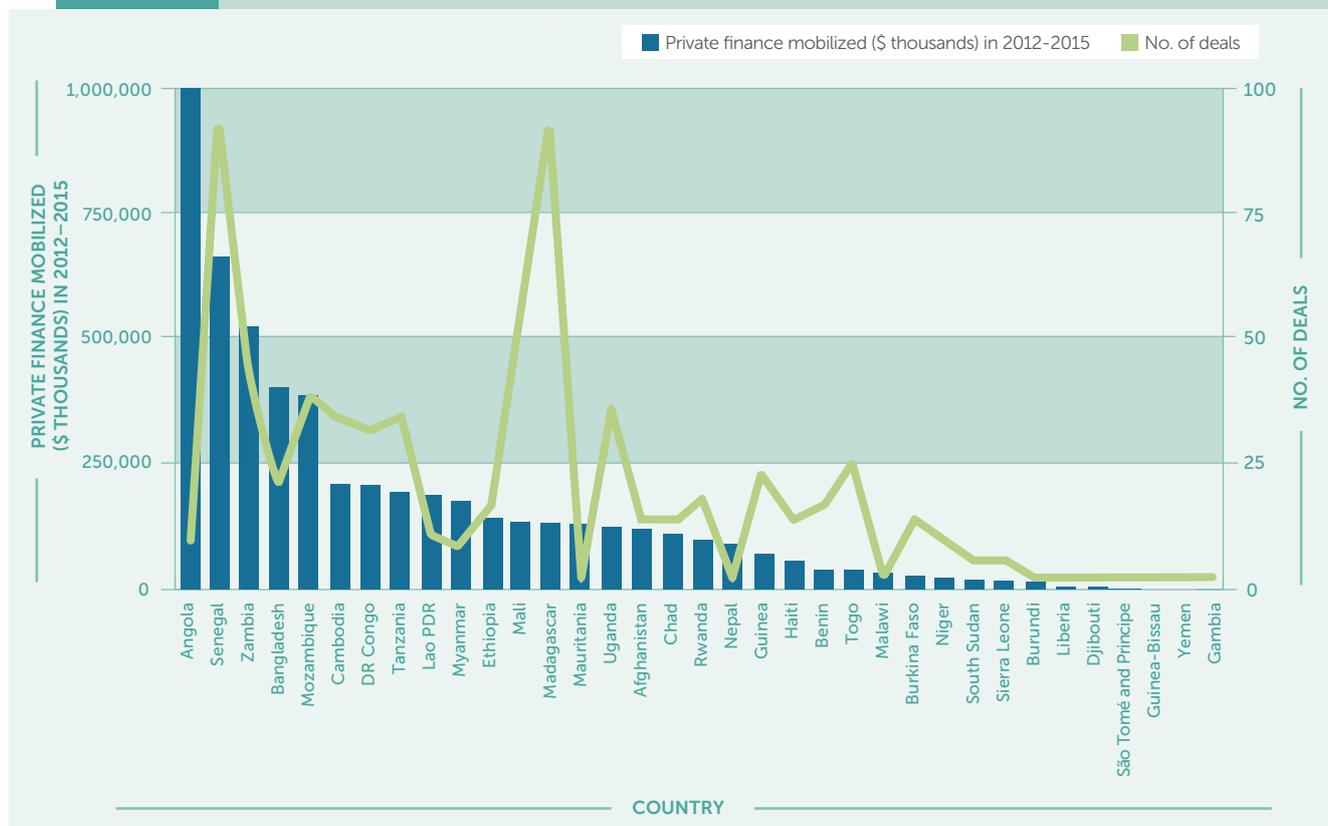
The amount of private finance mobilized varies significantly among LDCs (see Figure 6).

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 Príncipe, Guinea-Bissau, Yemen and Gambia. The 13 LDCs with no private capital mobilized were mostly small islands and conflict-affected States.⁷²

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.

FIGURE 6. Private capital mobilized by LDC (2012–2015)



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/lcd-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.

⁷² Bhutan, Central African Republic, Comoros, Equatorial Guinea (subsequently graduated from LDC status in 2017), Eritrea, Kiribati, Lesotho, Solomon Islands, Somalia, Sudan, Timor-Leste, Tuvalu and Vanuatu.

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.

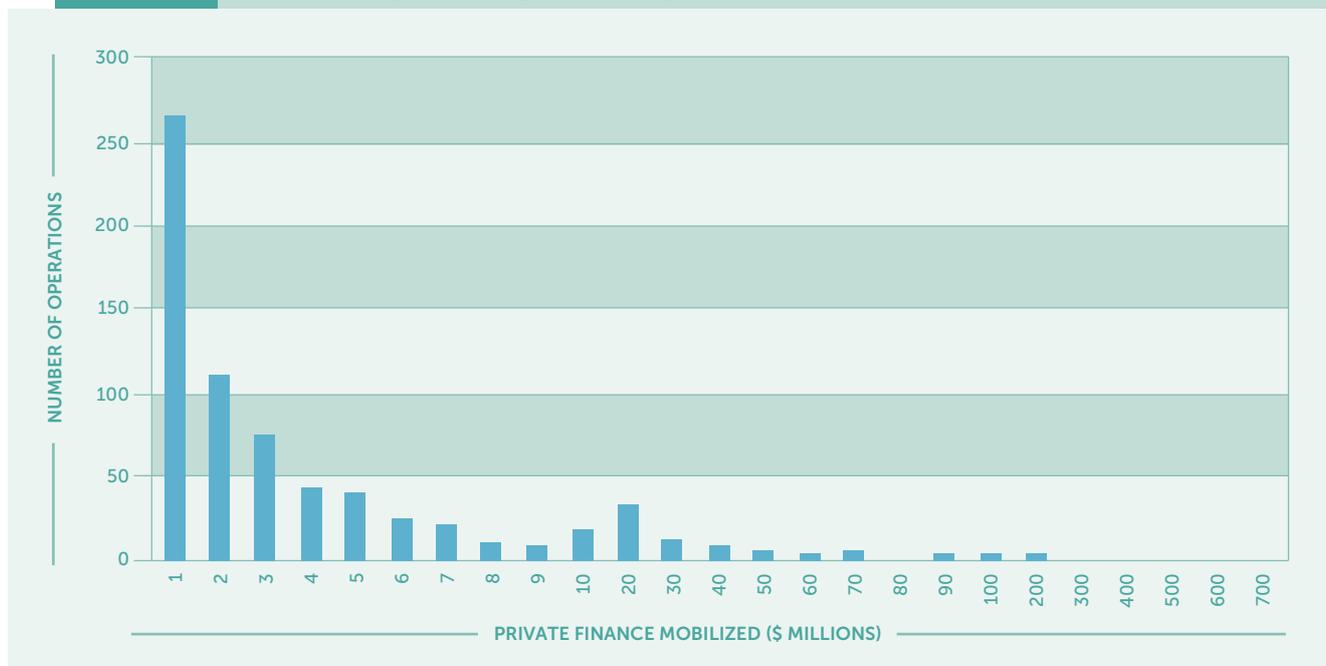
OECD data confirm the **small size of blended finance transactions in LDCs.** LDCs represented only 7 percent of total private finance mobilized over 2012–2015, but 23 percent of the number of blended finance transactions reported (or 701 out of 3,035 deals).

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.

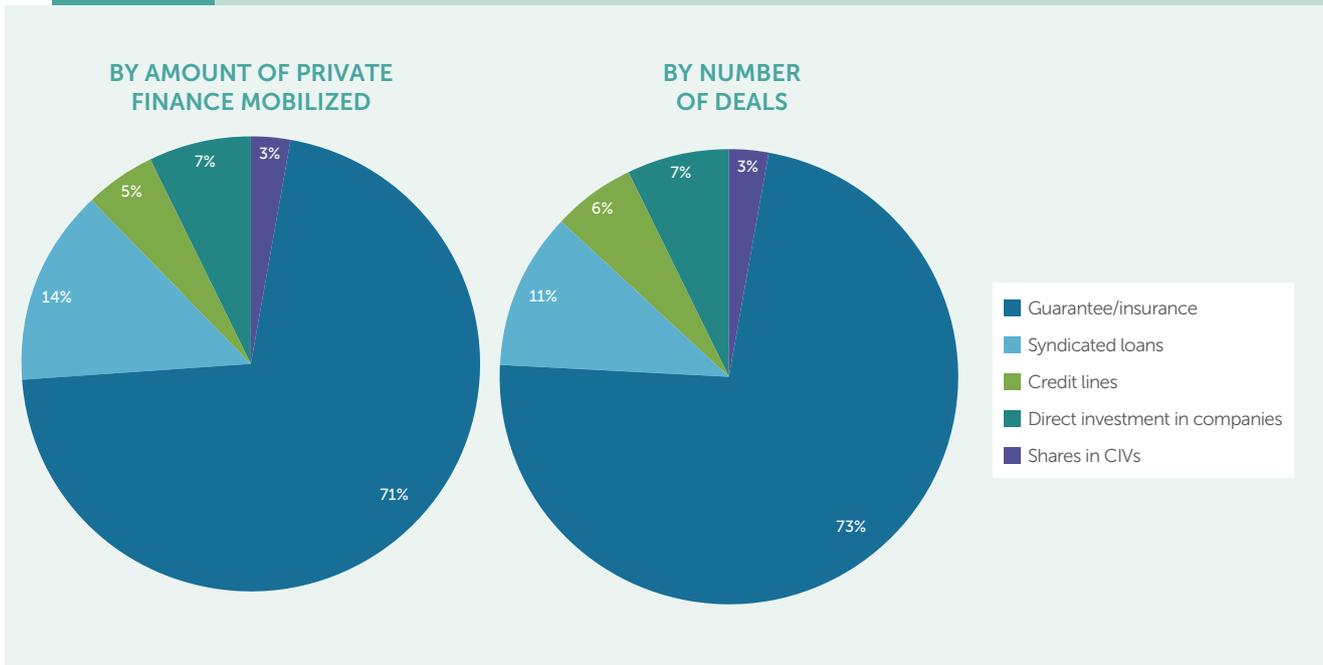
Over one third (38 percent) of the blended finance deals reported in LDCs mobilized less than \$1 million in private capital, and more than half mobilized less than \$2 million (see Figure 7). Fewer than 5 percent of the LDC transactions mobilized more than \$50 million in private finance. This speaks 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.

FIGURE 7. Number of operations by amount of private finance mobilized for LDCs (2012–2015)



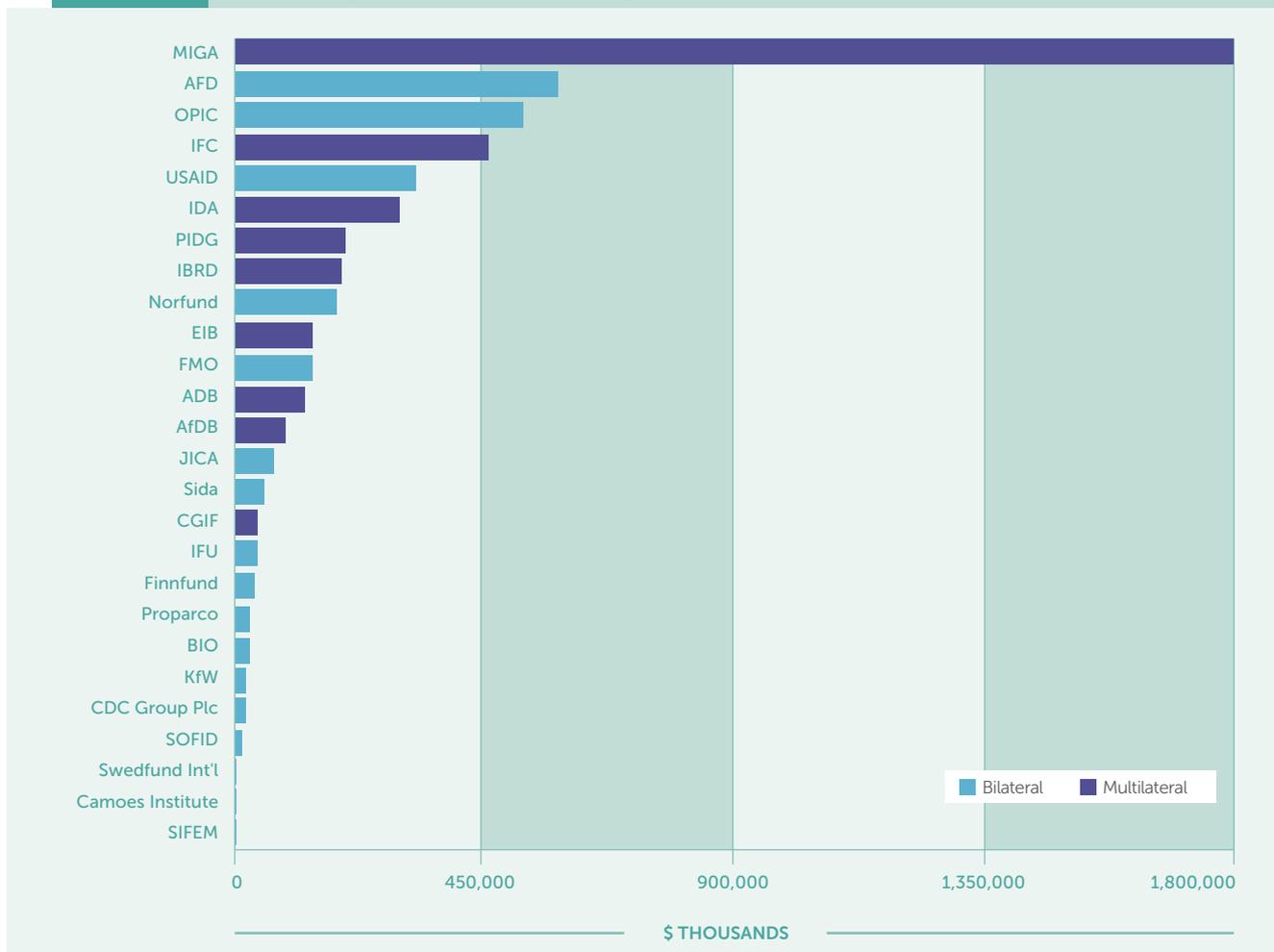
In terms of blended finance instruments deployed in LDCs, **credit and risk guarantees generated the highest absolute mobilization of private capital** in 2012–2015 (see Figure 8). They were used in 73 percent of the blended finance transactions in LDCs (compared to 50 percent for all developing countries)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

FIGURE 8. Blending instruments used in LDCs (2012–2015)

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.

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

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 catalyze 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.

⁷³ World Bank (2017). 'IDA18 IFC-MIGA Private Sector Window'. Washington, DC: World Bank. <https://ida.worldbank.org/financing/replenishments/ida18-overview/ida18-replenishment/ida18-private-sector-window>.

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'.

⁷⁵ See more information on the European Investment Plan at https://ec.europa.eu/europeaid/sites/devco/files/factsheet-eip-20171120_en.pdf.

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.⁷⁶ The LDCs represented 35 percent of all private capital mobilized by AFD.

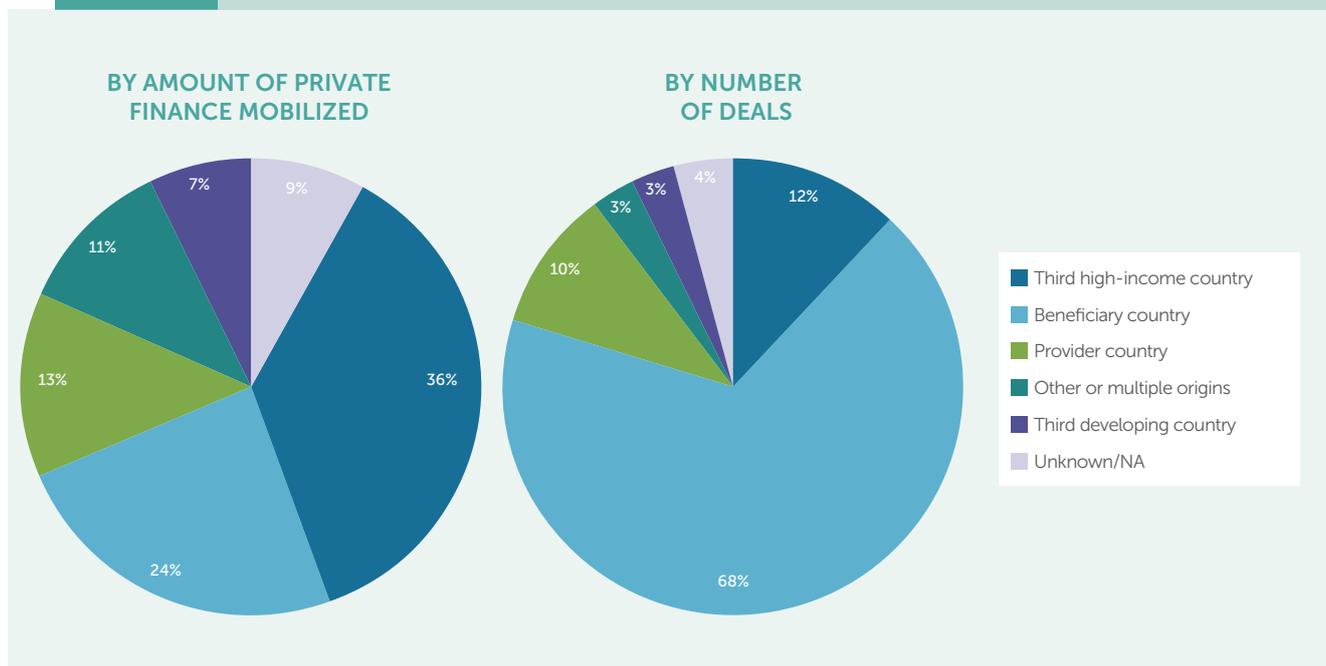
OPIC is the largest of the US agencies by volume of private finance mobilized, globally and in LDCs. Even with more than \$500 million mobilized, the LDCs only represent 3 percent of total private finance mobilized by OPIC. Of this, 74 percent was concentrated in three countries: Zambia (40 percent), 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 (Camoos 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.

FIGURE 10. Sources of private capital mobilized in LDCs (2012–2015)



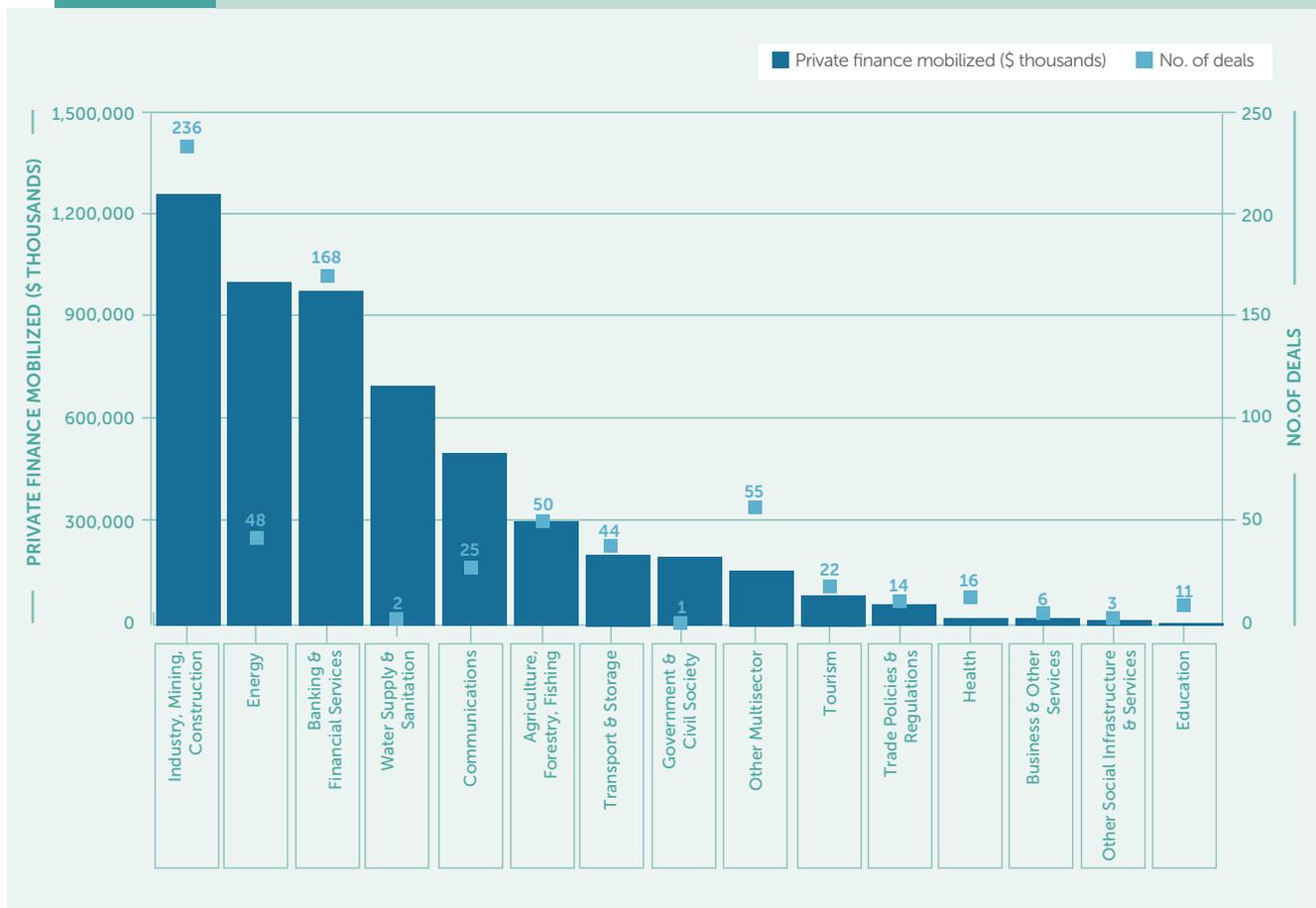
⁷⁶ More information on French development policy priorities can be found at <https://www.diplomatie.gouv.fr/en/french-foreign-policy/development-assistance/french-official-development/>.

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.**⁷⁷ This finding is corroborated by both the OECD survey and the database of Convergence, the global network for blended finance.⁷⁸

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).

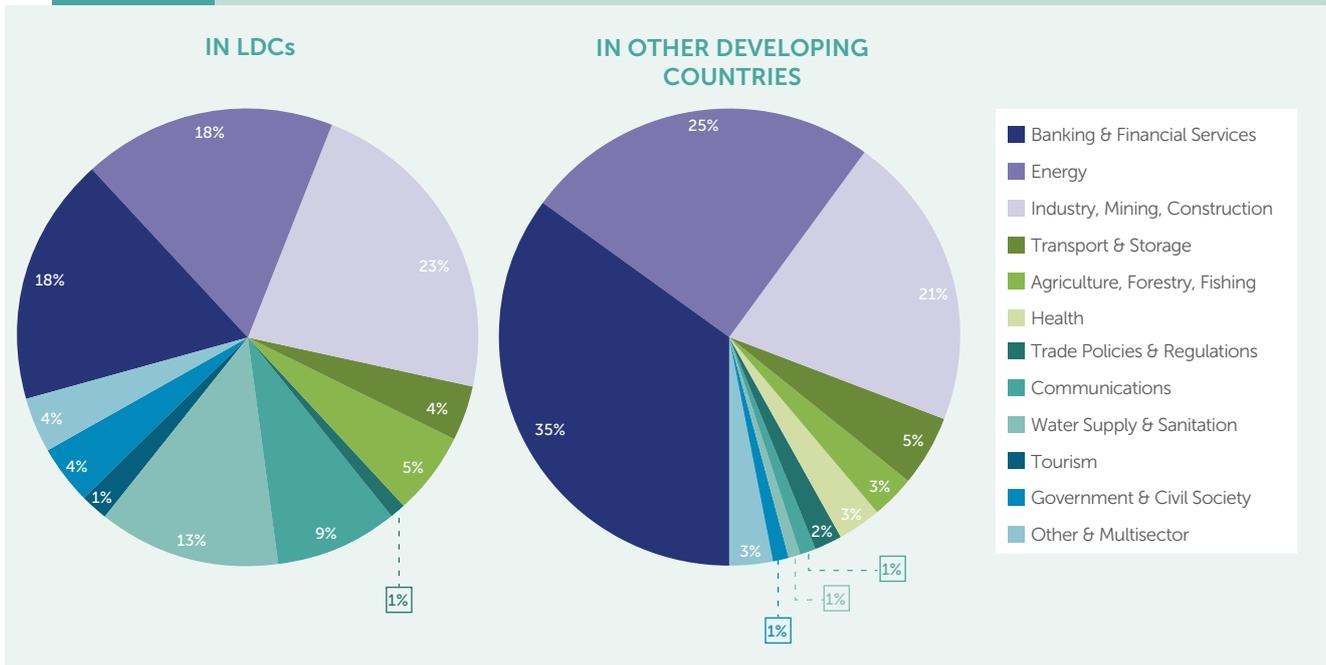
Water supply/sanitation and communications also feature prominently in LDCs but are relatively less present in other developing countries. The water supply and sanitation, and government and civil society sectors show very high mobilization per deal in LDCs, even higher than in other developing countries. 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.

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



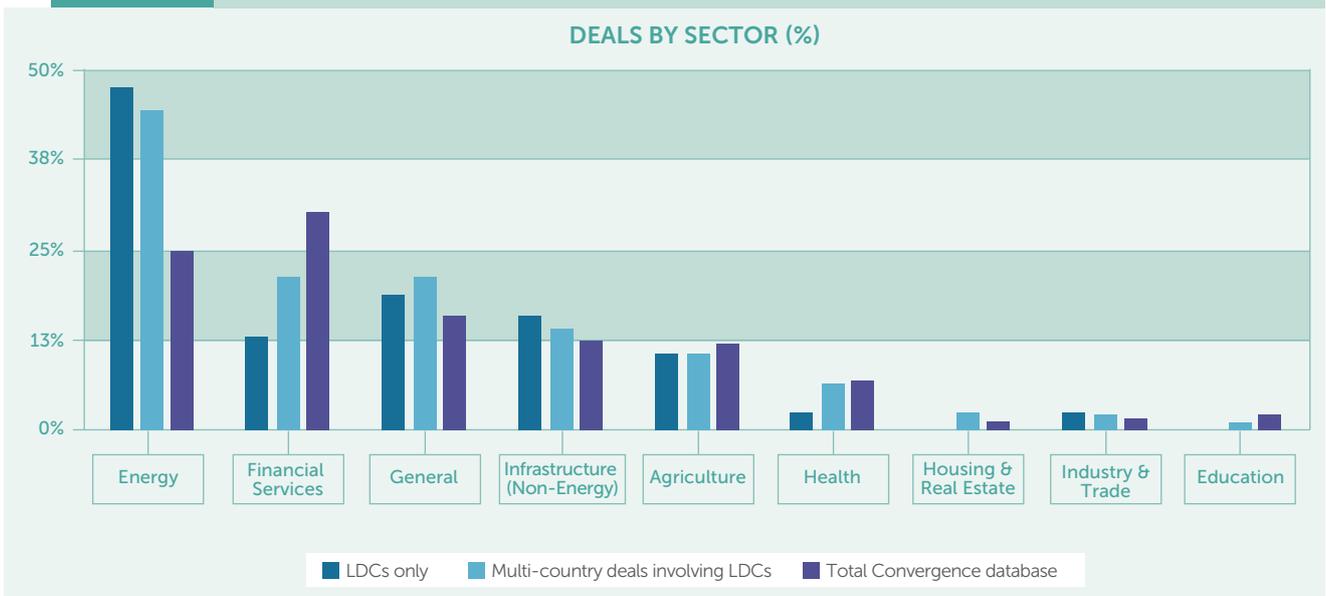
⁷⁷ This focus on revenue-generating sectors is also suggested by the four scoping papers which included overviews of blended transactions in LDCs in question.

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>.

FIGURE 12. Percentage split of private finance mobilized by sector (2012–2015)

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

FIGURE 13. Blended finance deals by sector

Source: Convergence database of blended finance deals.

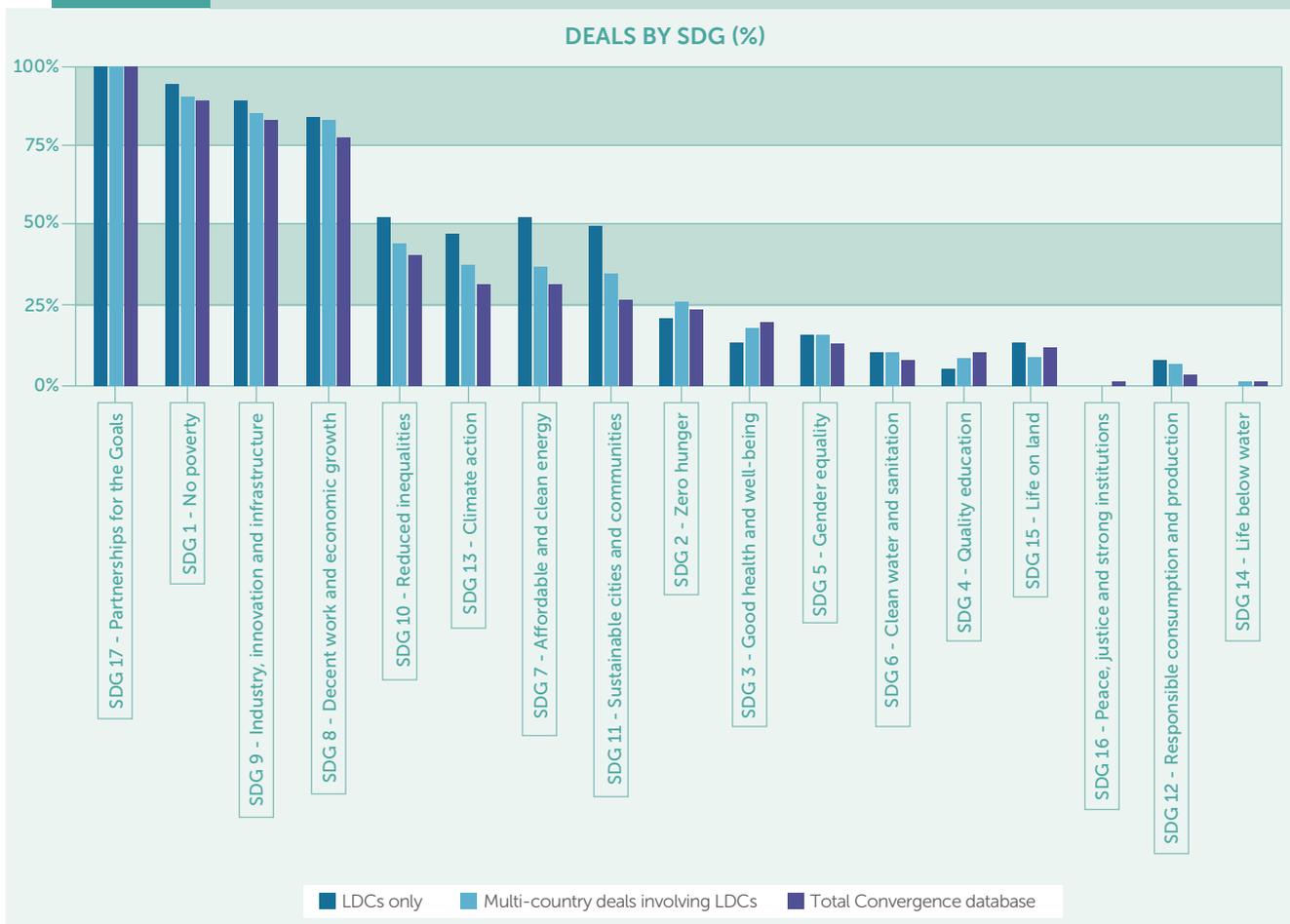
Note: 'General' refers to deals not allocated to a specific sector in the database.

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).⁸⁰

FIGURE 14. SDG focus of deals



Source: Convergence database of blended finance deals.

The OECD has also conducted a separate survey on blended finance funds and facilities.⁸¹ 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 LDC finance to expand access to clean energy in four LDCs.

⁸¹ Organisation for Economic Co-operation and Development (2018b). 'Making Blended Finance Work for the Sustainable Development Goals'. Paris: OECD Publishing. <https://doi.org/10.1787/9789264288768-en>.

⁸⁰ Note: Deals can target more than one SDG, which is why the total in Figure 14 adds up to more than 100 percent.

CHAPTER 3

BARRIERS TO PRIVATE CAPITAL IN 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:



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.

TABLE 4. Distribution of LDCs by quartile in select components of the World Bank's Doing Business 2018 rankings

	LDCs' distribution by:			
	1st quartile	2nd quartile	3rd quartile	4th quartile
Starting a business	6%	21%	26%	47%
Getting electricity	0%	6%	23%	70%
Registering property	2%	13%	38%	47%
Getting credit	11%	15%	13%	62%
Enforcing contracts	2%	13%	28%	57%
Resolving insolvency	0%	19%	28%	53%

Source: World Bank (2018). 'Doing Business 2018'. Washington, DC: World Bank. <http://www.doingbusiness.org/rankings>. (Last accessed July 2018.) Rounding may cause figures not to add up to 100 percent.

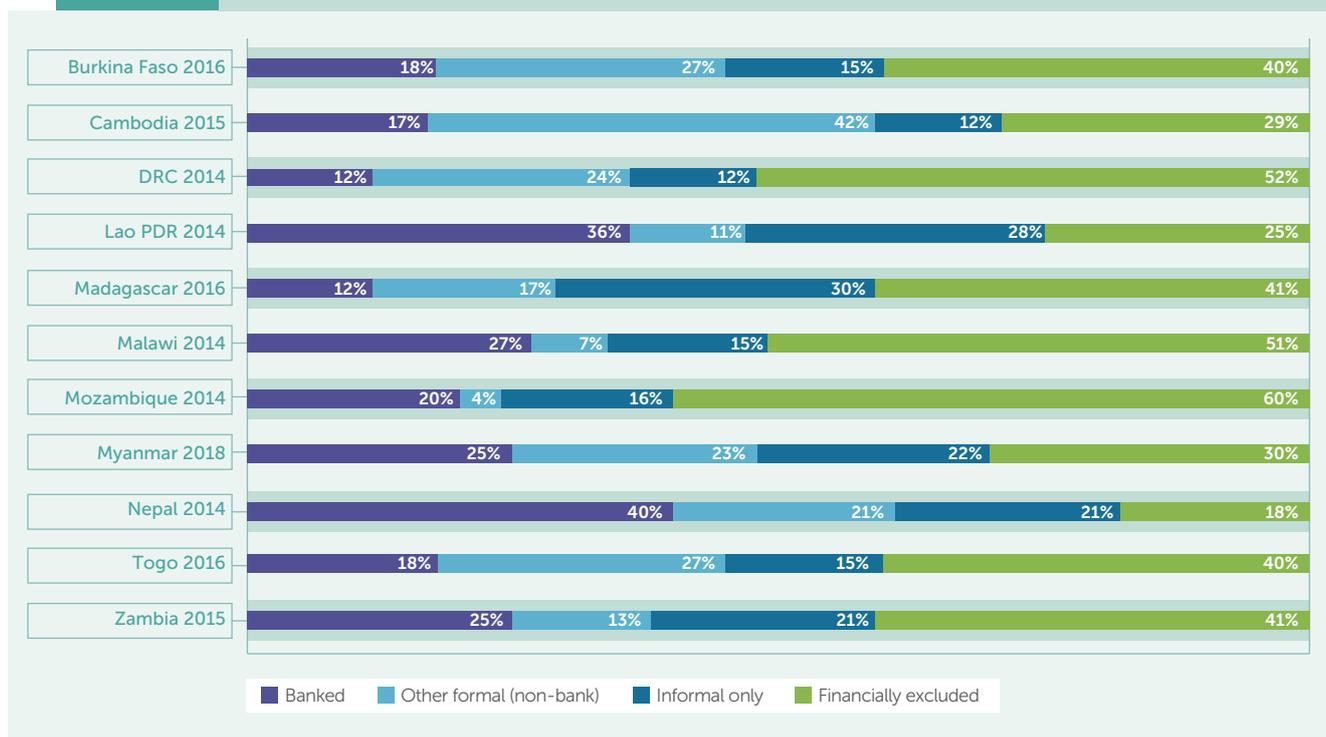
In particular, access to finance is a serious challenge in LDCs, where about 35 percent of firms identify this as a major constraint to business operations; that figure is 24 percent in the rest of the developing countries.⁸² UNCDF experience and the scoping studies confirm there is often a severe lack 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.

FIGURE 15. Financial inclusion in select LDCs



Source: UNCDF Making Access Possible programme.

⁸² Data from World Bank Group, World Bank Enterprise Surveys (<http://www.enterprisesurveys.org>), quoted in United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

⁸³ United Nations (2018a). 'Implementation of the Programme of Action for the Least Developed Countries for the Decade 2011–2020, Report of the Secretary-General, 23 April 2018'.

⁸⁴ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

⁸⁵ UNCDF calculations based on the World Bank, Global Findex Database 2017. <https://globalfindex.worldbank.org>. (Accessed July 2018.) Data are available for 39 of the 47 LDCs.

⁸⁶ Demirgüç-Kunt, Asli, Leora Klapper, Dorothe Singer, Saniya Ansar, and Jake Hess (2018). 'The Global Findex Database 2017: Measuring Financial Inclusion and the Fintech Revolution'. Washington, DC: World Bank.

⁸⁷ UNCDF calculations based on the World Bank, Global Findex Database 2017. <https://globalfindex.worldbank.org>. (Accessed July 2018.) Data are available for 39 of the 47 LDCs.

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 2017.⁸⁸

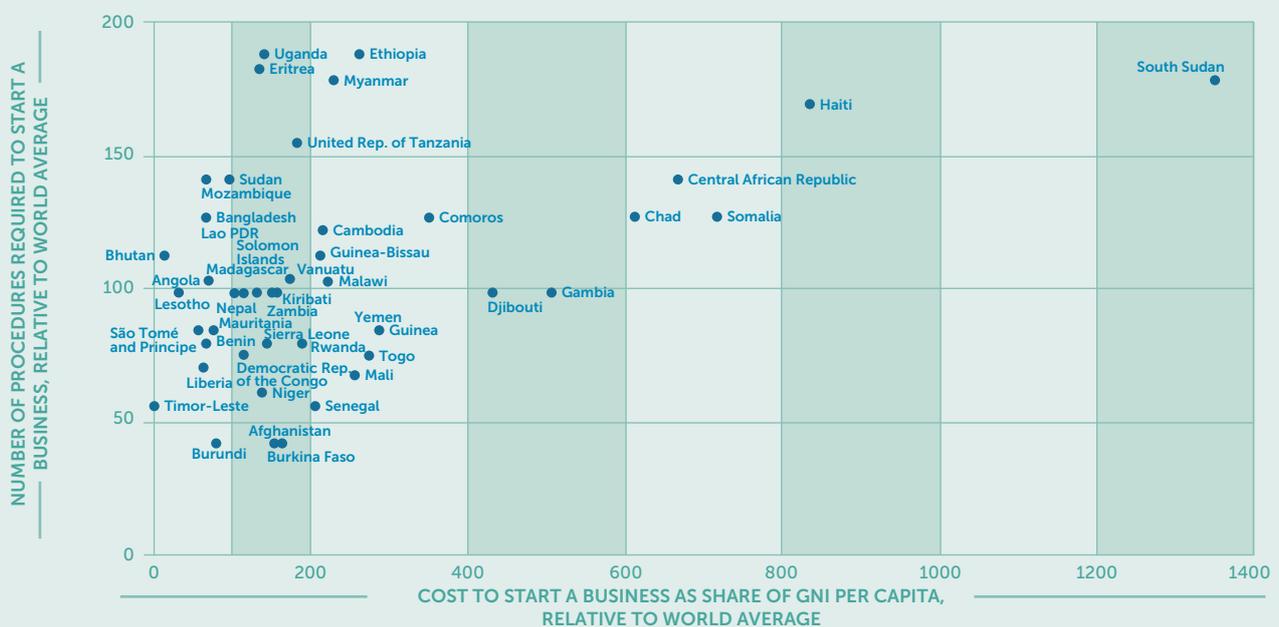
BOX 1. Registration procedures and start-up regulations in LDCs

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.⁸⁶ 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.

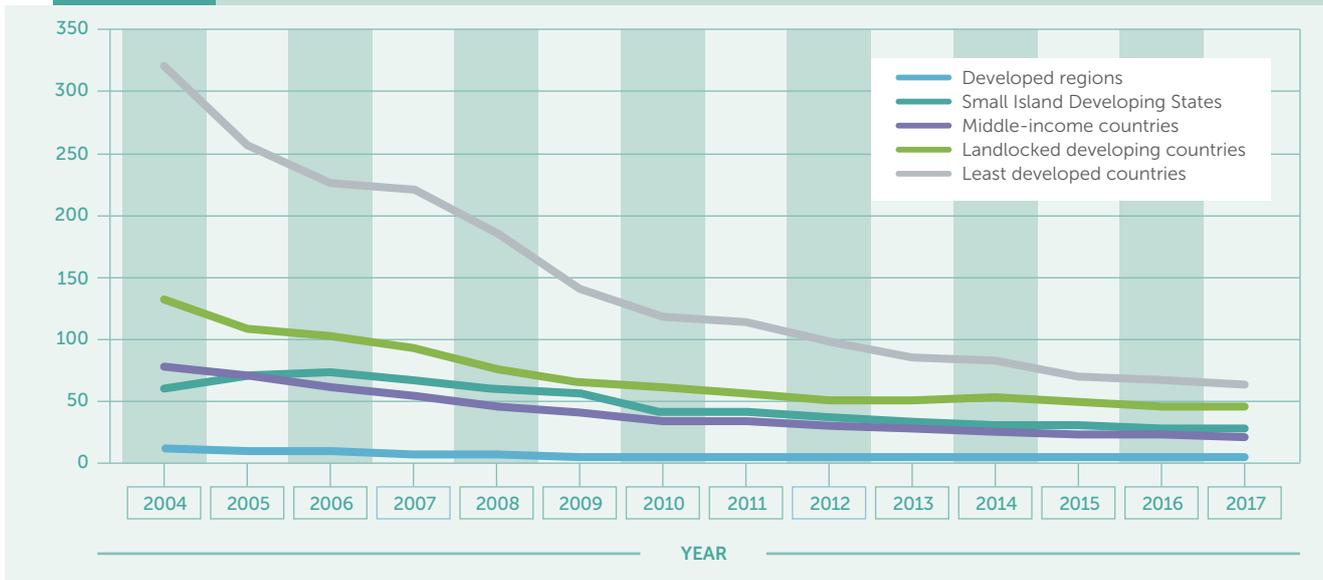
FIGURE 16. Costs and procedures to start up businesses in LDCs, compared to the world average (2015–2017)



Source: UNCTAD secretariat calculations, based on World Bank Doing Business database (February 2018), The Least Developed Countries Report 2018, forthcoming in November 2018.

⁸⁸ Inter-agency Task Force on Force on Financing for Development (2017). 'Financing for Development: Progress and prospects, 2017 Report'. New York: Inter-agency Task Force on Force on Financing for Development, p. 56. http://www.un.org/esa/ffd/wp-content/uploads/2017/03/2017-IATF-Report_AUV_30-Mar-2017.pdf.

⁸⁹ United Nations Conference on Trade and Development (2012). 'The Least Developed Countries Report 2012. Harnessing Remittances and Diaspora Knowledge to Build Productive Capacities'. Geneva: UNCTAD. http://unctad.org/en/PublicationsLibrary/ldc2012_en.pdf.

FIGURE 17. Cost of starting a business (in percentage of income per capita), 2004–2016

Source: UN-DESA calculations based on World Bank Doing Business database (<http://www.doingbusiness.org>). United Nations Department of Economic and Social Affairs (2017). 'Financing for Development: Progress and Prospects 2017. Report of the Inter-agency Task Force on Financing for Development'. New York: UN-DESA.

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.⁹⁰ 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.

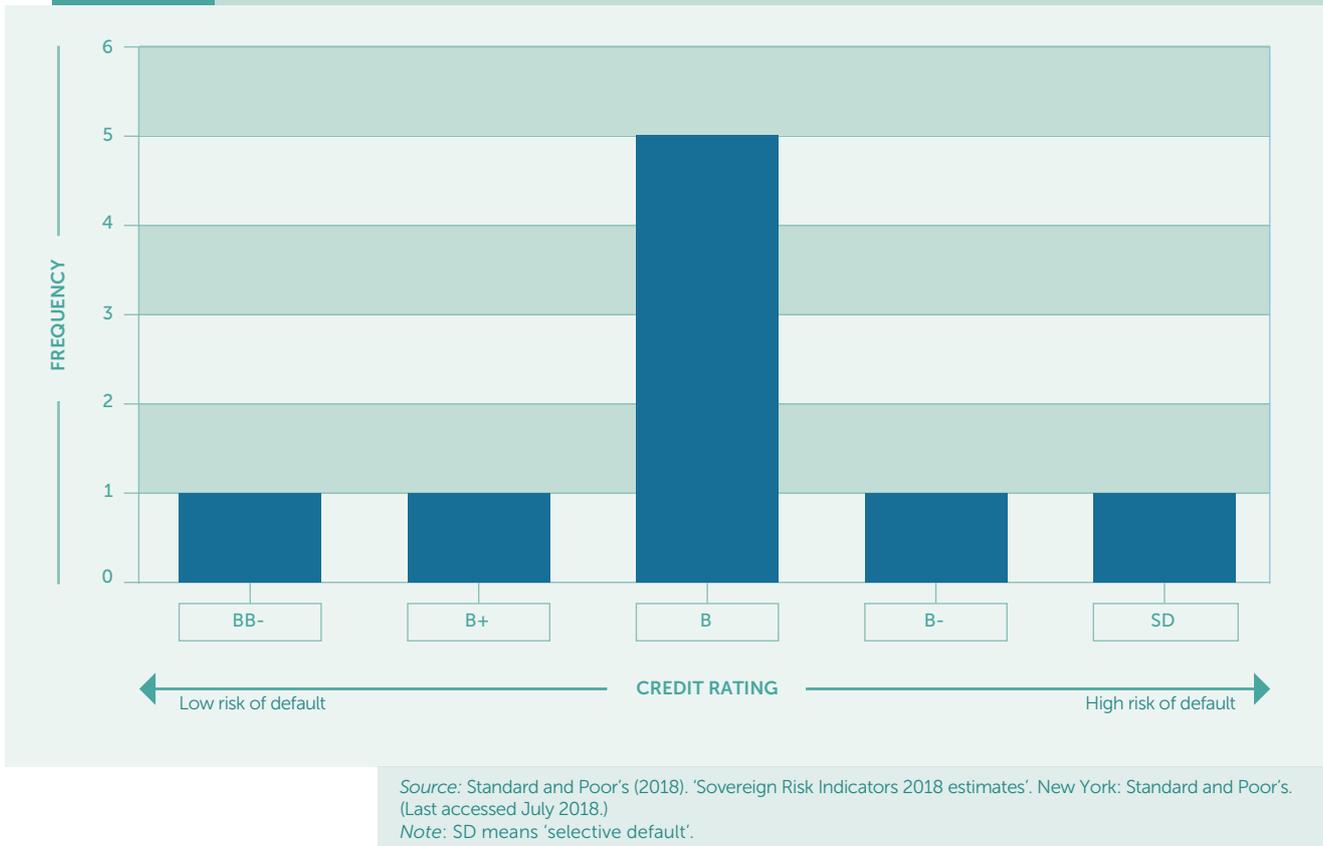
BOX 2. Impact of currency risk on private investment in LDCs

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 valuation 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 predominantly 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.

⁹⁰ For data on country debt risks, see <https://www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf>.

FIGURE 18. Distribution of LDCs' sovereign credit ratings (S&P)

Overall, enabling environment, political and macroeconomic factors impact the risk premia in LDCs.⁹¹

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.

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.⁹² This topic is discussed further in Chapter 6.

⁹¹ Measuring the impact of enabling environment on risk premia in LDCs is beyond the scope of this report, and is complicated by the fact that few securities (bonds or stocks) exist in LDCs, making benchmarking of returns difficult; expected returns are often different from realized returns; and risk premia cannot be isolated from international enabling environments and the global macroeconomic cycle (at times of exuberance and low global interest rates, risk premia tend to compress even in riskier and less familiar markets).

⁹² United Nations Development Programme (2013). 'Derisking Renewable Energy Investment: A framework to Support Policymakers in Selecting Public Instruments to Promote Renewable Energy Investment in Developing Countries'. New York: UNDP.

BOX 3. Blended finance and clean energy in Nepal

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.⁹³ 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.

Source: Dolma Himalayan Climate Fund (Tim Gocher and Mathew Norley).

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

⁹³ World Bank (2016). 'Nepal Development Update. Powering Recovery'. Washington, DC: World Bank. <https://openknowledge.worldbank.org/bitstream/handle/10986/25273/108880-WP-add-series-NDU-PUBLIC.pdf?sequence=1&isAllowed=y>. Note: The figure has been updated from what the report mentioned (1,800MW) to today's number of 3,000MW, in line with the Nepal Electricity Authority's projections.

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.

TABLE 5. Most common project-specific barriers in LDCs

Barriers	Relevance in LDCs
Costly and time-consuming pipeline origination	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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 concessionality, equity and/or debt providers would likely reject the deal.
Untested business models	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> In some LDCs and some business sectors within LDCs, there may be limited market data on which to base investment decisions.⁹⁵

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.⁹⁶ 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.

⁹⁵ Organisation for Economic Co-operation and Development and World Economic Forum (2015). 'Blended Finance Volume 1: A Primer for Development Finance and Philanthropic Funders'. Paris: Redesigning Development Finance Initiative 2015.

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).

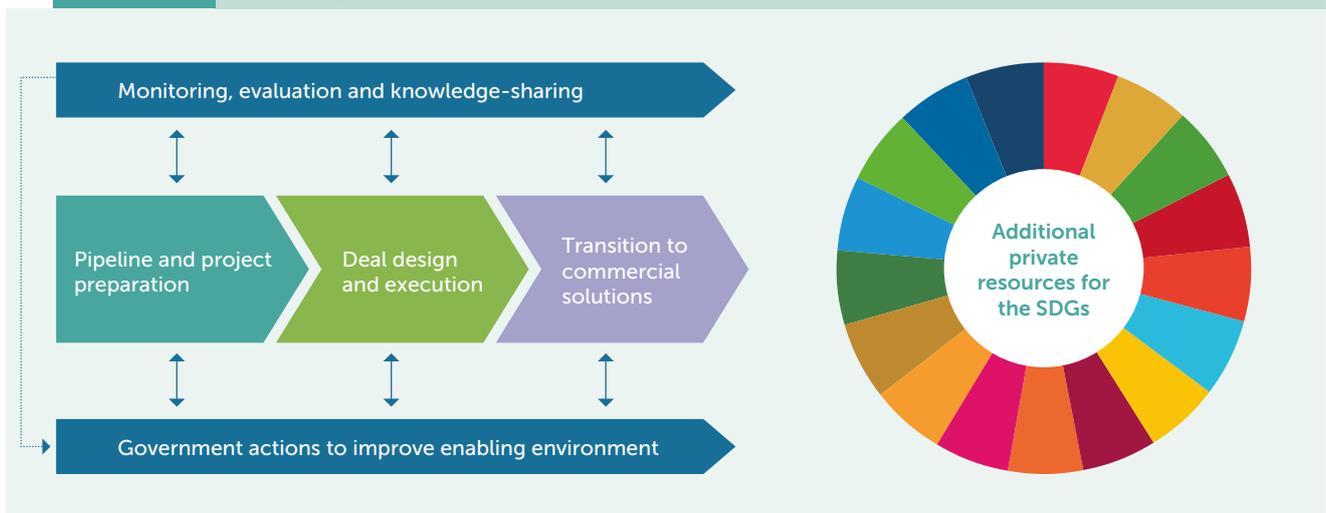
CHAPTER 4

APPLYING BLENDED FINANCE IN LDCs THROUGHOUT THE INVESTMENT LIFE CYCLE

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.

FIGURE 19. Applying blended finance throughout the investment life cycle



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.

⁹⁷ Bhattacharya, Debapriya, and Sarah Sabin Khan (2018, forthcoming). 'Is blended finance trending in LDCs? Perspectives from the ground'.

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.

Source: Sahel Irrigation Initiative Support Project website (<http://projects.worldbank.org/P154482?lang=en>); informal exchanges with IFC.

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.⁹⁸

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.

⁹⁸ Kasirye, Ibrahim, and Job Lakal (2018, forthcoming). 'Blended Finance in Uganda: Opportunities, challenges, and risks'.

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.⁹⁹ 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.

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).

⁹⁹ 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.

BOX 7. Scaling Solar: Attracting investors through competition

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

Goal	<ul style="list-style-type: none"> • 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.
Concessional instruments	<ul style="list-style-type: none"> • <i>Ex ante</i> 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	<ul style="list-style-type: none"> • <i>Ex ante</i> 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	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • Pipelines are sourced in an <i>ad hoc</i> manner skewed to 'easier' projects from a financial standpoint, even if development additionality 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.¹⁰⁰

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.¹⁰¹

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;¹⁰² 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.¹⁰³

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.

¹⁰⁰ DANIDA (2016). 'Evaluation study: Private Capital for Sustainable Development: Concepts, Issues, and Options for Engagement in Impact Investing and Innovative Finance'.

¹⁰¹ European Commission (2016). 'Evaluation of Blending. Final Report Vol. 2 – Main Report'. Brussels: European Commission. https://ec.europa.eu/europeaid/sites/devco/files/evaluation-blending-volume1_en.pdf.

¹⁰² See the guest piece by Jonny Gill, 'Paving the way: Creating a track record for mobilizing private capital in risky markets'.

¹⁰³ Rahman, Mustafizur, Towfiqul Islam Khan and Sherajum Monira Farin (2018, forthcoming). 'Blended Finance in Bangladesh: A scoping paper'.

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.¹⁰⁴

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.

¹⁰⁴ Bhattacharya, Debapriya, and Sarah Sabin Khan (2018, forthcoming). 'Is blended finance trending in LDCs? Perspectives from the ground'.

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.¹⁰⁵

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.

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

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

IN FOCUS:

Design and execution of blended finance deals in LDCs

Goal	<ul style="list-style-type: none"> 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.
Concessional instruments	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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 concessional support. 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.

Source: International Finance Corporation (2016). 'Inclusive Business Case Study, bKash'. Washington, DC: IFC. https://www.ifc.org/wps/wcm/connect/9f504d1a-4204-461a-b847-d55825fa3c33/bKash_Builtforchangereport.pdf?MOD=AJPERES.

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.

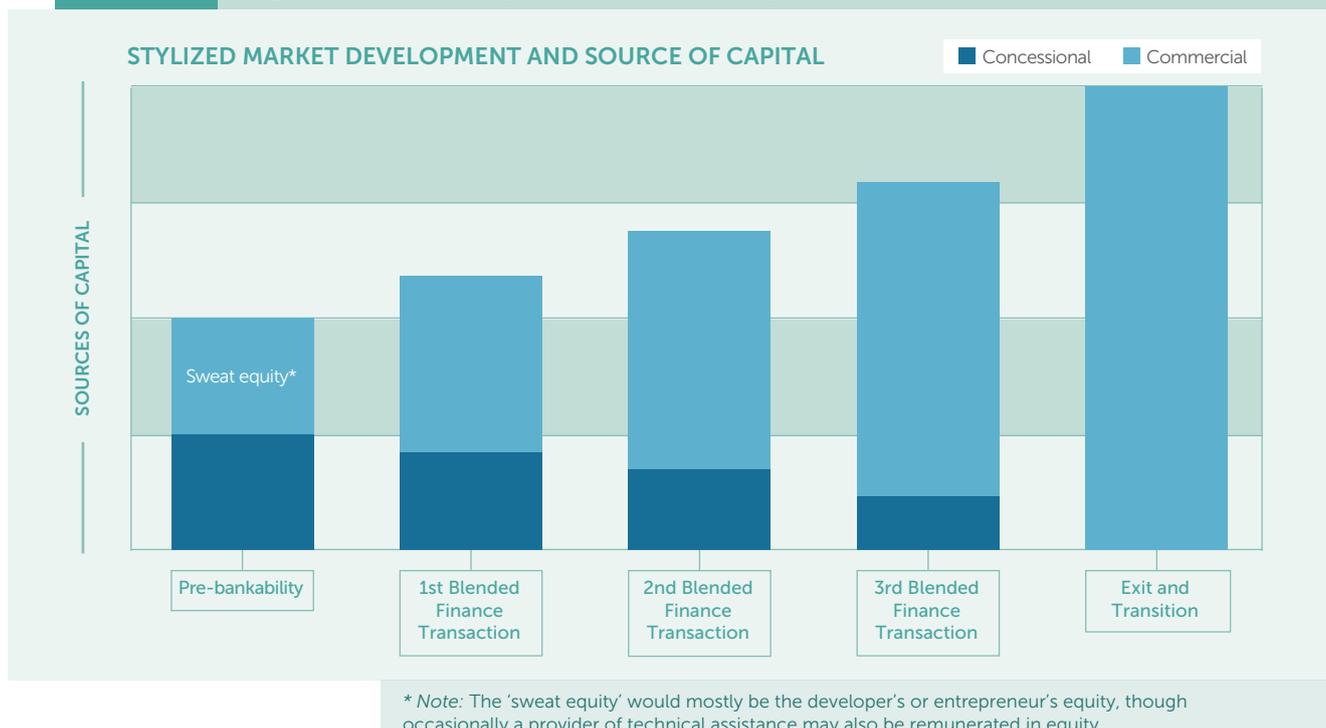
Second, some enabling environment barriers may persist, such as regulatory bottlenecks and currency volatility.¹⁰⁶ In these cases, there may be a need for concessional support for the foreseeable future, though this needs to be provided in a way that does not substitute for, delay or, worse, disincentivize 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.

FIGURE 20. Stylized market development and source of capital



¹⁰⁶ See, for instance, 'Case Study 3: Myanmar. Currency hedging to support lending to MFIs'.

IN FOCUS:

Transition to commercial solutions in LDCs

Goal	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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 <i>ex post</i> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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

¹⁰⁷ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

¹⁰⁸ European Commission (2016). 'Evaluation of Blending. Final Report Vol. 1 – Main Report'. Brussels: European Commission. https://ec.europa.eu/europeaid/sites/devco/files/evaluation-blending-volume1_en.pdf.

¹⁰⁹ Organisation for Economic Co-operation and Development (2018b). 'Making Blended Finance Work for the Sustainable Development Goals'.

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.¹¹⁰ 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.¹¹¹ *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.¹¹² 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 they support strengthen the quality of their M&E with sustainable development impact in mind.¹¹³ 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.¹¹⁴

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.

Source: Organisation for Economic Co-operation and Development (2018b). 'Making Blended Finance Work for the Sustainable Development Goals'.

¹¹⁰ See, for example, Sene, Seydina (2018, forthcoming). 'Blended Finance in the National Planning Process and the SDGs in Least Developed Countries: Evidence from Senegal'. Southern Voice Occasional Paper, No. 47. Dhaka: Southern Voice.

¹¹¹ Organisation for Economic Co-operation and Development (2018b). 'Making Blended Finance Work for the Sustainable Development Goals'.

¹¹² DANIDA (2016). 'Evaluation study: Private Capital for Sustainable Development: Concepts, Issues, and Options for Engagement in Impact Investing and Innovative Finance'.

¹¹³ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

¹¹⁴ Kasiry, Ibrahim, and Job Lakal (2018, forthcoming). 'Blended Finance in Uganda: Opportunities, challenges, and risks'.

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).

¹¹⁵ "Principle 5: Monitor blended finance for transparency and results" (Organisation for Economic Cooperation and Development Development Assistance Committee (2018). 'Blended Finance Principles for Unlocking Commercial Finance for the Sustainable Development Goals').

CHAPTER 5

BLENDING 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.¹¹⁶ 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.¹¹⁷ Also in October 2017, a working group of DFIs proposed five principles, enhanced with detailed guidelines, on blended concessional finance for private-sector projects.¹¹⁸

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.¹¹⁹

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.¹²⁰

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 entrepreneurs¹²¹ and strengthening domestic industry.¹²²

Still, there is some evidence that suggests the involvement of recipient countries in decision-making is fairly low in blended finance.¹²³ 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.

¹¹⁶ Inter-agency Task Force on Financing for Development, 'Principles for Blended Finance', New York, 2015. <https://developmentfinance.un.org/closing-the-infrastructure-gap>.

¹¹⁷ G7 (2018). 'Charlevoix Commitment on Innovative Financing for Development'. Charlevoix, QB: G7. <https://g7.gc.ca/en/official-documents/charlevoix-commitment-innovative-financing-development/>.

¹¹⁸ The nine DFIs in the working group are: EBRD, IFC, ADB, IDBG, AfDB, EIB, ICD, AIIB and EDFI. The principles can be found in the working group's Summary Report: https://www.ifc.org/wps/wcm/connect/30635fde-1c38-42af-97b9-2304e962fc85/DFI+Blended+Concessional+Finance+for+Private+Sector+Operations_Summary+R...pdf?MOD=AJPERES.

¹¹⁹ Development Initiatives (2016b). 'Aligning blended finance with the Busan principles of development effectiveness'. Bristol: Development Initiatives. http://devinit.org/wp-content/uploads/2016/10/Aligning-blended-finance-with-the-Busan-principles-of-development-effectiveness_DI_discussion-paper.pdf.

¹²⁰ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

¹²¹ Ibid.

¹²² Oxfam (2017). 'Private-finance blending for development: Risks and opportunities'.

¹²³ Ibid. See also Development Initiatives (2016b). 'Aligning blended finance with the Busan principles of development effectiveness'.

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.¹²⁴ 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.¹²⁵

Second, blended finance may become a back door to increased use of tied aid.¹²⁶ 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.¹²⁷ 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.¹²⁸ 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.¹²⁹

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.¹³⁰

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.¹³¹ In Senegal, for example, there is a PPP National Committee in the Ministry of Investment Promotions and Partnerships which is responsible for preliminary project assessment, institutional capacity-building, and technical support through the project life cycle. The Senegal scoping study suggests that mechanisms such as this committee could promote coordination and knowledge exchange with the players involved in the project across the different stages, helping to gather evidence and improve the design and execution of future projects.¹³²

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.¹³³

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.¹³⁴ 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.

¹²⁴ Ibid.

¹²⁵ United Nations (2018a). 'Implementation of the Programme of Action for the Least Developed Countries for the Decade 2011–2020, Report of the Secretary-General, 23 April 2018'.

¹²⁶ See also Pereira, Javier (2017). 'Blended Finance. What it is, how it works and how it is used'. Oxford: Oxfam and Eurodad. <https://eurodad.org/files/pdf/58a1e294657ab.pdf>.

¹²⁷ Meeks, Polly (2017). 'Unravelling Tied Aid. Why aid must never be tied to donor country companies at the expense of women and men living in poverty'. Brussels: Eurodad. <https://eurodad.org/files/pdf/1546810-unravelling-tied-aid-1516803666.pdf>.

¹²⁸ Organisation for Economic Co-operation and Development Development Assistance Committee (2017). '2017 Report on the DAC Untying Recommendation'. Paris: OECD DAC. <https://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/2017-Report-DAC-Untying.pdf>.

¹²⁹ See, for example, Kwakkenbos, Jeroen (2012). 'Private profit for public good? Can investing in private companies deliver for the poor?'. Brussels: Eurodad. <http://eurodad.org/files/pdf/1543000-private-profit-for-public-good-can-investing-in-private-companies-deliver-for-the-poor-pdf>.

¹³⁰ Bhattacharya, Debapriya, and Sarah Sabin Khan (2018, forthcoming). 'Is blended finance trending in LDCs? Perspectives from the ground'.

¹³¹ Ibid.

¹³² Sene, Seydina (2018, forthcoming). 'Blended Finance in the National Planning Process and the SDGs in Least Developed Countries: Evidence from Senegal'.

¹³³ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

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'Énergie 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.

Source: European Commission (2016). 'Evaluation of Blending. Final Report Vol. 2 – Main Report'. Brussels: European Commission; and interviews with AFD in July and August 2018.

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'.

¹³⁶ See more about FONSIS at <http://www.fonsis.org/en/who-we-are/what-we-do>.

¹³⁷ See the guest piece by Formanul Islam, 'Financing infrastructure in Bangladesh: Ways forward'.

¹³⁸ Rahman, Mustafizur, Towfiqul Islam Khan and Sherajum Monira Farin (2018, forthcoming). 'Blended Finance in Bangladesh: A scoping paper'.

¹³⁹ The most recent budget includes a proposal to establish an Infrastructure Development Bank, as well as to seek a sovereign rating and deepen capital markets (Wagle, Achyut (2018, forthcoming). 'Nepal's Potential for Blended Finance: A Country-level Study'. Southern Voice Occasional Paper, No. 48. Dhaka: Southern Voice).

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).

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.¹⁴⁰

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.¹⁴¹

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.¹⁴²

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.¹⁴³ This could mean

¹⁴¹ Pereira, Javier (2017). 'Blended Finance. What it is, how it works and how it is used?.'

¹⁴² Bhattacharya, Debapriya, and Sarah Sabin Khan (2018, forthcoming). 'Is blended finance trending in LDCs? Perspectives from the ground'.

¹⁴³ This point is underscored also in the OECD DAC Blended Finance Principles. The Dutch Infrastructure Development Fund, for instance, started providing information on potential investments online in 2016 to ensure that it does not overlook important concerns of stakeholders. See FMO (2016). 'Infrastructure Development Fund, Annual Report 2016'. The Hague: The Government of the Netherlands. <https://www.fmo.nl/about-us/reports>.

¹⁴⁰ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

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.

¹⁴⁴ Development Initiatives (2016b). 'Aligning blended finance with the Busan principles of development effectiveness'.

¹⁴⁵ Bhattacharya, Debapriya, and Sarah Sabin Khan (2018, forthcoming). 'Is blended finance trending in LDCs? Perspectives from the ground'.

¹⁴⁶ Kasiye, Ibrahim, and Job Lakal (2018, forthcoming). 'Blended Finance in Uganda: Opportunities, challenges, and risks'.

¹⁴⁷ See, for example, Romero, María José (2015). 'What lies beneath? A critical assessment of PPS and their impact on sustainable development'. Brussels: Eurodad. <http://www.eurodad.org/files/pdf/55cb59060d9d4.pdf>.

¹⁴⁸ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

¹⁴⁹ See the guest piece by John Morris, 'How women and millennials, blended finance and the SDGs can impact LDCs'.

¹⁵⁰ Hale, Jon (2015). 'The Appeal of Sustainable Investing', Morningstar Magazine, December 2015/January 2016. http://www.nxtbook.com/nxtbooks/morningstar/magazine_20161201/#/38.

¹⁵¹ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

¹⁵² Ibid.

¹⁵³ Bhattacharya, Debapriya, and Sarah Sabin Khan (2018, forthcoming). 'Is blended finance trending in LDCs? Perspectives from the ground'.

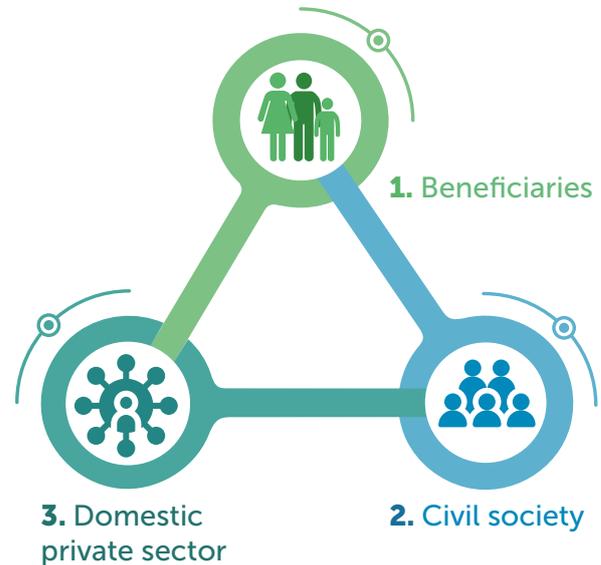
¹⁵⁴ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

It is also important that projects, especially large infrastructure ones, do not widen disparities—gender, income or regional—within a country.¹⁵⁵ 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.¹⁵⁶

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.¹⁵⁷

Stakeholder participation in blended finance should include



¹⁵⁵ Kasiye, Ibrahim, and Job Lakal (2018, forthcoming). 'Blended Finance in Uganda: Opportunities, challenges, and risks'.

¹⁵⁶ For example, see the takeaways from the roundtable hosted by Convergence, Deloitte, and Global Affairs Canada in July 2017: <https://www.convergence.finance/news-and-events/news/3D51HwPqYosQSIYOY8Mies/view>.

¹⁵⁷ Development Initiatives (2016b). 'Aligning blended finance with the Busan principles of development effectiveness'.

CHAPTER 6

ISSUES FOR FURTHER DISCUSSION

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 providers¹⁵⁸—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.

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

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.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.¹⁶⁰

This speaks to the potential role blended finance can play in improving risk-return profiles in this sector.¹⁶¹ For example, UNCDF is working with the Commonland Foundation¹⁶² 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.¹⁶³

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

¹⁵⁹ Credit Suisse, WWF and McKinsey (2014). 'Conservation Finance Moving beyond donor funding toward an investor-driven approach'. Geneva: Credit Suisse, WWF and McKinsey. <https://www.credit-suisse.com/media/assets/corporate/docs/about-us/responsibility/environment/conservation-finance-en.pdf>; JP Morgan Chase, NatureVest and The Nature Conservancy (2016). 'State of Private Investment in Conservation 2016. A Landscape Assessment of an Emerging Market'. New York: JP Morgan Chase, NatureVest and The Nature Conservancy. https://www.forest-trends.org/wp-content/uploads/2017/03/doc_5474.pdf.

¹⁶⁰ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

¹⁶¹ Environmental Finance (2017). The growing case for conservation finance, 6 April 2017. <https://www.environmental-finance.com/content/market-insight/the-growing-case-for-conservation-finance.html>.

¹⁶² For more about the Commonland Foundation, see <https://www.commonland.com/en/about-us>.

¹⁶³ Davies, Ryan, Hauke Engel, Jürg Käppeli and Todd Wintner (2016). 'Taking Conservation Finance to Scale'. New York: McKinsey and Company. <https://www.mckinsey.com/business-functions/sustainability-and-resource-productivity/our-insights/taking-conservation-finance-to-scale>.

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 for 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

¹⁶⁴ See the guest piece by Régis Marodon, 'Getting the price right: Using blended finance to address risks'.

¹⁶⁵ Organisation for Economic Co-operation and Development Development Assistance Committee (2018). 'Blended Finance Principles for Unlocking Commercial Finance for the Sustainable Development Goals'.

¹⁶⁶ 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 Africa Growth Initiative at Brookings (2017). 'Leveraging African Pension Funds for Financing Infrastructure Development'. Washington, DC: Africa Growth Initiative. <http://www.un.org/en/africa/osaa/pdf/pubs/2017pensionfunds.pdf>.

¹⁶⁸ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018'.

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

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

	✓ Advantages	✗ Disadvantages
 International capital	<ul style="list-style-type: none"> • Overall, a larger capital pool • More extensive track record in the sector and strategy • More established reputation with concessional providers • Must comply with international governance standards • FDI can bring not just resources, but know-how and technology 	<ul style="list-style-type: none"> • More limited country knowledge • Harder to attract to high-risk, untested LDCs • If a fund, may struggle to attract local institutional investors because of regulatory restrictions affecting them • Currency risk is a big issue • Capital controls (if in force) • Subject to regulatory limits originating in domicile countries
 Domestic capital	<ul style="list-style-type: none"> • Country, sector and perhaps even direct sponsor knowledge • Better at assessing local risk, and may be more prone to support domestic businesses • If a fund, more likely to attract local institutional capital • No currency risk if domestic investor invests in local currency (as is often the case) and project revenues are also in local currency • Not subject to FDI controls • Might be politically important to have domestic capital in projects 	<ul style="list-style-type: none"> • A smaller capital pool with established track record or expertise in particular sectors • Corporate governance may be sub-par • Less familiarity with concessional providers and ESG standards

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.

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.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.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.^{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”.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.

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, Samantha (2018). ‘Can blended finance work for the poorest countries?’. London: Overseas Development Institute, 1 June 2018. <https://www.odi.org/comment/10650-can-blended-finance-work-poorest-countries>).

¹⁷¹ EuropeAid (2016). ‘Evaluation of Blending, Final Report’, Volume I. Brussels: EuropeAid. https://ec.europa.eu/europeaid/sites/devco/files/evaluation-blending-volume1_en.pdf. The evaluation covers EuropeAid’s support through seven investment facilities over the period 2007–2014.

¹⁷² Caio, Cecilia (2018). ‘The enabling environment for private sector development: donor spending and links to other catalytic uses of aid’. Discussion Paper. Bristol: Development Initiatives. <http://devinit.org/post/enabling-environment-private-sector-development/>.

¹⁷³ In 2013, four LDCs figured among the top recipients of official development finance for private-sector development: Myanmar (\$3.1 billion), Bangladesh (\$2.3 billion), Tanzania and Afghanistan (\$1.8 billion each) (Miyamoto, Kaori, and Emilio Chiofalo (2017). ‘Development Co-operation for Private Sector Development. Analytical Framework and Measuring Official Development Finance’. OECD Development Co-operation Working Papers, No. 32. Paris: OECD Publishing. <https://www.cbd.int/financial/2017docs/oecd-privateoda2017.pdf>).

¹⁷⁴ Sierra-Escalante, Kruskaia, and Morten Lykke Lauridsen (2018). ‘Blended Finance – A Stepping Stone to Creating Markets’.

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.¹⁷⁵ 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.¹⁷⁶ 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.

¹⁷⁵ See Blended Finance Taskforce (2018). ‘Better Finance, Better World: Consultation Paper of the Blended Finance Taskforce’. London: Blended Finance Taskforce.

¹⁷⁶ Carter, Paddy, ‘The Pitfalls of Leverage Targets’, Center for Global Development blog post, 9 February 2018. <https://www.cgdev.org/blog/pitfalls-leverage-targets>.

02

PART II

Case studies



INTRODUCTION

The five case studies analysed in Part II aim to ground in concrete examples the understanding of blended finance's role in LDCs and to contribute to a richer description of the challenges and opportunities of applying blended finance in LDCs. While the sample is necessarily limited, the studies aim to capture some of the diversity that characterizes blended finance in LDCs.

The five countries covered represent a fairly diverse geographical sample, with different social and macroeconomic conditions and enabling environments. Four are in Africa, the continent with the highest density of LDCs: Tanzania, Mali, Rwanda and DRC. The fifth is Myanmar, one of the fastest-growing LDCs.

The case studies also examine the application of blended finance in different sectors. Two case studies involve the infrastructure sector: a solar power project in Mali and a water supply infrastructure project in Rwanda. They highlight the challenges of attracting private capital to countries where the affordability of user tariffs for basic infrastructure is limited and PPP regulation is still developing. The African Development Bank (AfDB) (in Mali) and the Private Infrastructure Development Group (PIDG) (in Rwanda) were extensively involved in project development and as providers of loans, grants and technical assistance. Their involvement and that of other concessional providers helped mobilize commercial loans and equity for projects that would otherwise have been unbankable.

Given its focus in this report, three of the case studies concern the missing middle. As highlighted in Part I, these blended finance projects present different opportunities and risks from infrastructure projects.

One case study involves the agriculture value chain: a project to scale up a sunflower oil processing business in rural Tanzania. This study highlights the difficulty in raising commercial loans for SMEs with limited collateral, informal budgeting and reporting practices, and promoters that, while commercially savvy, lack the formal training necessary to secure financing from commercial lenders. UNCDF supported this project by providing technical assistance, a grant and a concessional loan, helping to attract a larger commercial loan from a local bank.

A further case study involves the microfinance sector: a hedging facility aimed at crowding in international lenders to MFIs in Myanmar. This study highlights the difficulty in raising external capital for financial institutions in countries subject to currency depreciation and undeveloped capital markets. It also shows how regulatory restrictions can create a real challenge for the growth of a business sector, regardless of underlying consumer demand. TCX provided a currency hedging solution, subsidized by the Livelihoods and Food Security Trust Fund (LIFT), a multi-donor trust fund, which helped local MFIs raise significant amounts in commercial loans from international DFIs so that they could expand their operations.

The final case study involves the private equity sector: a first-time fund to support growth of SMEs in DRC and CAR. This study highlights the difficulties in raising capital for

SMEs lacking collateral and track record and the need for more flexible financing solutions, such as private equity and long-term loans. It also shows the challenges in fundraising from commercial investors faced by first-time private equity funds in frontier markets. XSML, a Dutch private equity fund, managed to raise capital from DFIs and deploy it to more than 50 SMEs. Thanks to a concessional technical assistance facility, it also helped investees improve budgeting, ESG standards and reporting.

Each case study discusses a specific development challenge and related barriers, the blended finance solution adopted and key takeaways. Five general considerations emerge from the case studies:

First, to succeed, projects need to be supported through their life cycle—from preparation through to financing and transition to commercial solutions.

Whether in infrastructure or SMEs, even in difficult contexts and underserved regions in LDCs, there are opportunities for profitable investments. However, blended finance projects require a hands-on approach by concessional providers and a significant time commitment, especially in project preparation. In Tanzania, UNCDF devoted 18 months to due diligence and to bringing the project promoter up to speed with the governance, accounting and disclosure standards required by commercial lenders. UNCDF also continued to provide support after the financing stage of the project. The solar project in Mali was initiated in 2012, when the developer first approached the government, and took a while to get off the ground. The Rwanda project was initiated in 2010, but only reached financial close at the end of 2017; a restructuring of Rwanda's water and electricity utility took place in between. The TCX/LIFT hedging solution in Myanmar was implemented after significant preparatory work on the ground, including a proactive dialogue with the regulator and government stakeholders. In DRC and CAR, XSML has provided technical assistance to its portfolio companies to help them improve their operations and skills.

Second, going from individual projects to scale is important but requires systematic approaches.

Because of the effort often required by blended transactions in LDCs—coupled with smaller transaction size—scalability and replicability become important factors when concessional providers decide to commit to a certain project, alongside efforts not to distort markets or over-subsidize the private sector. UNCDF's involvement in the Tanzania project is part of its broader Local Finance Initiative, aimed at supporting a range of missing-middle projects in LDCs. Based on the lessons learned from these projects and the findings from a recent mid-term evaluation, UNCDF is helping LDC governments to set up national platforms that will take over the activities of the programme when it comes to an end. XSML, with its flexible capital, presence on the ground and technical assistance, has provided growth funding to dozens of SMEs in DRC and CAR since 2010.

Connected to this, the case studies also highlight the need for robust M&E as well as the capture and sharing of knowledge, especially in LDC markets. In Mali, for instance, where the first utility-scale on-grid solar photovoltaic power plant is being deployed under an independent power producer structure, performance during project implementation will be monitored and reported to relevant stakeholders. The types of lessons captured could inform other similar projects aimed at addressing Mali's large power deficit.

Third, early and strategic engagement with national authorities and other government stakeholders supports national ownership.

The success of blended projects in LDCs—especially infrastructure projects—hinges on close collaboration and coordination not only among multiple commercial and concessional providers but, crucially, government stakeholders. Rwanda is a case in point: an infrastructure developer contributed equity; the AfDB and the Emerging Africa Infrastructure Fund (EAIF) provided commercial loans; other PIDG units facilitated the project through a grant and technical assistance; and the local utility signed a long-term PPP agreement, guaranteed by the government. Mali presents similar features: three equity co-investors, two commercial lenders, a concessional lender and a power purchase agreement with the national utility, backed by government and IDA guarantees.

Fourth, in LDCs the path to full commercial solutions, involving private investors, can be very gradual, and DFIs may initially be the main investors in some cases.

In the case of infrastructure projects, given social equity considerations and tariff affordability constraints, a full commercial solution may not be possible for a long time. In the case of the missing middle, this may include mobilizing domestic investments. It is important to maximize the demonstration effects of individual transactions as a way to support commercial replication.

In the Mali and Rwanda cases, loans were provided by a development bank, a DFI and a donor-funded infrastructure facility; as business models and transaction structures become proven, private lenders could be involved in future financing rounds. In Myanmar, the hedging solution mobilized primarily DFI loans to MFIs; as the microfinance sector reaches critical scale, in part because of the funding facilitated by TCX/LIFT, and if regulatory bottlenecks are resolved, MFIs might be able to access private sources of capital more directly, alongside domestic savings. In the Tanzania case study, UNCDF specifically sought to mobilize domestic investors into the project; not only was their risk tolerance for supporting SMEs ostensibly higher, among other reasons because they faced no foreign currency risks, but the engagement of one local investor can demonstrate to others that such projects in their own countries can be financially viable investments.

Finally, the proactive involvement and leadership of national authorities is a crucial factor in addressing enabling environment barriers.

This highlights the importance for providers of concessional finance to: (i) use lessons learned from blended transactions to support governments to improve the investment climate; (ii) ensure, where possible, that the deployment of concessional resources does not substitute for or delay required reforms; and (iii) ensure that there is greater coordination between blended transactions and other efforts to support governments in improving the enabling environment. In Myanmar, MFIs are only allowed to borrow at local currency rates capped by regulation. Because of this cap, absent the TCX/LIFT hedging facility, international lenders would not be able to fund local MFIs at rates commercially attractive to them. The infrastructure projects in Mali and Rwanda show the importance of regulatory dialogue to design PPP concession frameworks that reward commercial investors while ensuring service affordability.

CASE STUDY 1

DEMOCRATIC REPUBLIC OF THE CONGO AND CENTRAL AFRICAN REPUBLIC A FIRST-TIME PRIVATE EQUITY FUND

Development challenge

In 2010, when the fund in this case study was launched, DRC had seen strong headline GDP growth, but the poverty rate stood at 71 percent¹⁷⁷ and the country was looking to recover from years of conflict. Today, DRC ranks 176th out of 189 countries on the UNDP Human Development Index,¹⁷⁸ and is heavily dependent on the commodity industry. Macroeconomic indicators such as GDP, exchange rates and inflation can fluctuate significantly with commodity prices. Other sectors of the economy remain underdeveloped, as is the financial system, with few banks catering to the small formal sector.

For its part, CAR is ranked the country with the second lowest level of human development in the world.¹⁷⁹ Around the time the project was launched, the country saw a modest increase in GDP growth from 3.3 percent in 2011 to 4.1 percent in 2012, but a subsequent 36 percent contraction in 2013 following civil conflict.¹⁸⁰ The primary sector currently accounts for over 50 percent of the country's economy, and agriculture is the main economic activity: over 70 percent of the population are engaged in subsistence farming. The country is endowed with significant mineral reserves and, prior to 2013, was ranked 12th in the world as a producer of rough diamonds (according to volume).¹⁸¹

SMEs can be especially important drivers of economic growth, innovation and job creation, including in countries affected by crisis. The availability of SME finance is positively associated with the number of start-ups—an important indicator of entrepreneurship—as well as with business dynamism and innovation. Moreover, SME finance allows existing firms to exploit growth and investment opportunities.¹⁸²

Yet, as Part I in the report notes, SMEs in LDCs often lack access to the capital they need to grow and thrive. In LDCs, only 25 percent of small firms and 40 percent of medium-sized firms have bank accounts.¹⁸³ In DRC specifically, there can be little to no long-term financing available for SMEs—the maximum credit duration is typically six months to two years, and in exceptional cases up to three or four years. As a result, commercial banks mainly finance trade businesses, rather than production, agriculture or services, where long-term credit is needed. Further, interest rates can be high, typically ranging from around 12 percent to 40 percent per year. Most loans are not investment loans, but rather used to finance working capital or to overcome cash flow shortages.¹⁸⁴

Barriers to private-sector investment

In DRC, the main constraints to access to finance for SMEs include: a lack of financial products customized to their specific needs; the perception of risk of investing in SMEs; the inflexibility of credit disbursement processes and practices at financial institutions; the inability of SMEs to provide the required collateral; and concerns over the management skills of SME owners.¹⁸⁵

¹⁷⁷ International Monetary Fund (2010). 'Democratic Republic of the Congo: Poverty Reduction Strategy Paper', IMF Country Report 10/327, Washington, DC, 2010. <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Democratic-Republic-of-the-Congo-Poverty-Reduction-Strategy-Paper-Progress-Report-Joint-24301>.

¹⁷⁸ United Nations Development Programme (2018). 'Human Development Indices and Indicators. 2018 Statistical Update'. New York: UNDP.

¹⁷⁹ Ibid.

¹⁸⁰ United Nations Development Programme (2017). 'Country programme document for the Central African Republic (2018-2021)'. New York: UNDP. <http://undocs.org/DP/DCP/CAF/4>.

¹⁸¹ Ibid.

¹⁸² Beck, Thorsten, and Robert Cull (2014). 'Small-and Medium-sized Enterprise Finance in Africa'. Washington, DC: Africa Growth Initiative at Brookings. https://www.brookings.edu/wp-content/uploads/2016/06/SME-Finance-in-Africa-Designed_FINAL.pdf.

¹⁸³ International Trade Centre (2015). 'Competitiveness Outlook 2015: Connect, Compete and Change for Inclusive Growth'.

¹⁸⁴ KfW (2011). 'Financial Institutions' Challenges to Provide Credit in the Democratic Republic of Congo: Experiences from Financial Cooperation'. Frankfurt am Main: KfW. https://www.kfw-entwicklungsbank.de/Download-Center/PDF-Dokumente-Sektoren-Berichte/2011_06_Congo-Kredit_E.pdf.

¹⁸⁵ See, for example, <http://www.elanrdc.com/sme-finance>.

To bridge this gap, there was and still is a need for governments and market players to strengthen existing, traditional credit channels (e.g. bank finance), as well as to expand SME financing options. Ripe investment opportunities with development impact exist even in complex operating environments, but they remain unexploited due to the lack of risk capital and long-term financial support.

In countries such as DRC and CAR, SMEs are often reliant on straight debt to fulfil their start-up, working capital and investment needs. The need for a wider range of terms and conditions (e.g. tenor and security coverage) make mezzanine capital, equity and quasi-equity important types of alternative financing for SMEs there. By investing risk capital, private equity investors can become partners in a firm's growth, providing technical expertise and networks, driving operational advances and improving ESG standards.

Currently, there is very little private equity in many of Africa's LDCs. In addition to higher operating costs in these countries, management costs tend to be high relative to the unit values of the transactions, which are often small in an industry where certain costs (e.g. those arising from pipeline origination and deal due diligence) are inescapable. Attracting private investment—domestic or international—can be very difficult, with costs having an automatic knock-on effect on net profitability for investors.

Against this background, DFIs remain a crucial source of capital for private equity funds in LDCs, especially in countries where most private investors—outside sectors such as extractives—are reluctant to allocate resources. DFIs can play an important role by providing the early financing needed to prove the commercial viability and attractiveness of investing in such vehicles and countries. Yet, even then, attracting private finance to support SMEs in crisis or post-crisis settings remains challenging. That is why providers of development finance have considered taking on an even more catalytic role by creating new fund managers in LDCs (e.g. private equity funds) and backing intermediary partners with adequate commitment and capability to reach SMEs.

Blended finance solution

The Central Africa SME Fund (CASF) is a \$19 million fund that provides private equity, long-term debt and technical assistance to SMEs in DRC and CAR. CASF leverages a grant-funded technical assistance facility to support SMEs pre- and post-investment. The fund aims to achieve sustainable economic development by: (i) encouraging entrepreneurship; and (ii) creating a local manufacturing, services and agricultural base to provide Central African economies with locally produced goods and services.

CASF was launched by XSMF in November 2010. XSMF is an independent private equity fund manager, founded in 2008, with a focus on frontier markets in Central and East Africa. CASF was the first of several private equity funds launched under the IFC's SME Ventures Program, which provides risk capital and technical assistance to locally based fund managers to drive growth and job creation, with an emphasis on crisis- and conflict-affected countries. CASF is the first private equity fund in DRC and CAR to provide scarce, high-risk capital to SMEs. IFC subscribed to \$12.5 million in equity, with the intention of mobilizing a total of \$25 million for the fund from

other DFIs and the private sector.

In addition to equity, IFC also provided XSMF with grant capital for a small \$1.3 million technical assistance fund. Operating in DRC and CAR is not easy. Key challenges include scarcity of qualified human resources, high operating costs, lack of electricity and basic infrastructure, corruption, concerns over the macroeconomic as well as the political and security situation, and lack of transparency. While SMEs in DRC and CAR hold potential to generate attractive returns for investors, providing only capital is not enough—businesses need expertise and guidance to achieve sustainable growth. Therefore, in addition to capital investments, pre- and post-investment technical assistance is an important part of CASF's work, including business plan development, strengthening of financial systems and controls, and ESG support.

Through the IFC's anchor investment and accompanying technical assistance funds, XSMF was able to attract additional equity investments from FMO and the Lundin Foundation. FMO committed \$5 million equity from the MASSIF Fund, which FMO manages on behalf of the Dutch government. MASSIF provides both concessional and quasi-commercial investments in the form of seed capital, local currency debt, and mezzanine structures to direct equity and investment funds. In addition, the Lundin Foundation, a Canadian non-profit organization, committed \$1.5 million. CASF closed at \$19 million, less than the \$25 million target, which indicates the significant challenges to raising capital—commercial or quasi-commercial—for private equity in DRC and CAR.

With offices and a team on the ground in DRC (Kinshasa) and CAR (Bangui), XSMF developed a model inspired by private equity: highly selective and providing close management support. CASF targeted investments in at least 30 SMEs across various sectors, all financed through secured loans. In addition, XSMF acquired minority equity stakes in about 40 percent of the companies. Ultimately, CASF allocated 90 percent of its risk capital to DRC and 10 percent to CAR, with an investment size ranging from \$100,000 to \$500,000. Key investment criteria included: (i) economic impact: in-country production and/or increased access for the general population; (ii) collaborative mindset: a willingness to work with the fund manager towards common goals; (iii) growth potential: opportunity for business growth; and (iv) track record: experience in the focus sector or proven success in business.

Following the success of CASF in deploying and managing invested capital, XSMF closed its second fund, the African Rivers Fund (ARF), in February 2016 at \$50 million. ARF has an expanded geographical focus—adding Uganda, the Republic of the Congo and Burundi to the eligible country list—and an increased target investment size (\$250,000 to \$5 million). The three existing investors in CASF—IFC, FMO and the Lundin Foundation—were joined by additional capital providers, including the Belgium Investment Company for Developing Countries (BIO), CDC, the Dutch Good Growth Fund and Proparco, the French development finance institution. ARF also has a technical assistance facility for pre- and post-investment support to investees, with \$1.3 million contributed by IFC and the Dutch Good Growth Fund.

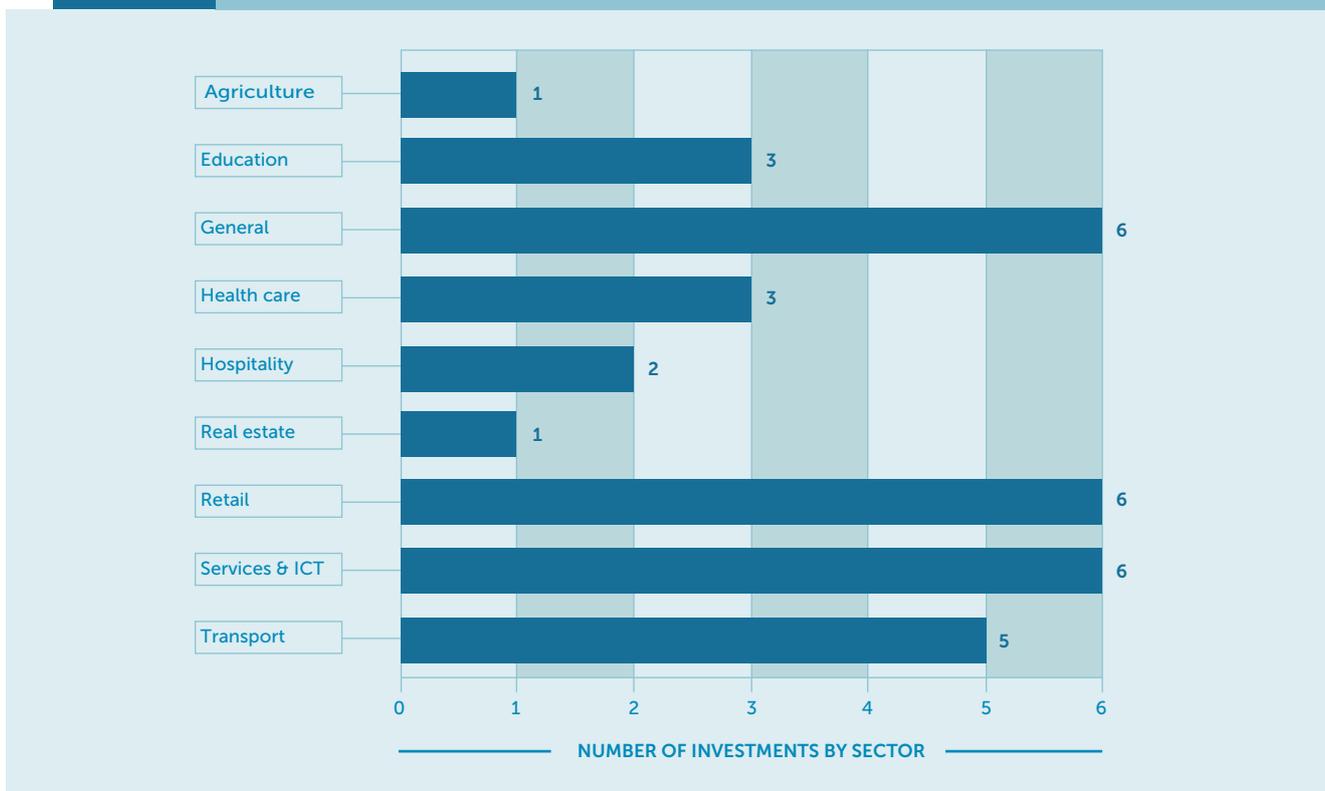
Figure 21 outlines the current portfolio by sector across all eligible countries (Burundi, CAR, DRC, Republic of the Congo and Uganda).

Outcomes

CASF supported underserved SMEs, creating opportunities for economic and social development. CASF became fully invested in 2015, providing finance to 32 SMEs across 10 sectors in DRC and CAR. Since February 2016, the new fund (ARF) has made investments in 19 companies in a range of industries and has committed 72 percent of its capital. CASF has exited four investments completely and has so far returned over 50 percent of invested capital to investors, performing in line with initial return targets.

This track record makes XSML the most active private equity investor in both DRC and CAR. CASF's tailored investment offerings and pre- and post-investment technical assistance have created strong business partnerships and sustainable companies that positively contribute to the economic and social development of the Central African region. Investee firms have expanded their businesses, created significant numbers of jobs and provided essential goods and services to their local populations. More than 500 jobs have been created at portfolio companies since investment by CASF alone.

FIGURE 21. Current portfolio by sector



Takeaways

1. Even more challenging contexts provide many profitable opportunities that are waiting for investment.

With the right support, SMEs even in more challenging contexts offer growth potential, as evidenced by XSML's ability to invest its funds—both CASF and ARF—in a short time period. XSML invested over 50 percent of ARF's total capital within the first two years.

The public and philanthropic sectors can play a catalytic role in sponsoring riskier, impact-focused funds and projects, and should consider supporting even more instruments (e.g. private equity funds) and backing intermediary partners with adequate commitment and capability to reach SMEs.

2. Crowding in private commercial investors—particularly in crisis or post-crisis settings—is difficult.

CASF demonstrates both the challenges associated with attracting private commercial capital to crisis or post-crisis settings, despite market opportunities, and the important role DFIs and foundations can therefore play in supporting SMEs. Likewise, while XSML attracted additional development capital to ARF, it did not mobilize private commercial capital.

This further underscores why efforts to crowd in additional capital—in this case for SMEs—must be complemented by government-led efforts (with backing from donors where appropriate) to improve the business enabling environment and investment climate through policy reforms and enhanced legal and regulatory frameworks.

3. A combination of financing and technical assistance is particularly useful to SMEs.

DFIs can play a catalytic role in sponsoring riskier, impact-focused funds and projects. SMEs benefit from being supported with more than just funds. In addition to equity and quasi-equity finance, the second category of resources needing rapid deployment is technical support. Private equity funds can use such resources to benefit the companies in which they are investing. Through investment capital, technical support and active management, fund managers can optimize the value of the business for exit and longer-term growth.

Between the two funds, XSML has provided technical assistance to more than 35 of their portfolio companies to help them improve their operations and skills. XSML provides both pre- and post-investment technical assistance, but primarily post-investment and with an emphasis on financial management as well as ESG reporting. As early-stage companies begin to grow and mature, they require increasingly robust and sophisticated systems for financial management. SMEs greatly benefit from support to manage cash flows, generate and analyse financial statements, develop financial plans and structure capital. Many impact-driven investors, such as XSML, also use technical assistance to improve companies' ESG compliance and adherence to other international and regulatory standards.

CASE STUDY 2

MALI

A SOLAR POWER PROJECT

Development challenge

Mali suffers from a deficit in power generation capacity, owing to a combination of underinvestment and growing electricity demand. The electrification rate is around 35 percent nationwide.¹⁸⁶ Rural areas are particularly underserved. Growth in demand is significant—estimates indicate 10–12 percent per annum¹⁸⁷—driven by demographic trends and economic expansion, particularly in the mining sector.

The Government of Mali has considered several solutions. Some hydropower plants are under construction, but progress is slow, and hydro resources are exposed to the risk of droughts and climate impacts. Connections with neighbouring countries can provide some stability in supply but would not solve the energy deficit alone. Thermal power capacity has increased, especially in the mining sector, but it is expensive to operate, environmentally unfriendly and exposed to volatility in oil prices.

Given Mali's low income per capita, power affordability is limited. The end-user tariff charged by the State-owned utility Energie du Mali (EDM) is well below the average production cost. As a result, the government steps in every year to plug EDM's financial gap, with these subsidies representing approximately a third of EDM's revenues.

Mali has optimal conditions for the deployment of solar photovoltaic (PV) technologies, with solar radiation potential well above average¹⁸⁸ and 7–10 hours of sunlight per day. Since on-grid utility-scale solar PV power plants can be deployed in a flexible, scalable and rapid manner, this is an attractive approach to fill the capacity gap. Solar PV is becoming more and more established and cost-competitive. Based on a positive track record in other regions, developers are open to new investment opportunities in frontier markets such as Mali.

Barriers to private-sector investment

Solar PV developers in Mali face several first-mover challenges, which have significantly hindered the development of this industry:

- **High transaction costs:** Even without accounting for equipment, it costs on average \$2 million per MW to set up a solar PV project in Mali. Equipment needs to be shipped to Senegal and transported from there. Negotiating bankable concession and power purchase agreements (PPAs) is time-consuming. There is no established domestic financing scheme for renewable energy projects, and sponsors must find solutions to mitigate off-taker risk, linked to EDM's financial position.
- **Off-taker risk:** EDM is indebted and has a low credit rating as a result of revenue uncertainty (issues with collecting payments and illegal connections), the high cost of fossil fuel imports for its thermal power plants, and growing capital expenditure. Under these conditions, any sponsor and lenders may find that a long-term PPA, critical to the commercial feasibility of a utility-scale solar PV, is not bankable without additional and expensive insurance.
- **Limited commercial financing options:** International banks tend to shy away from this sector in Mali owing to political and off-taker risk. Local and regional banks face capital restrictions and are unable to offer loans with tenors above 8 years, well short of the 12 or more years required by solar PV projects. Expertise in renewable energy financing is limited, given the paucity of previous similar deals in this space.
- **Limited investor expertise in the local renewable market, resulting in high risk perception:** Developers and lenders are concerned about the lack of an established supply chain, experienced local operators and off-taker risks. The cost and time to build, operate and maintain a solar PV system are high, as is the risk of prolonged downtimes and expensive repairs. Environmental and social risks are also difficult to evaluate (e.g. risk of claims over land purchased for the solar site).

¹⁸⁶ See, for example, https://www.usaid.gov/sites/default/files/documents/1860/Mali_Fact_Sheet_Power_Africa.pdf.

¹⁸⁷ Ibid.

¹⁸⁸ Solar radiation potential estimated at 5–7 kWh/m²/day vs. a global average of 4–5 kWh/m²/day.

- **Lack of regulation for solar PV:** The Government of Mali has approved renewable energy policies and targets, but specific regulations regarding feed-in tariffs and investment/production tax credits are not yet in place. Permitting procedures are unclear.
- **Weak transmission network and unreliable grid:** The electricity grid's ability to absorb and transport generation to load centres, especially large amounts of intermittent power, is limited or unknown, adding potential cash flow risk to renewable projects.
- **Country risk:** High poverty levels and political and security concerns further increase project risk for investors and sponsors.

Blended finance solution

In 2012, the project developer, an integrated independent solar power producer, approached the Government of Mali to explore the potential launch of a solar PV plant in Mali. The company develops, builds, owns, operates and maintains solar PV power plants, and already has a total installed capacity in excess of 383MW. The company partnered with IFC InfraVentures¹⁸⁹ and another private company as co-developers and equity investors, and formed a project company under Malian law, responsible for the design, construction and operation of a 33MW solar PV power plant, located approximately 240km north-east of the capital Bamako, and 2km of transmission line connecting the plant to the grid. The site lies on 90 hectares of publicly owned land. The project is structured as a 25-year Build, Own and Operate & Transfer concession agreement with the Government of Mali with a 25-year take-or-pay PPA with EDM.

The Malian Regulatory Commission of Electricity and Water, established in 2000, is responsible for regulating and overseeing the provision of electricity and water services. However, in light of persisting regulatory uncertainties, the government offered strong support to the project, including being a joint obligor to the PPA in addition to EDM. Lenders also signed a direct agreement with the government to protect the project against any change of law.

The total project costs are approximately EUR49 million, financed 25 percent with equity provided by the sponsors according to their stakes (around EUR12 million) and 75 percent with debt (around EUR37 million). The AfDB and the IFC provided approximately EUR17 million in senior debt at commercial terms, split equally between the two, with the remainder amount coming from a \$25 million concessional loan (in EUR equivalent) disbursed under the

Scaling up Renewable Energy Program (SREP)¹⁹⁰ of the Climate Investment Funds (CIF),¹⁹¹ on request by the AfDB as a CIF Implementing Entity. The SREP loan has a 17-year maturity and a 2-year grace period.¹⁹² A cross-currency swap will be undertaken to hedge the currency risk arising from the fact that the SREP loan is denominated in US dollars but project cash flows will be in CFA francs,¹⁹³ the local currency pegged to the euro but floating versus the US dollar.

SREP concessionality improves the investment's risk-return profile for the equity sponsors, facilitates their involvement as first-movers in a new sector, makes the project bankable for the other lenders and contributes to lowering the overall cost of solar PV generation in Mali. Crucially, because of the concessionality of this loan, the purchase price for EDM under the PPA is set below the price currently charged by EDM to its end-users and, therefore, will allow EDM to improve its financial standing.

In addition to the SREP loan, concessionality comes in the form of a partial risk guarantee provided by the World Bank's IDA covering the risk of delay or non-payment by EDM, in breach of the obligations set out in the PPA and concession agreement. The guarantee package comprises: (i) a letter of credit from an international bank covering four months of power bills (equivalent to six months of debt service); (ii) a sovereign guarantee from the government backing all EDM contractual obligations; and (iii) IDA's guarantee covering the government's ensuing obligations.

The involvement of the AfDB and the IFC ensures the application of rigorous ESG criteria and performance standards. Early involvement of the private company co-developer helped the project reach financial close, minimizing concessionality in the pre-blend phase by rewarding project preparation assistance with an equity stake.

Financial close is expected in the third quarter of 2018. The construction phase should take approximately nine months.

Both SREP and the AfDB conducted an *ex ante* assessment of project outcomes, in line with their rules and procedures. During project implementation, performance against outcomes will be monitored and evaluated, and reported to relevant stakeholders.

¹⁸⁹ IFC InfraVentures is a \$150 million global infrastructure project development fund that has been created as part of the World Bank Group's efforts to increase the pipeline of bankable projects in developing countries. IFC InfraVentures project support is not grant funding. In return for its development funding and assistance, IFC will have the right to a stake in the equity of the project at financial close, in most cases the right to arrange the long-term debt for the project, and IFC may provide part of such debt. For more information, see https://www.ifc.org/wps/wcm/connect/Industry_EXT_Content/IFC_External_Corporate_Site/Infrastructure/Priorities/Innovation/InfraVentures.

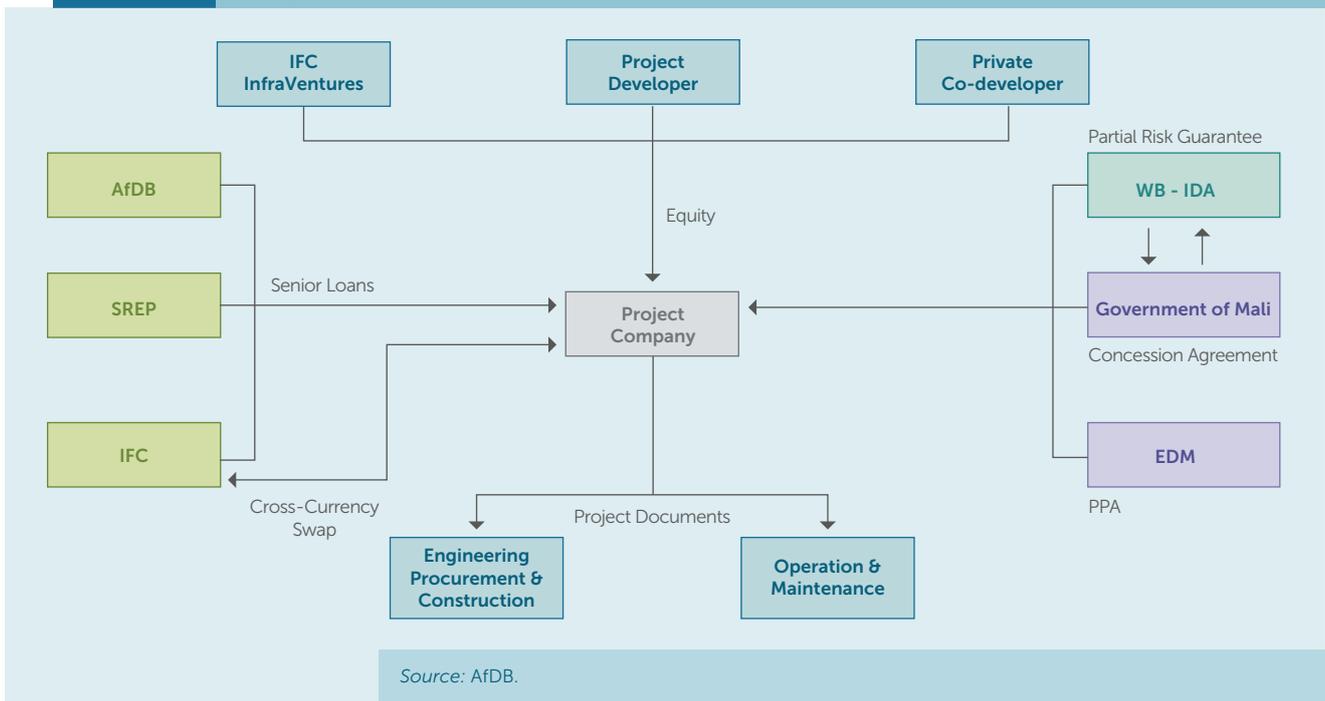
¹⁹⁰ The Scaling up Renewable Energy Program (SREP) in Low Income Countries is a targeted programme of the Strategic Climate Fund (SCF), which is one of two funds within the framework of the CIF.

¹⁹¹ The CIF were designed by developed and developing countries and are implemented with the MDBs to bridge the financing and learning gap between now and the next international climate change agreement.

¹⁹² Other terms of the financial structure are confidential.

¹⁹³ The West African CFA franc is the currency adopted in the West African Economic and Monetary Union and is pegged to the euro.

FIGURE 22. Project structure



Takeaways

1. The project has clear development and financial additionality.

The project will install the first utility-scale on-grid solar PV power plant being deployed in Mali under an independent power producer structure. It improves the country's energy mix, reduces the current power deficit, and provides clean energy access at affordable prices. The power output of the power plant will be sufficient to power around 60,000 households, with a substantial reduction in greenhouse gas emissions over the concession period.

The project will contribute to reducing Mali's reliance on expensive fossil fuel imports for thermal power production and the government's subsidies to the electricity sector. The project will also mitigate the negative impact of Mali's droughts on hydropower production.

The terms of the SREP loan were determined as a result of a detailed sensitivity analysis undertaken on the project's financial model. This took into consideration the need to abide by the principles of minimum concessionality, avoidance of market distortion and crowding-out of other investors, while preserving appropriate levels of debt service coverage and equity return. Concessional interest rates were carefully assessed against these variables.

2. Blended finance cannot solve all barriers to private investment but can contribute to market development.

A longer track record and a better understanding of the risks associated with these transactions in the country are needed to attract local commercial banks and other traditional financiers beyond MDBs. This is especially

important, as, over time, the use of concessional finance must be phased out.

Although still in the early stages of implementation, the project's goal is to demonstrate the business case for solar PV in Mali and catalyse market transformation, while complying with strict ESG criteria. By supporting the first mover, SREP aims to contribute to the future bankability of solar PV, strengthen the enabling environment and facilitate sector transformation.

The project's demonstration efforts should also lead to an improvement in the capacity of local solar PV technology service providers (equipment supply, engineering, advisers etc.). This should further enhance the bankability of future utility-scale solar PV projects in Mali at prevailing tariffs, at the same time as global markets continue to grow and equipment costs continue to fall.

3. There is a need for strong M&E and knowledge capture.

Monitoring impact and capturing lessons in a market such as this can help to provide lessons learned that not only inform investors about opportunities in this sector in Mali, but that can also inform government-led improvements in policies and regulations. This also speaks to the importance of conducting and sharing publicly *ex post* impact evaluations.

CASE STUDY 3

MYANMAR

CURRENCY HEDGING TO SUPPORT LENDING TO MFIs

Development challenge

In recent years, Myanmar has experienced substantial economic growth, a decline in poverty¹⁹⁴ and an increase in FDI.¹⁹⁵ An estimated 70 percent of the population live in rural areas, where poverty, albeit declining, remains high.¹⁹⁶ Increased access to finance is important for improving the livelihood of rural communities in the country.

The Myanmar financial sector, however, is underdeveloped and tightly regulated. Nearly half (48 percent) of adults are formally served with financial service products, up from 30 percent in 2013, but only 25 percent of adults have access to bank accounts, up from 17 percent in 2013. Eleven percent of adults have access to financial services from MFIs. In addition, 50 percent are informally served—the same level as in 2013. Over one fifth (22 percent) of Myanmar adults only use informal financial services.¹⁹⁷

To fill this gap, a number of MFIs have launched in recent years. LIFT surveyed the 22 largest, representing the majority of the market. At the time of the survey, they had an estimated 2.6 million loans outstanding and a combined loan portfolio of 723 billion kyat (\$541 million). With the exception of Pact Global Microfinance Fund, with a loan portfolio of approximately \$150 million (in local currency), the typical MFI had a balance sheet of \$10–15 million. The average microloan is a couple of hundred dollars and has a maturity of around 12 months. Around 60 percent of microloans surveyed by LIFT were used for small livestock purchases (for household consumption and small business purposes). The industry-wide non-performing loan ratio is currently very low. The microfinance industry has its own regulator, under the Ministry of Planning and Finance. Most MFIs are not permitted to raise voluntary deposits among clients.

MFIs could expand their balance sheet significantly to serve the growing needs of households and SMEs.

Macroeconomic and regulatory barriers, however, limit the appetite of commercial investors—international in particular—to fund Myanmar MFIs to undertake such an expansion.

Barriers to private-sector investment

As is the case with many LDCs, there can be barriers to private-sector investment. Myanmar is experiencing strong GDP growth (expected by the IMF to exceed 6 percent in 2017-2018).¹⁹⁸ The Myanmar economy is largely informal, but it is transforming and has a growing industrial base. Inflation and the current account deficit have put pressure on the currency. The kyat has been subject to several episodes of rapid depreciation, losing significant value against the US dollar in the five years prior to April 2018 and experiencing further sharp depreciation in recent months. In addition, the humanitarian context could affect investor decisions.

Strict regulations apply to the Myanmar financial services sector, preventing lending at market rates. This creates bottlenecks in the financial system that affect MFIs in particular. The primary sources of funding for MFIs are equity and long-term loans denominated in kyat—the latter capped in size to a maximum of five times equity. The interest rate on kyat loans to MFIs and banks or other borrowers is capped by regulation at 13 percent per annum. While domestic savings represent a sustainable source of long-term financing and provide proven benefits to savers, deposit-taking by MFIs is limited in practice, inter alia, both by regulatory barriers and the fact that some MFIs are still early-stage. The regulatory protections for MFI depositors become important in this context. On the asset side of the balance sheet, MFIs are not allowed to charge more than 30 percent interest to their end-customers (excluding fees).

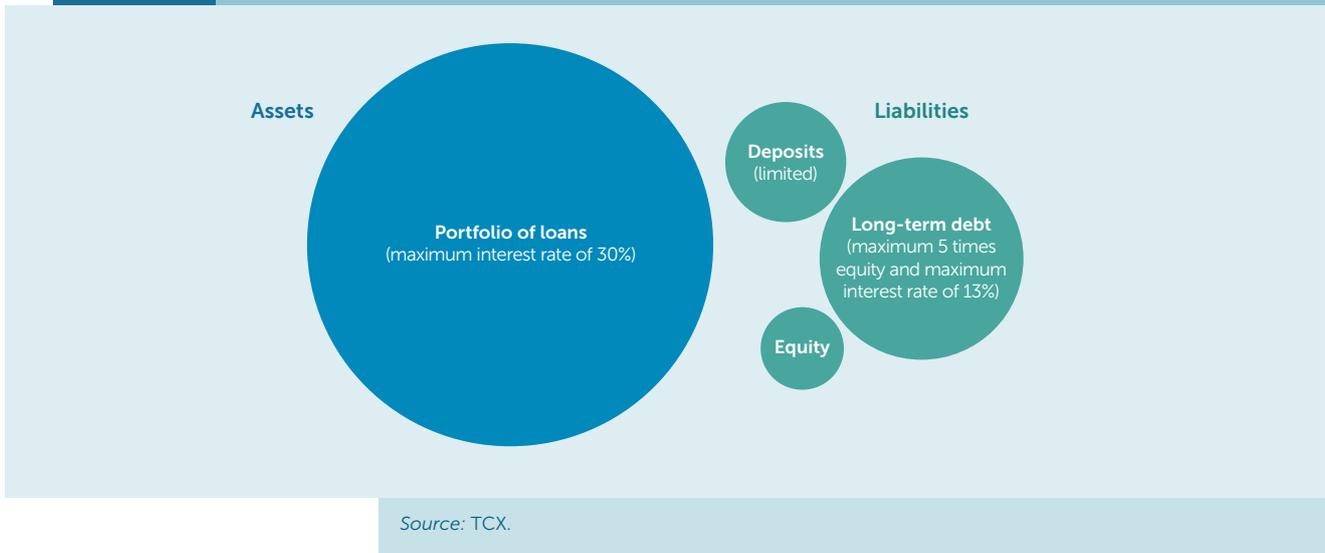
¹⁹⁴ World Bank (2017). Myanmar Poverty Assessment: Part Two. Key findings. 12 December 2017. <https://www.worldbank.org/en/country/myanmar/publication/myanmar-poverty-assessment-2017-part-two>.

¹⁹⁵ World Bank. World Bank Open Data. <https://data.worldbank.org/indicator/BX.KLT.DINV.WD.GD.ZS?locations=MM>. (Accessed June 2018.)

¹⁹⁶ World Bank (2017). Myanmar Poverty Assessment: Part One. Key findings. 30 August 2017. <http://www.worldbank.org/en/country/myanmar/publication/myanmar-poverty-assessment-2017-part-one-examination-of-trends>.

¹⁹⁷ UNCDF and Finmark Trust (2018). 'Finscope: Consumer Survey Highlights, Myanmar 2018'. New York: UNCDF and Finmark Trust—a report published by UNCDF's Making Access Possible (MAP) initiative.

¹⁹⁸ See <https://www.imf.org/en/Countries/ResRep/MMR>.

FIGURE 23. Capital structure of a typical MFI in Myanmar

The 13 percent interest rate cap on lending severely limits the appetite of domestic and foreign lenders to finance MFIs. This is particularly true for foreign lenders that face currency risk, in addition to country- and company-specific credit risk. Indeed, rates of 13 percent have proven too low to incentivize lenders once the costs for currency hedging and the risk of supporting greenfield MFIs is taken into account. Local banks have also shown limited appetite for funding MFIs, though rising growth in private (local and foreign) bank MFI lending is showing promise.

The debt-to-equity cap, in addition to creating a concrete limit to the amount of debt an MFI can assume, also limits the appetite of equity investors to finance MFIs—returns on equity are limited by the inability to leverage the equity base beyond the cap.

A last resort would be for MFIs to borrow directly in US dollars or other hard currencies from foreign lenders, at an interest rate also capped by regulation at 8 percent per annum. However, they would need to find a way to hedge the currency exposure, since they must lend to end-customers in kyat. A local bank has launched a hedging facility addressing MFIs directly, but progress remains very limited due to the underdevelopment of local capital markets, and the pricing is roughly aligned to that of TCX.

Blended finance solution

In 2016, TCX and LIFT launched a joint blended facility that allows international investors to lend to Myanmar MFIs in kyat at the cap rates, while realizing their targeted commercial returns in US dollars.

TCX was founded in 2007 by a group of DFIs to provide currency and interest rate derivatives in financial markets where such products are unavailable or poorly accessible. It is backed by the Dutch and German governments and several other multilateral and bilateral development organizations. It acts as a market-maker, offering longer-dated foreign exchange forwards and cross-currency swaps

to support local currency finance. TCX is active in over 70 currencies worldwide; since inception, it has hedged some 2,000 local currency loans for a total of \$5 billion.

LIFT is a multi-donor trust fund established in 2009 to improve the lives and prospects of poor people living in rural areas of Myanmar. To date, donors have committed more than \$400 million, used to finance 147 projects and provide technical expertise, research and oversight to improve programme design and impact. LIFT also works closely with the Government of Myanmar to promote pro-poor policies.

TCX was competitively selected by LIFT to run a currency hedging programme to facilitate international funding of Myanmar MFIs. \$10 million in concessional resources from LIFT allowed TCX to hedge, at commercially attractive rates, \$86 million worth of local currency loans, extended by 12 international lenders to 11 MFIs. The selection of the MFIs was left to the discretion of the lenders.

It took approximately two years to set up the programme. TCX conducted the first scouting mission in Myanmar in 2013 and started developing a macroeconomic forecasting model to construct a local currency yield curve, essential for pricing any hedging contract. Later, TCX, LIFT and UNCDF organized an investor conference, and TCX and LIFT launched a partnership to provide hedging. Stakeholders supported several other initiatives in 2014 and 2015, showcasing the need for an expanded microfinance industry. In 2016 LIFT and TCX signed the formal agreement detailing the size of the grant, its use and procedures.

Lenders approached TCX with the objective to secure a US dollar return of $\text{Libor} + 5.83$ percent on average on their kyat-denominated loans to MFIs. Without support, TCX would have offered such a US dollar rate only in exchange for a 19–20 percent interest rate in kyat. Since kyat loans to MFIs at rates exceeding 13 percent are forbidden by regulation, international lenders would not have been able to proceed with the transaction, leaving MFIs short of funding. The LIFT support allowed TCX to

bridge the gap, swapping 13 percent kyat rates for Libor + 5.83 percent US dollar rates on average (the range was 4.5 percent to 6.5 percent).

The 12 international lenders include DFIs (40 percent of loans hedged), as well as international funds investing in MFIs, and other impact funds (the latter two categories representing 60 percent of loans). All of the latter and also some of the DFIs pursue commercial returns. The programme in Myanmar is, therefore, an example of concessional resources mobilizing private or commercial finance.

Additionality is ensured by the fact that TCX only intervenes when its hedging counterparties have no adequately priced commercial alternatives. In the case of Myanmar, no commercial banks are currently providing hedging solutions for kyat currency exposures of foreign lenders. The programme is, therefore, seen as filling a funding gap generated by regulatory constraints as well as real and perceived country and sector risks, providing an important bridge as private banks develop the systems and knowledge to lend to MFIs.

Outcomes

LIFT's support allowed TCX to hedge 40 loans issued by 12 lenders for 11 MFIs in Myanmar. The MFIs pay 13 percent interest in kyat, in compliance with the regulatory cap. International lenders realize a Libor + 5.83 percent return on average, in line with their commercial objectives.

Each loan to the MFIs averaged approximately \$2 million in size. Since Myanmar regulation also caps the size of any loan to \$3.6 million (local currency equivalent), some lenders had to extend multiple loans to the same MFIs to fulfil the requested amounts.

TCX hedged 109.3 billion kyat of funding, equivalent to \$86 million of debt. Every dollar of concessional support mobilized 8.60 dollars of funding to Myanmar MFIs.

The average loan maturity is 2.8 years. MFIs lend to their end-customers for around 12 months. The loans hedged by TCX allow MFIs to cover two or three lending cycles.

The first loan was hedged at the end of 2016. Once launched, the entire hedging programme was executed in less than one and a half years.

The demand for TCX hedges far exceeded the \$86 million available: 20 lenders approached TCX to hedge kyat exposures on 92 loans to 17 MFIs for a total notional amount of \$200.7 million. This is a demonstration of the strong demand for such hedging programmes.

With the help of kyat-denominated loans, the MFIs served over 337,000 clients. The average loan size to clients was \$237. Around 84 percent of the MFIs' clients are women, and 64 percent live in poorer rural areas. As a direct result of the LIFT facility, the workforce of the 12 borrowing MFIs increased by 21 percent (1,027 new jobs created in the MFI sector alone).

Takeaways

1. The specificities of each country, the barriers to finance in a particular sector, and the unique regulations in each country need to be taken into account when trying to devise blended finance solutions.

This type of currency hedging programme was designed in response to a situation where—and under the right conditions could potentially be replicated or scaled up in other LDCs where—(i) currency volatility constrains international investors from lending to financial institutions at affordable rates in local currency; (ii) the financial infrastructure to hedge currency exposures does not exist or is underdeveloped; and (iii) regulatory challenges and capacities limit the ability of MFIs to mobilize domestic savings to fund their loan portfolio.

2. Regulatory change, in addition to blended finance, is essential to produce long-lasting catalytic effects.

The programme achieved its goals and created important demonstration effects, allowing MFIs access to capital they needed to grow and extend their operations. TCX suggests that this growth in size could help the industry influence regulations.

At the same time, the hedging programme cannot on its own solve the two regulatory problems at the heart of the MFI funding gap in Myanmar:

- The regulatory barriers that limit financial service providers/MFIs—especially more established MFIs—from mobilizing domestic savings: Addressing these barriers could see domestic resources providing MFIs with the financing they need to expand their operations, while providing significant benefit to clients.
- The limitations to market pricing for loans by and to MFIs (and other financial institutions): If market dynamics could play out freely, MFIs could borrow at local rates higher than 13 percent and closer to the levels required for commercial-rate hedging. While domestic banks are increasing their lending to MFIs, even with the cap in place, the 13 percent cap nonetheless means that public support may continue to be required to offer attractive US dollar returns to international lenders.

Loans extended to MFIs under the programme will expire in 2019-2020, presenting MFIs with some level of risks. At that point, to pay back those loans, MFIs will have to find alternative sources of funding or they will not be able to renew their microloan portfolios. If the 13 percent cap is still in place, and assuming domestic commercial banks are not filling the financing gap, a new round of concessional support may be needed to allow the hedging programme to continue and attract more international funding. LIFT is considering the possibility of such a second round of concessional support.

This shows the importance of working on the enabling environment in addition and in parallel to the blended finance intervention. TCX, LIFT and development stakeholders in Myanmar are aware of the regulatory bottlenecks and are working with the government to try to address them. Indeed, the interest rate cap was raised from 8 percent in 2010 progressively to the current 13 percent level.

3. Blended finance has allowed the MFI industry to expand.

To get to the point where MFIs can raise more deposits, there is a need, inter alia, for a strong regulatory framework. The programme covered \$86 million. Demand for microfinance loans in Myanmar, however, is substantial and growing fast. If MFIs are unable to source the required funding, a portion of this demand will go unmet.

Nonetheless, and notwithstanding the persisting regulatory bottlenecks, TCX and LIFT mobilized much-needed capital at a critical juncture and under specific circumstances; this helped the Myanmar MFI industry accelerate its expansion. MFIs have increased their balance sheet significantly, achieved greater efficiency (operating costs as a percentage of total assets decreased from 17 percent to 15 percent in the past two years), expanded their client base, and gained broader acceptance among households.

An evaluation on the first round of the blended facility could capture what worked and provide lessons to inform the development of any second round of concessional support, including helping to ensure that it has strong SDG impact, does not delay or disincentivize market reforms and supports local market development.

CASE STUDY 4

RWANDA

KIGALI BULK WATER SUPPLY PPP

Development challenge

Kigali, the capital of Rwanda, is a city of over 1 million people and growing rapidly. This is putting pressure on its water infrastructure. Rwanda has made impressive progress in expanding access to water over the last 15 years: access to improved sources of drinking water rose from 69 percent to 79 percent of the population between 2002 and 2015.¹⁹⁹ Still, many customers in Kigali are served by communal stand posts, and supply is intermittent because of limited water production capacity. Some residents have no alternative but to travel far, several times every day, to fetch drinking water from a nearby reservoir.²⁰⁰

In response, the Government of Rwanda included in its Economic Development and Poverty Reduction Strategy for the period 2013–2018 a commitment to achieve universal access to water and sanitation, improve the quality of water consumed, and increase management of water supplied by the private sector.

Barriers to private-sector investment

The barriers to private investment in water infrastructure in Rwanda are similar to those encountered in many other developing countries and LDCs, namely:

- There is a lack of commercial loans for the long tenors necessary for an infrastructure PPP project, often exceeding 15 years.
- First-time project under an untested regulatory framework: While PPP legislation was in place in Rwanda when the project was first considered, it had never been applied to bulk water supply, only to water distribution.
- Uncertainties surrounding the sector's governance framework: When the project was first considered by the government, one entity—the Energy Water and Sanitation Authority (EWSA)—was in charge of setting tariffs for and operating both electricity and water services. The government subsequently decided to restructure EWSA and unbundle its water and electricity operations. The former became what is now known as the Water and Sanitation

Corporation (WASAC), which is in charge of setting tariffs for bulk supply and distribution of water as well as operating water distribution infrastructure in Kigali. In its capacity as a water distributor, WASAC is the off-taker in any bulk water supply project. As a new corporate entity, its financial performance and credit history were unknown, a risk for its counterparties in a long-term off-take agreement, which forms the basis of a PPP.

- Water tariff affordability is limited due to low levels of household income. WASAC water tariffs are currently insufficient to fully cover the capital investment, future capital replacement, operations and maintenance costs, financing costs, and the return on equity targeted by commercial infrastructure developers and operators.

Blended finance solution

In September 2010, the Government of Rwanda retained IFC PPP Advisory Services as lead adviser to develop and structure a bulk water supply PPP in the Kigali area (the 'project'). IFC was responsible for assisting the client in the preparation, design and implementation of private-sector participation in the project by attracting one or more private-sector investors with established financial standing and technical experience. The IFC project team carried out the assignment in two phases, including: (i) due diligence, which included identifying the most appropriate location for the project, as well as demand assessment to determine the plant sizing; and (ii) competitive selection of investors to implement the PPP.²⁰¹

Capacity was limited within Kigali's public water utility, both in terms of developing and implementing the PPP and reforming the utility to ensure the long-term sustainability of water services in the city. Therefore, the IFC team also mobilized funding from the Public-Private Infrastructure Advisory Facility (PPIAF) to support capacity-building for the water utility and the water sector reform process. PPIAF is a multi-donor technical assistance facility, working closely with and housed inside the World Bank Group, focused on mobilizing private-sector participation in infrastructure in emerging markets. PPIAF complemented the IFC's transaction-specific advisory mandate.

¹⁹⁹ World Health Organization and United Nations Children's Fund Joint Monitoring Programme (JMP) for Water Supply and Sanitation: <https://washdata.org/data>.

²⁰⁰ Project Finance International (2018). 'Africa's First Water PPP'. London: Project Finance International. <http://www.pfie.com/africas-first-water-ppp/21320834.fullarticle>.

²⁰¹ International Finance Corporation (2015). 'Rwanda: Kigali Bulk Water Project'. Public-Private Partnership Stories series. Washington, DC: IFC. <https://www.ifc.org/wps/wcm/connect/cd5490004a9a80f99d5ddd9c54e94b00/PPP+Stories+2015+-+Kigali+Oct+26+2015.pdf?MOD=AJPERES>.

The government announced a competitive tender for the Kigali Bulk Surface Water Supply PPP Project in 2013. EWSA managed the bidding process with the support of the Rwanda Development Board (RDB), the government department that integrates all government agencies responsible for the attraction, retention and facilitation of investments in the national economy. Technical advice was also provided by the Infrastructure Development Collaboration Partnership Fund (DevCo), a multi-donor facility managed by the IFC and part of PIDG.

Metito Utilities Limited, a Dubai-based global provider of intelligent water management solutions with 60 years of experience developing and managing water facilities across the world, along with two other developers, was pre-qualified in December 2013, with the bid due in August 2014.

The successful bidder was required to submit a detailed technical and financial bid package. Considering the strategic importance of the project for the Rwandan government, Metito put together a highly competitive financial and technical package, based on which Metito was awarded preferred bidder status in October 2014 in one of the first competitively tendered water concessions in sub-Saharan Africa outside South Africa.

EWSA undertook its restructuring, leading to the creation of WASAC, soon after the bid submission in August 2014. As a result, a realignment of the off-taker team was necessary, and the process was undertaken to finalize the concession agreement. Support from RDB and the DevCo IFC advisory team was instrumental in managing the transition.

Metito is the 100 percent shareholder of Kigali Water Limited (KWL), the Rwandan incorporated limited liability company which owns and operates the project. KWL will sell potable water to WASAC under a 27-year PPP agreement. The 27-year term includes a 24-month construction period. The Ministry of Infrastructure will be the guarantor of the project on behalf of the government. WASAC will pay a regulated tariff in consideration for the water supplied by KWL.

The project includes development, financing, construction and operation of a bulk water production facility in Kanzenze, in the south-eastern part of Kigali. This will supply 40,000m³/day of potable water—equivalent to one third of Kigali's total supply—to the Kigali and Bugasera distribution networks of WASAC. Water will be drawn from the Nyaborongo River to be treated before distributing a clean supply to up to 500,000 customers.²⁰² KWL is a crucial part of Rwanda's drive to achieve universal access to clean water.

The project seeks to improve water supply, reduce water rationing, and enhance access to reliable and safe water for domestic and industrial use. These improvements are expected to contribute to: (i) improved health outcomes, including lower rates of water-borne diseases, higher productivity and lower health-care costs; (ii) time and cost savings for households in parts of Kigali that are currently underserved; and (iii) economic growth and job creation in businesses that are dependent on a reliable water supply,

including tourism and manufacturing. The project will also employ 100 people during construction.

Based on its experience in financing two independent power producer concessions in Rwanda (Kivuwatt and Gigawatt), EAIF was appointed as the mandated lead arranger for the transaction, co-lending with the AfDB. EAIF is a donor-funded company launched by PIDG to support infrastructure PPPs in 47 sub-Saharan African countries with long-term debt or mezzanine capital on commercial terms.

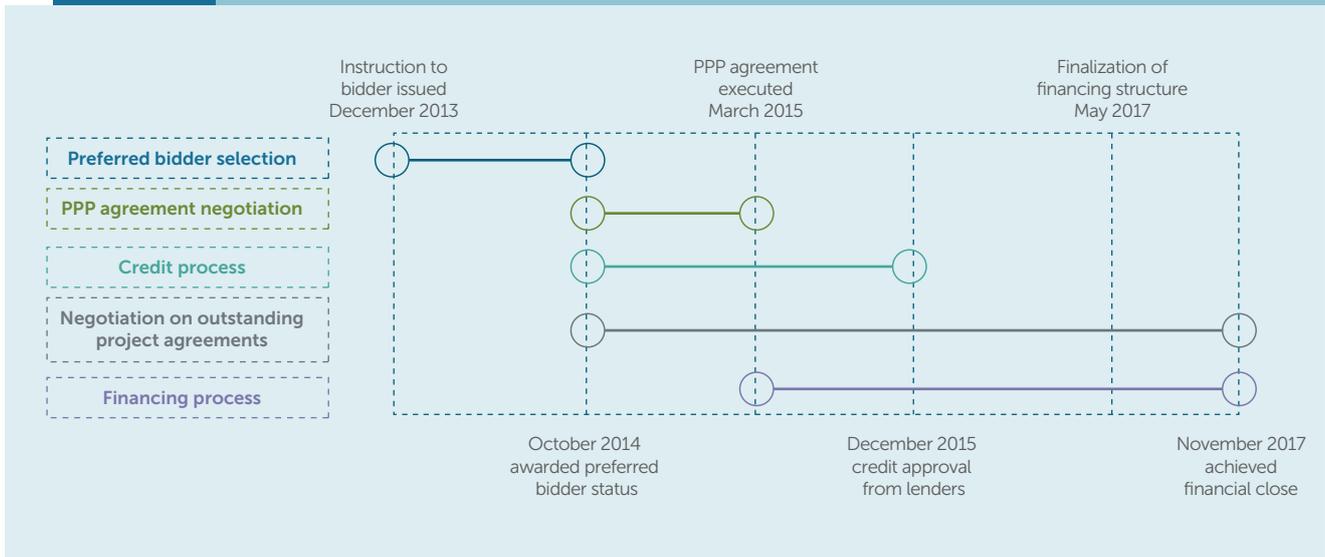
EAIF worked with Metito to refine the financing model and identified a need for subsidies to make the project viable for all parties—EAIF and the AfDB as commercial lenders, Metito as equity investor, and the off-taker with its tariff affordability objectives. As a result, another PIDG company—the PIDG Technical Assistance Facility—provided a grant as viability gap funding.

In addition, throughout the project structuring phase, DevCo provided additional support in the form of government advisory services worth \$1 million.

The original project timeline envisaged a concession agreement by the end of 2014, and a fully operational plant two years after financial close. This timeline was revised following the EWSA restructuring and the set-up of WASAC. As the first project of its kind, there were also few existing project templates or benchmarks; therefore, additional time was needed to negotiate project agreements. As a result, the concession agreement was finalized in March 2015, project scope and costs were revised in 2016, and the project reached financial close in November 2017. Construction begins in 2018, with the plant due to become operational in 2020.

²⁰² Based on the average water usage per person.

FIGURE 24. Project timeline to financial close



The total capital investment is approximately \$61 million.²⁰³ The funding mix comprises senior debt and junior debt facilities with an 18-year tenor, grants, and equity provided by Metito.²⁰⁴

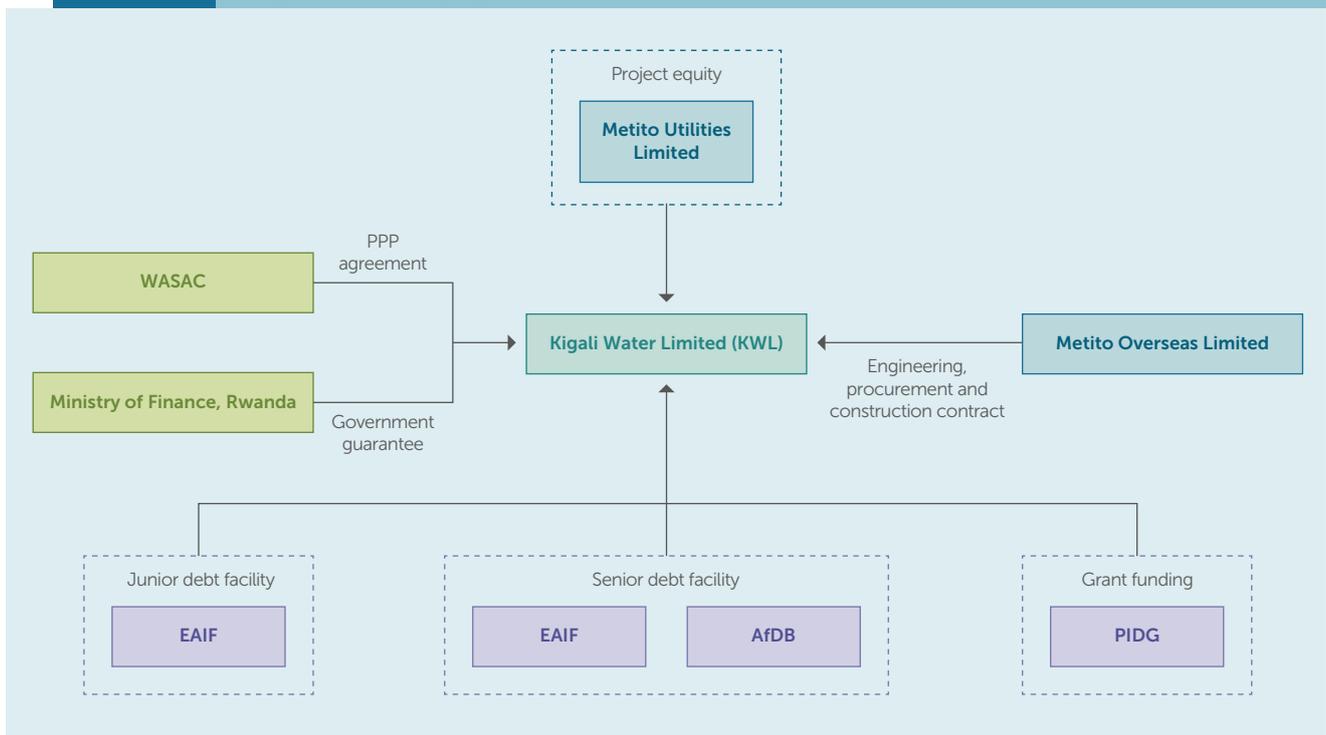
- EAIF and the AfDB each provided approximately \$18.9 million of senior debt on commercial terms.
- EAIF provided an additional tranche of \$2.6 million in the form of junior debt on commercial terms.
- The PIDG Technical Assistance Facility provided \$6.25 million in Viability Gap Funding²⁰⁵ to ensure the project was both commercially viable and affordable. This funding is crucial to reduce upfront capital costs and allow the government to enhance services and establish new connections to new customers classified as poor by international standards without the need to raise the existing tariff structure.
- Metito is providing the balance of funding as equity (approx. \$11 million).

²⁰³ Without valued-added tax (VAT), the project budget is about \$57.5 million.

²⁰⁴ Specific financing terms, beyond what is disclosed in this case study, are confidential.

²⁰⁵ The Viability Gap Funding grant is based on PIDG guidelines (PIDG Technical Assistance Facility (2016). 'Window 3: Project Capital Grants Policy and Procedures'. London: PIDG Technical Assistance Facility. <https://www.pidg.org/resource-library/other-documents/vgf-policies-and-procedures-june-2016.pdf>). These include: (i) disbursement pari passu with debt draw-downs once equity subscriptions are made; (ii) repayment requirements in the event of a serious contract breach; and (iii) requirements that projects include mechanisms to ensure pro-poor outcomes.

FIGURE 25. Kigali bulk water project structure



Takeaways

1. Adapting to evolving circumstances can help ensure a more timely and efficient execution.

The original scope of the project included production and distribution infrastructure such as pumping stations, reservoirs and piping, all of which are vital to delivering clean water to the local population. As the project developed, the Government of Rwanda sought to lower the infrastructure construction costs. An agreement was reached between Metito and the government to split the construction of the production and distribution infrastructure, delivering the latter through WASAC, supported by a separate concessional loan from the AfDB. The revised project will construct wells, a water treatment plant and two pumping stations. Three reservoirs, onward pipelines and a pumping station will be constructed under the separate project managed by WASAC. This helped lower the overall cost of the project led by Metito and EAIF from \$79 million to \$61 million.

2. Financial structuring is a dynamic process that must reflect policy and governance changes.

The project financing structure evolved to accommodate changes in the project and cost structure. One of the key challenges faced was to manage the credit risk of the newly incorporated WASAC as the off-taker. During the project preparation phase, WASAC was reorganized by the government as a new corporate entity, with implications for its credit standing. WASAC's credit risk was mitigated by structuring multiple layers of cash reserves to improve the credit profile of the project.

3. Coordination of blended finance providers and solutions is key to successful financial closing.

The project benefited from a well-coordinated package of blended finance: EAIF and the AfDB provided loans, DevCo provided funding for technical advice to help structure the project at the earliest stages, while a PIDG Technical Assistance Facility grant helped bridge the gap between the costs of development and operation, and the tariff level (set by WASAC) that is affordable. Blended finance will also play a critical role in the downstream infrastructure under development in separate projects, in particular the AfDB-supported development of reservoirs, pipelines and a pumping station.

4. Currency risk is a challenge where projects have long development timelines, significant hard currency costs in construction and operation, and are funded by foreign currency but generate revenue in local currency.

This was the case with Kigali Bulk Water. The project financing package is denominated in US dollars, which has the benefit of being compatible with construction costs and inputs also denominated in dollars, as well as allowing for cheaper debt than would be available in local currency. This, however, comes at the cost of higher currency risk for the off-taker, since the revenue stream is in free-floating Rwandan francs. The partners addressed this by finding ways to minimize project costs and maximize efficiencies, and by covering the project's distribution component through a separate concessional loan.

Projects with similar profiles may benefit from considering the appropriate roles for hard currency and local currency finance, and the role of grant or concessional funding to mitigate currency risks passed on, ultimately, to customers. Provision of hard currency debt during project construction, when most costs are incurred in dollars, followed by refinancing in local currency to match the off-taker's revenue stream, for example, may be one potential way to ensure an affordable service for the public.

5. Stakeholder engagement and country ownership are key in PPP projects.

As one of the first bulk surface water supply projects in sub-Saharan Africa to be structured on a PPP basis taking place in the context of an untested regulatory framework, close coordination with the government and among all the providers was essential in determining the project's scope, alignment with broader water access goals and water affordability implications. In addition, considerable time and effort were invested by the stakeholders to develop a bankable set of project agreements, which would serve as a benchmark template for future water projects in the region. Clear and continuous communication between all project stakeholders was crucial, particularly given changes between project procurement and financial close. Several rounds of all-party meetings were required during delicate PPP negotiations. Having Metito's commercially minded development team on the ground helped project partners to anticipate and mitigate issues in consultation with government stakeholders.

CASE STUDY 5

TANZANIA

MWENGE, AN AGRICULTURAL VALUE CHAIN PROJECT

Development challenge

The United Republic of Tanzania has a large national demand for edible oil. More than half of the demand is met by imported palm oil. The balance is covered by the local production of unrefined crude sunflower oil, which is primarily dominated by small producers and processors. Currently more than half of the edible oil consumed is imported. Local production of both factory and small-scale extracted oils contributes to about 40 percent of the domestic demand.²⁰⁶

National production of sunflower oil has been increasing over the years, including because the cost of producing sunflower oil in Tanzania is lower than for other oilseed crops (sesame, groundnuts), and because there is an active local market demand for sunflower oil for domestic use, as well as demand for the by-product (seed cake for livestock feeding).

Mwenge Sunflower Oil Company Limited (Mwenge) is a privately owned medium-sized oil mill that has been operating for over nine years. The company's main activities include processing sunflower seeds into oil, trading sunflower seeds and selling the by-products of the seed-oil process (e.g. animal feeds). Since 2012, Mwenge has been collaborating with the Singida district council (the local government), partnering with government extension officers in the field to identify and train farmers on proper agronomic activities and post-harvest treatment of sunflower seeds. At the time of the case study, Mwenge had registered 7,500 farmers in 50 villages to supply sunflower seeds to the factory.

For more than five years, the founder and owner of the company had been seeking financing to modernize and expand Mwenge's sunflower oil processing plant. The plant expansion would result in doubling Mwenge's crude oil processing capacity from 29 to 69 metric tons per day. A new 10 metric tons per day double refinery capacity will also be added; through the double refining process, Mwenge would also fortify the oil with vitamin A, which helps increase the shelf-life of the oil product and enhances its nutritional value, thereby helping to address malnutrition.

Singida is one of the poorest regions in Tanzania.²⁰⁷ It is located in the central part of the country, and agriculture is the mainstay economic activity in the region. Singida is among the few regions in Tanzania with a small-scale sunflower oil industry using simple technology; this industry has limited productive capacity to meet increasing local consumer demand. While these companies have succeeded in introducing new cash crops into the region, the commercialization and production of new crops has been constrained by poor farming methods, seed selection and farm management. Often the absence of a sustainable value chain for these crops provides little incentive for smallholder farmers to invest and increase production.

Barriers to private-sector investment

Many local authorities in LDCs are able to identify projects with transformational impact on their communities, and typically undertake small-to-medium-sized public investments to promote equitable and sustainable local economies. Yet they frequently lack the resources (skills and finances) to do so.

Commercial banks and private investors are typically reluctant to fund associated private investments or revenue-generating PPPs, owing to the perceived risks and lack of knowledge of a specific sector. In addition, banks often favour short-term loans and have asset allocation strategies skewed towards microfinance at one end of the spectrum and urban real estate or import/export finance at the other. This means that little priority is given to more complex transformative investments that qualitatively change local economies and not just quantitatively increase total output. This often holds back the expansion of economic activities that add value within the locality, resulting in the export of raw materials from the local economy with processing taking place elsewhere.

Mwenge's inability to obtain capital from commercial lenders illustrates these constraints:

First, the expansion plan required a significantly larger loan than most domestic private commercial banks were willing to take on, especially for a first-time borrower. Even though

²⁰⁶ United Republic of Tanzania (2016). 'Sunflower Sector Development Strategy 2016–2020'. Geneva: International Trade Centre. http://unoss1.undp.org/sscexpo/content/ssc/library/solutions/partners/expo/2016/GSSD%20Expo%20Dubai%202016%20PPT/Day%20_November%201/SF%204_Room%20D_ITC/Value%20chain%20roadmaps/Tanzania/Tanzania%20Sunflower%20Sector%20Development%20Strategy.pdf.

²⁰⁷ United Nations Development Programme and United Republic of Tanzania (2014). 'Tanzania Human Development Report 2014: Economic Transformation for Human Development'. New York: UNDP and United Republic of Tanzania. <http://hdr.undp.org/sites/default/files/thdr2014-main.pdf>.

the company was fully funded by the owner's equity and had been profitable for over three years, the company was perceived as high-risk with insufficient track record. The owner lacked experience in access to finance, could not post sufficient collateral and lacked a credit history.

Second, Mwenge's owner lacked the requisite skills and knowledge to prepare the necessary financing package and the resources to pay for such costs. Although a skilled entrepreneur, he lacked formal education and had been operating in the context of a mostly informal, rural economy. As such, he did not have the expertise to produce a business plan complete with risk assessment, a financial model, a project information memorandum and other documentation required to support a loan request.

Blended finance solution

In 2012, UNCDF launched the Local Finance Initiative (LFI), a programme aiming to unlock private finance so that these kinds of projects with strong development impacts can get to closure. The programme adopts a 'dual-key' screening system, through which UNCDF vets each investment on both development impact and bankability, taking measures to crowd in commercial finance from the domestic private sector. As appropriate, the team works jointly with UNCDF programmes on women's economic empowerment, climate resilience, fiscal decentralization and local economic development for the development of partnerships with potential sponsors. UNCDF ensures that the projects funded through this programme support national ownership and alignment of national priorities, and that lessons learned are captured to inform national policies.

The purpose of the UNCDF programme is to create demonstration effects for the viability of investing in local transformational projects. By using these lessons to inform national policies and regulations, the programme seeks to help correct market failures and attract greater amounts of private capital for investments that are not otherwise being picked up by investors. It does this by improving the capacities of public and private project developers to structure investments and sharing the risks with domestic investors so that they will fund them.

As part of LFI, UNCDF issued a call for proposals in 2015 and screened many applications submitted by entrepreneurs in Tanzania. Following the screening process, in early 2016 it decided to engage with Mwenge.

UNCDF's key activities in support of Mwenge—a mix of technical and financial assistance—involved three distinct phases over a period of 24 months: pre-financing, financing and post-financing.

In the **pre-financing phase**, lasting 18 months, UNCDF investment officers worked closely with the Mwenge project developer to conduct due diligence and structure the project financing and governance—ensuring the accuracy, validity, timeliness and completeness of all relevant operational, financial and legal information. Key tasks comprise project preparation, revenue and expenditure forecasting, governance structure, ownership structure, scenario planning, compliance with regulatory and tax laws, and designing the financing options.

Specifically, UNCDF advised the entrepreneur on: simplifying the shareholding structure by buying out minority shareholders; obtaining a certificate of incentives from the Tanzania Investment Centre to receive exemption on import duties for equipment; and delaying investment in anticipation of new legislation which expunged value-added tax on imports of oil processing equipment, generating an 18 percent saving that could be used towards loan repayment. UNCDF also prepared the investment package for submission to potential lenders and equity investors, connected the developer to local commercial banks and a guarantee institution, and supported the entrepreneur in the presentation of the investment and negotiation of the initial term sheets from potential private-sector financiers.

In the **financing phase**, lasting around seven months, UNCDF provided financing in the form of a grant and a concessional loan, and unlocked private domestic finance in the form of a commercial loan from a local lender and a loan guarantee from a local institution. This was one of the first loans issued under UNCDF's new loans and guarantees policy. The project raised a total of \$1,165,000 (in addition to a \$422,000 equity contribution by the owner) split as follows:

- a \$150,000 grant from UNCDF to help the owner meet the equity capital threshold required by an external lender;
- a \$250,000 UNCDF concessional loan in local currency. The loan is unsecured and has a six-year tenor and one-year grace period. The interest rate of 11.5 percent is below the 20–24 percent prevailing market rate at the time of issuance. The loan is subordinated and unhedged (i.e. UNCDF assumed currency risk);
- a \$765,000 senior secured loan (in local currency) from the National Microfinance Bank (NMB), a fully commercial bank. Collateral came in the form of land and buildings, existing machinery, and new equipment to be purchased with the loan proceeds; and
- a partial guarantee issued by a local institution, Private Agriculture Sector Support (PASS), covering 50 percent of the senior loan principal. The loan guarantee enabled the owner to meet the collateral requirement of the bank (125 percent of the loan amount). Mwenge paid a one-off fee for the guarantee at inception; ongoing quarterly fees are paid by the bank to the guarantor.

In the **post-financing phase**, UNCDF provided technical assistance and advisory support in the recruitment process of the key management positions. This was particularly important, as bank loan disbursements were conditional on the hiring of a robust management team to strengthen the factory's operational and technical capacity. UNCDF also ensured that Mwenge engaged new professional service providers such as a corporate lawyer and an accounting and audit firm to increase accountability and transparency. The company also hired a collateral manager to monitor disbursements intended for working capital (for purchases of sunflower seeds), a measure meant to mitigate credit risk (for UNCDF and the bank) and ensure proper utilization of loan proceeds.

Takeaways

1. Concessional finance can crowd in private investors for transformational investments, even in underserved regions in LDCs.

The Mwenge case demonstrated that limited development finance from UNCDF helped unlock 65 percent of the total financing gap from a private-sector bank, with a leverage ratio of 1:2, and enabled the implementation of a \$1.6 million (debt plus equity) local development project in rural Tanzania.

Although it remains early in the implementation process, UNCDF believes that Mwenge's expansion project can have broad impact, including: job creation, development of the sunflower oil value chain, increased work engagement of women (who play a significant role in sunflower farming), support for sustainable agriculture practices, demonstration effects for commercial banks considering financing similar projects, and, potentially, down the line, market expansion beyond Singida.

2. Technical assistance is important for pipeline development of transformational investment projects.

Mwenge shows the importance of technical assistance from an early stage to jumpstart project development and enhance bankability. Importantly, the scope of technical assistance was broad. UNCDF's capacity-building efforts helped Mwenge transition from a family business to a professional company with greater transparency, accountability and governance. To achieve this goal, technical assistance aimed to strengthen the project developer's financial and non-financial capabilities.

At the same time, the significant commitment of UNCDF staff time and resources in the pre-financing phase highlights the importance of focusing on projects with clear scale-up and/or replication potential. It also underscores the importance of having sufficient resources dedicated to supporting pre-blend work. UNCDF is seeking to establish platforms for local development finance in LDCs that mobilize these resources.

While UNCDF cannot take an equity stake, other models could be explored in the future in return for its support. These could include requiring project sponsors to co-finance project preparation; a convertible instrument that will trigger reimbursement of UNCDF support once a set profit threshold is reached; or requiring that the project reimburses a percentage of the UNCDF grant once the project obtains a loan.

3. Tailoring the solution to the local context is essential.

Mwenge shows the importance of precise tailoring of blended finance solutions. Without a combination of grant, subordinated concessional debt and guarantee, it would have been difficult to attract the senior commercial loan that represents the largest component of the capital structure. At the same time, UNCDF had to work within the constraints of its institutional mandate, which prevents it from making equity investments.

4. Concessional providers can actively support replicability.

Mwenge is one of a number of projects supported by UNCDF through the LFI. Based on the lessons learned from these projects and the findings from a recent mid-term evaluation, UNCDF is now helping governments in programme countries to set up national platforms (in the form of trusts or companies) that will take over the activities of the LFI programme when it comes to an end. These platforms would allow project developers, financiers and other stakeholders to network, share experiences and resolve constraints, so that the work of supporting missing-middle projects can continue after UNCDF support comes to an end.

03

PART III

Guest pieces



The views and opinions expressed in these guest pieces are those of the author(s) and do not necessarily represent those of the United Nations, including UNCDF, or its Member States, or those of OECD, Southern Voice, Convergence or the UN Foundation.

GETTING THE PRICE RIGHT: USING BLENDED FINANCE TO ADDRESS RISKS

(Régis Marodon, Special Advisor, AFD)

Meeting the SDGs will require not only additional investments, but also shifting trillions of dollars that are already invested towards initiatives that support sustainable development. This requires the collective efforts of all stakeholders, both public and private. Blended finance is one of the many tools that the development finance community has at its disposal to help drive this shift.

Addressing perceived and real risks

One of the challenges in mobilizing private finance in LDCs is that perceived risks can be very high. This perception can be fuelled in part by lack of knowledge of these markets and the uncertainty of operating in them, but also by the difficulty of pricing risks accurately in the absence of sufficient market references, reporting systems on credit defaults, or independent assessments of credit risks, leaving investors and lenders to design their own set of criteria.

In particular, perceived political risks result in investors shunning projects that could otherwise be bankable, or requiring large risk premia, which in turn lead to high costs for the project sponsors and governments. Paradoxically, as the experience from the 2008 financial crisis shows, sophisticated financial systems can on occasion be very risky, even with all their safeguards. Nonetheless, because projects may find it more difficult to attract private financing in LDCs, there is a perception of high risk, even though we have very little actual evidence on the rate of defaults.

This is where blended finance can help. It can transfer risks from the private to the public sector, leveraging concessional finance to attract private-sector investors for whom the risk of being involved in a particular project would otherwise be too high for the expected returns. Providers can use different variations and combinations of tools to absorb the perceived or real risks. However, abiding by the 'minimum concessionality' principle—and avoiding undue gains potentially associated with blending while maintaining the right incentives—is a difficult balancing act, one made trickier when there are fewer price references in a market.

Crowding in the private sector

Capital markets on their own often misallocate resources towards investments and activities that undermine sustainable development. The investments may be

financially viable but fail to price in, for example, activities that deplete natural resources or generate inequalities.

But blending—including through grants—can be engineered to solve specific development issues in sectors where the opportunities for generating revenue may be less certain but where significantly more resources are required to achieve the SDGs. The following examples are currently being implemented by AFD in developing countries, but they could also be replicated in LDCs.

In the sectors of health and education, AFD is using blended finance in the Dominican Republic to mobilize private investors to support projects which give poor people access to a private clinic or enable students to attend private universities. In the sector of biodiversity, AFD is supporting the creation of so-called 'biocultural landscapes' in Mexico by providing public-sector loans at market conditions alongside technical assistance funded by grants. The objective is to develop rural territories in a way that maximizes their economic potential while protecting their biodiversity.

Ideally, blended finance projects should be designed to be scaled to crowd in local banks and investors by demonstrating the business case for a sector that is seen as financially weak. Lines of credit to local banks, dedicated for SME investors or mid-cap companies, when blended with grants, can provide entrepreneurs with non-banking services to access new technologies or social and environmental responsibility. AFD has adopted that kind of approach in the renewable energy and energy efficiency sector through its SUNREF scheme, which incentivizes local financial institutions to invest in green energy projects, including in a number of LDCs.

Blended finance has many potential benefits. Through demonstration effects, deals can establish a track record and help investors gain a better understanding of certain markets or sectors. Blended finance can also be used strategically to help address some of the challenges in the broader investment climate, including reforms to policies, laws and regulations. This aspect of blended finance is often overlooked, as development agencies prioritize project implementation.

For blending to mobilize commercial resources on a substantial scale in LDCs, however, its application will need to: be based on robust, simple and clear rules that make it easier for private actors to get involved; strengthen domestic financial players; and embed blended finance in a larger framework that avoids 'one-shot' operations but which sees blended finance also as an opportunity to support governments in undertaking necessary policy reforms that can attract long-term private finance.

Dr. Régis Marodon is Special Advisor to the Agence Française de Développement (AFD) Presidency of the International Development Finance Club. A PhD in Development Economics, he participated in development studies in more than 15 African countries before joining AFD in 1989. He served in different countries (Ghana, Mauritius) before joining the Policy Department. He moved back to operations

as country manager for East Africa, then Morocco, before being promoted to Deputy Director of the Middle East and North Africa region in 2002. Posted in Istanbul as Country Director for Turkey, then Mexico City, he was appointed Director for the Latin America Department in 2013, before joining the AFD's CEO office as Special Advisor.

FINANCING INFRASTRUCTURE IN BANGLADESH:

WAYS FORWARD

(S.M. Formanul Islam, CEO, Bangladesh Infrastructure Finance Fund Limited)

Bangladesh's goal is to reach Upper MIC status and graduate from the LDC category in a few years. This represents an ambitious agenda for the country, one that requires consolidating and building on the progress made in past decades on economic growth and reducing extreme poverty. Achieving structural transformation also requires increasing productivity, improving infrastructure and energy, and managing urbanization.

In recent years, the Government of Bangladesh has invested heavily in basic infrastructure, including roads, highways and bridges, power and energy, and economic zones, including in rural areas. This has resulted in better services provided to the population. Typically, such projects requiring long-term financing have been funded through the government's own budget, grants from multilateral and bilateral development partners, and concessional loan facilities from international development banks.

The Bangladesh Infrastructure Finance Fund Limited (BIFFL) has played an important role in this context. It is a government-owned non-banking financial institution, operating since 2011. It was established under the Ministry of Finance to address the importance and urgency of investing in the country's infrastructure. BIFFL envisages attracting private investment from local as well as foreign investors and investing in companies that are implementing infrastructure projects in Bangladesh. BIFFL has been able to attract concessional capital from bilateral and multilateral donors and is planning to leverage its good track record to mobilize additional capital for its projects in the coming years.

BIFFL is committed to protecting the environment and contributing to economic and social development. Its

Five-Year Strategic Investment Plan includes investments into green and renewable projects, social infrastructure projects, and financing for women entrepreneurs. That plan sees BIFFL investing around \$1.6 billion by 2021, which will leverage investment in projects worth nearly \$8 billion. About \$720 million of the proposed investment amount would be financed from BIFFL's own sources, and the rest from the development agencies as loans; through the issuance of local foreign currency bonds; through public and private placement of shares; from investment by strategic partners; and by taking loans from the Government of Bangladesh.

Bangladesh's steady growth, financial stability, vibrant private sector and good rating provide a concrete opportunity to attract private capital, including foreign capital, and fill the estimated \$9 billion annual gap for developing and maintaining sustainable infrastructure in the country. By bringing in concessional capital, blended finance can provide additional opportunities to attract private investment to address the country's infrastructure demand and to provide investment opportunities to global investors. For example, blended instruments could be used to crowd in long-term debt; this would help increase the issuance of loans for infrastructure projects that usually require tenors of 20–30 years, as opposed to the short- and medium-term loans offered by commercial banks and non-banking financial institutions in Bangladesh. If blended transactions can provide loan guarantees to local banks, this could contribute to local market development. Blended finance instruments can also help address the issue of foreign currency risk through hedging tools. Indeed, there are no futures markets in Bangladesh, and dollar indexation is not allowed, creating risks due to inflation.

Financing infrastructure projects through the issuance of social bonds is another avenue that can be explored. Social bonds are primarily used for projects related to social welfare outcomes; these are more attuned to finance social infrastructure projects in Bangladesh. However, development impact bonds could also be explored to finance physical infrastructure projects.

There are already successful examples of mobilization of private capital in the context of infrastructure PPPs.

Building on those examples, and seizing the many opportunities offered in the blended finance space, requires in parallel important reforms in the regulatory and policy frameworks in Bangladesh, such as strengthening regulatory institutions and corporate governance, relaxing some administrative rules that make it easier to start a business, and improving initial public offering procedures so that investors have more options for exiting deals. Working to get deals done through blended transactions, using those lessons to inform policy reforms, and improving the enabling environment can together help attract more private finance into Bangladesh.

In short, concessional capital from bilateral and multilateral donors could continue to play a key role in helping Bangladesh to unlock private capital for infrastructure investments. Such support can help graduating LDCs such as Bangladesh to mobilize the resources they need to transform their economies and grow in ways that are inclusive and sustainable.

Mr. S.M. Formanul Islam is a legal counsel and financial adviser in the field of infrastructure investments. Since June 2015, he has served as the Executive Director and CEO of Bangladesh Infrastructure Finance Fund Limited (BIFFL), a leading financier of infrastructure projects in Bangladesh. Previously, Mr. Formanul Islam served as the Deputy Chief Executive Officer of Infrastructure Development Company Limited (IDCOL) for over 12 years. Prior to that, he worked with PricewaterhouseCoopers Securities LLC and Bangladesh Legal Aid and Services Trust. He is a Lee Kuan Yew fellow from Bangladesh. He received his Master's in Public Management (MPM) from the National University of Singapore (offered jointly with Harvard Kennedy School of Government) in 2014. Earlier, he completed his Master of Laws (LL.M) from Bond University, Australia, in 2000, and his Bachelor of Laws (LL.B) from Calcutta University, India, in 1998.

PAVING THE WAY: CREATING A TRACK RECORD FOR MOBILIZING PRIVATE CAPITAL IN RISKY MARKETS

(Jonny Gill, Director, CDC)

Often when faced with the question of investing in an LDC, many investors will bow out, citing fears of market risks or the small size of investable opportunities. But it does not always have to be that way. CDC is the UK's DFI. Established in 1948 and owned by the UK government, CDC invests in the private sector in Africa and South Asia to create jobs and make a lasting difference to people's lives in some of the world's poorest places. CDC is the only DFI in the world that invests solely in Africa and South Asia—where 80 percent of the world's poorest people live, and where 85 percent of LDCs are located. Since 2012, we have been increasing our focus on the most challenging countries²⁰⁵ within our geographic remit, with our disbursements to such countries increasing from 23 percent in 2009–2011 to 53 percent between 2012 and 2016.

A crucial element of our development impact is attracting²⁰⁸ other investors into our markets, thereby mobilizing more capital to help progress towards the SDGs. Our experience has taught us that markedly different approaches to achieving this are required for different countries. In particular, commercial investors that have not previously invested in Africa and South Asia tend to be much more willing to consider investment opportunities in more developed markets (for example, South Africa) than to move straight to investing in an LDC. This is not to say that we consider that LDCs cannot or should not attract much more commercial capital; however, there are a number of very real barriers which lie behind this. In partnership with others, we are working to address some of them, while others (for example, strengthening legal systems) are more appropriately being tackled by other actors.

Two significant barriers are a lack of understanding of these markets among international investors and the small size of investment opportunities. We have developed a variety of mobilization tools which can help address these barriers, including product development (for example, managed accounts or permanent capital vehicles), co-investment

(with both other DFIs and private investors) and investment promotion (for example, speaking directly to other investors about investments we have made, to help them understand why we have invested and help answer questions that may be holding them back from investing). However, our most established approach is to help establish investment intermediaries (such as fund managers) in these markets. This then provides a route for international investors to delegate individual decisions on investments to experienced investment professionals who are based in these markets, and to allocate larger amounts of capital than would be possible via individual investments.

It is, however, a long and difficult process to establish such teams in LDCs that can gain the confidence of private investors. In particular, many investors will only consider investing with teams that have an established relevant track record—i.e. they have invested for a number of years as a team, with a similar strategy to the one they propose to execute going forward, and have been successful in doing so.

This journey can, therefore, take years, with the first step—raising an initial fund to begin building this track record—often being the hardest. This is where CDC, as an experienced investor with a developmental mandate, steps in. Since the early 2000s we have invested in many 'first-time teams' that have gone on to raise subsequent funds which have attracted greater amounts of commercial capital. While these funds are generally structured in a commercial manner, they often require support from development-focused investors such as CDC to raise their first funds.

One recent example is a \$15m commitment we made to the InFrontier Afghanistan Fund in 2016. Evidently a very difficult market to invest into, this is the only private equity fund focused on Afghanistan. We hope that this fund will be able to build a track record so that the team can raise future funds which can raise greater amounts of private capital, and also that it will provide a demonstration effect in showing investors that private investment in Afghanistan is possible and can be successful—both financially and developmentally.

A second example is a \$20m commitment that we made to Solon Capital Holdings, an investment company based in Sierra Leone. This is the first time CDC has invested in a permanent capital vehicle (a relatively novel structure in developing markets), as part of its commitment to find new ways to meet the different needs of African markets to create jobs and deliver long-term growth. The approach complements our well-established funds strategy. As its first institutional investor, CDC will support Solon's management team as it continues to fundraise. Again, our aims are to both help Solon attract more private capital, but also to demonstrate the potential of investing in Sierra Leone.

²⁰⁸ CDC measures the investment difficulty of countries and Indian states through an index based on five factors: (i) market size; (ii) income level; (iii) credit to the private sector; (iv) 'Doing Business' rankings; and (v) fragility.

In parallel to this, we are also working through other routes to increase the flow of private capital into the hardest markets. For example, through the direct investments that we make, we are aiming to help build successful, well-managed businesses which can demonstrate the quality of investable companies available to invest into in our target markets. During the time that we are invested in a company we actively work to build up relationships with other private-sector companies and investors that may be interested in purchasing our investment from us in time. This then provides us with a route to bring in private capital to replace us when the time comes for us to exit.

Jonny Gill is a director in CDC's corporate strategy team, where he focuses on key strategic projects and its relationship with the UK's Department for International Development (CDC's sole shareholder). He previously worked within CDC's investment team for six years, investing into funds in Africa, and also spent two years with Social Finance, a non-profit organization focused on providing advice and raising capital for social-sector organizations, where he primarily worked on social impact bonds and impact investments in the health sector.

BLENDED FINANCE IN CLEAN ENERGY: EXPERIENCES AND OPPORTUNITIES

*(Valerio Micale, Manager, and Bella Tonkonogy,
Associate Director, Climate Policy Initiative)*

According to a recent CPI study,²⁰⁹ finance for energy access is not on track to meet universal energy access goals. More than 1 billion people live without access to electricity, and many more live with inadequate electricity supply. Across the 20 'high-impact countries' we evaluated in the study,²¹⁰ only about \$6 billion, or just over one third, of the \$19.4 billion total electricity investment over 2013-2014 was estimated²¹¹ to result in new or improved access to electricity for residential users through investments along the electricity supply chain. This falls well below the \$45 billion needed annually to meet SDG 7 for universal electrification as estimated by Sustainably Energy for All.²¹²

Despite the great needs, private-sector investment for energy access is lacking. Among the same group of high-impact countries, approximately 70 percent of overall investment in energy access comes from the public sector, mostly from international public sources. Further, decentralized approaches to electricity, which are particularly relevant to remote rural populations, captured barely 1 percent of the overall funding, and will also need to increase substantially.²¹³

In this context, blended finance is key to address the risks faced by private investors and the needs of rural communities. Another study recently published by CPI²¹⁴ found that the greatest impact opportunities for blended finance in clean energy are in sub-Saharan Africa and South and East Asia. Within these regions, the study identified around \$18.8 billion in potential investment in four LDCs with potential high impact on energy access and climate change: Cambodia, Mozambique, Rwanda and Uganda.²¹⁵

²⁰⁹ Sustainable Energy for All (2017). 'Energizing Finance: Scaling and Refining Finance in Countries with Large Energy Access Gaps'. Washington, DC: Sustainable Energy for All. <https://www.seforall.org/content/energizing-finance-scaling-and-refining-finance-countries-large-energy-access-gaps-2017>.

²¹⁰ We looked at 20 high-impact countries in sub-Saharan Africa and Asia whose efforts are critical to meeting energy access objectives by 2030.

²¹¹ Investment needed to deliver first-year consumption of 500kWh per year in urban areas and 250kWh for rural households, rising to 750kWh per household per year within 20 years. The figure's scope is global; nevertheless, it remains the closest available proxy for comparing investment trends in the 20 high-impact countries with electricity investment needs.

²¹² SEforALL (2015). 'Scaling up Finance for Sustainable Energy Investments: Report of the SE4All Advisory Board's Finance Committee'. Washington, DC: SEforALL. <https://www.seforall.org/sites/default/files/SE4All-Advisory-Board-Finance-Committee-Report.pdf>.

²¹³ Sustainable Energy for All (2017). 'Energizing Finance: Scaling and Refining Finance in Countries with Large Energy Access Gaps'.

²¹⁴ Tonkonogy, B., J. Brown, V. Micale, X. Wang and A. Clark (2018). 'Blended Finance in Clean Energy: Experiences and Opportunities'. San Francisco, CA: Climate Policy Initiative. <https://climatepolicyinitiative.org/publication/blended-finance-clean-energy-experiences-opportunities/>.

²¹⁵ CPI selected countries that scored well in terms of being the most attractive for private-sector investment and reached at least 500MW in projected planned and targeted capacity for renewable energy sectors. We then ranked the 46 countries that met the abovementioned criteria by their energy access and climate change relevance scores, indicative of the marginal impact that each dollar invested in such countries in clean technologies would have in improving energy access and addressing climate change. Finally, we calculated the investment opportunity for the countries identified by applying regional or country-specific capital costs of technologies to the planned and targeted capacity in megawatts (MW).

Understanding context-specific risks is key to designing appropriate and effective blended finance initiatives. In these countries, off-taker, currency, policy, liquidity and scale risks are the most relevant barriers to private investment, while early-stage projects and clean energy companies face barriers in accessing financing. We identified political and commercial barriers in these high-impact LDCs using country-level macro-indicators which best represent and define such barriers.²¹⁶ More specifically:

- In Cambodia, administrative issues and ease of doing business can be a barrier for energy generation investments.²¹⁷ Although the government has set impressive targets to provide electricity access to the majority of the population by 2030, there are perceived risks given the lack of specific renewable development goals or policies put in place except for hydropower; there are also no feed-in-tariffs.²¹⁸
- In Mozambique, the enabling environment for on-grid generation is weakened by barriers to private-sector participation in power generation in the country.²¹⁹ Relatively low electricity prices and the risk of revenue volatility reduce investment attractiveness; this is heightened by the limited track record on standardized PPAs,²²⁰ as well as currency risks connected to inflation and depreciation against the US dollar,²²¹ which expose investors and project developers to devaluation.
- In Uganda, perceived risk in this space is related to a relatively short history of clean energy investment. Large-scale hydro—on which the country relies—is accompanied by significant resistance related to the social and economic impacts of constructing large dams, as well as the high cost of power and exposure to reduced generation due to low water levels.²²² As with other countries in the region, access to affordable capital, particularly debt, remains challenging.

²¹⁶ To identify key political and commercial barriers to private investment in each high-impact country which could be addressed by blended finance, CPI referred to individual or combined country-level indicators, assumed as proxies for specific risks in the region. Indicators include: country risk, ease of doing business, electricity prices, access to foreign investment, access to private investment, access to affordable credit, inflation stability, currency risk, loan repayment risk and supporting environment for climate-related investment. Indicator sources are: EIA international energy statistics, the World Bank database, the IMF World Economic Outlook Database, Climatescope, TE Trading Economics Credit Ratings, OECD Country Risk, OANDA and International Energy Agency Energy Prices and Taxes. For more information on the assessment, see Tonkonogy, Bella, Jessica Brown, Valerio Micale, Xueying Wang and Alex Clark (2018). 'Blended Finance in Clean Energy: Experiences and Opportunities', Annexes 1 and 2.

²¹⁷ GlobalEDGE (2017). 'Cambodia: Risk Assessment'. East Lansing, MI: Michigan State University. <https://globaleedge.msu.edu/countries/cambodia/risk/>.

²¹⁸ International Energy Agency (2017). 'Southeast Asia Energy Outlook 2017'. Paris: IEA. http://www.iea.org/publications/freepublications/publication/WEO2017SpecialReport_SoutheastAsiaEnergyOutlook.pdf.

²¹⁹ Climatescope (2016). 'Mozambique'. New York: Climatescope. <http://global-climatescope.org/en/country/mozambique/#/details>.

²²⁰ Ibid.

²²¹ OANDA (2017). <https://www.oanda.com/>.

²²² Frisari, Gianleo., and Valerio Micale (2015). 'Risk Mitigation Instruments for Renewable Energy in Developing Countries: A Case Study on Hydropower in Africa'. San Francisco, CA: Climate Policy Initiative. <https://climatepolicyinitiative.org/wp-content/uploads/2015/07/Risk-Mitigation-Instruments-for-Renewable-Energy-in-Developing-Countries-%E2%80%93-A-Case-Study-on-Hydropower-in-Africa.pdf>.

- In Rwanda, despite progress on the business climate and positive economic growth, the country is still perceived by some investors as risky, the availability and reliability of corporate financial information vary widely, and the regional security situation is perceived as fragile.²²³ Access to capital remains limited, with the limited availability of local currency capital being a contributing factor. No new investment has been recorded in clean energy since 2014,²²⁴ despite the country's strong enabling framework for both distributed and centralized energy.

Given steep declines in clean energy costs and persisting risks at the country level, blended finance initiatives need to shift from a focus on covering the 'viability' gap between clean energy and competing fossil fuel technologies, to a focus on targeted investment risks and barriers. This has important implications for which instruments to deploy looking forward—with risk-sharing instruments such as guarantees, insurance, and local currency hedging and financing playing a key role. For example:

- Only a few initiatives that CPI reviewed seem to target commercial risks, such as currency risk or off-taker risk, in their design. TCX's Long Term FX Risk Management²²⁵ initiative, which provides tools to address currency and interest rate risk for climate-relevant projects in developing countries, is one exception. The instrument has de-risked more than \$200 million in renewable energy and energy efficiency investments since 2014. For example, it facilitated local currency lending to a developer that is connecting 500 African homes per day to solar power. TCX is currently working to scale up this success through the development of the Common Risk Mitigation Mechanism.²²⁶
- Relatively few initiatives have reported a guarantee element in their design. An analysis of multilateral institutions indicated that guarantees represent approximately only 5 percent of their commitments²²⁷ but generate approximately 45 percent of their private-sector mobilization in all developing countries,²²⁸ and some 71 percent in LDCs, as this report notes. Furthermore, previous

²²³ GlobalEDGE (2017). 'Rwanda: Risk Assessment'. East Lansing, MI: Michigan State University. <https://globaleedge.msu.edu/countries/rwanda/risk/>.

²²⁴ Bloomberg NEF (2017). 'Installed Capacity'. New York: Bloomberg NEF.

²²⁵ Global Innovation Lab for Climate Finance (2017). 'Long-Term FX Risk Management'. San Francisco, CA: Global Innovation Lab for Climate Finance. <https://www.climatefinancelab.org/project/long-term-currency-swap/>.

²²⁶ Terrawatt (2018). 'Common Risk Mitigation Mechanism'. Paris: Terrawatt. <https://crmm.terrawatt.org/>.

²²⁷ Betru, Aron, and Christopher Lee (2017). 'Clearing a Path for Global Development Finance: Enabling Basel and Development Guarantees to Deliver on Sustainable Development Goals'. Santa Monica, CA: Milken Institute. <https://www.milkeninstitute.org/publications/view/878>.

²²⁸ Multilateral institutions consulted by the study include: African Development Bank, Asian Development Bank, Credit Guarantee and Investment Facility, Investment Fund for Developing Countries, European Bank for Reconstruction and Development, AFD, Proparco, KfW, International Bank for Reconstruction and Development, International Development Association, International Finance Corporation, MIGA, including MIGA Trust Fund, FMO, Camoes Institute, Sociedade para o Financiamento do Desenvolvimento (SOFID), Garantco, Sida, OPIC and USAID (Benn, Julia, Cécile Sangaré and Tomáš Hos (2017). 'Amounts Mobilised from the Private Sector by Official Development Finance Interventions: Guarantees, syndicated loans, shares in collective investment vehicles, direct investment in companies, credit lines).

CPI research²²⁹ found that, even among the already low-risk instrument offerings, only 10 percent of risk instruments focused on climate-related projects. Several administrative barriers prevent the wider use of guarantees as an instrument for private capital mobilization: DFIs typically record guarantees in the same way as loans for the purposes of risk capital allocation; in addition, guarantees are not officially regarded as development assistance (ODA), further lowering incentives to use them.

- Aggregating individual project and private company investments into liquid assets (e.g. through securitization) is critical to overcome investment hurdles, including liquidity risk, to access larger pools of capital, but there is little experience to date in emerging markets. In addition, for non-project-based financing, supporting risk mitigation instruments that allow energy generation companies, including distributed and off-grid generation companies as well as established utilities, to access capital markets for corporate financing will help to mainstream clean energy finance.
- Especially relevant to increasing energy access, there are large gaps in accessing early-stage risk financing for project preparation, distributed and off-grid generation companies and new technologies. This is true, for example, for project preparation during the earliest milestones of mid-to-large-scale projects (e.g. over 10MW). Some grant initiatives, notably the Africa Clean Energy Facility (ACEF), have focused on addressing gaps at this stage. However, to date, a financially sustainable solution has not been established. Several initiatives, including Climate Investor One's Development Fund²³⁰ and the Renewable Energy Scale-Up Facility,²³¹ seek to recoup at least some costs. For technologies involving high upfront commitment combined with significant resource risk, such as geothermal, where debt finance only steps in once 70 percent of the resource has been proven, early-stage financing is similarly difficult to obtain. In Africa, the Geothermal Risk Mitigation Facility programme plans to address this risk by co-financing surface studies and drilling. Finally, distributed and off-grid generation also faces scarcity of investment at the earliest stages—including equity and debt—particularly in countries with underdeveloped financial sectors. ACEF also sought to address this barrier through grants.

Ultimately, any new blended finance solutions for increasing energy access in LDCs need to be developed in specific contexts. An in-depth analysis of investor risks and barriers needs to be conducted for the geography under consideration, and the proposed solution tailored to address the most important risks, to mobilize local and international private investment in the near and long term.

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Bella Tonkonogy, an Associate Director in CPI's climate finance team, leads the analysis and development of innovative climate finance instruments for the Global Innovation Lab for Climate Finance. She also manages projects focused on understanding the effectiveness of innovative finance more broadly, including a recent project for the Blended Finance Taskforce on how blended finance can be more effectively deployed for clean energy. Bella previously served as a Policy Advisor in the US Treasury, overseeing the agency's energy and environment investments in emerging markets.

²²⁹ Micale, Valerio, Gianleo Frisari and Federico Mazza (2013). 'Mapping the World Bank Group Risk Mitigation Instruments for Climate Change'. San Francisco, CA: Climate Policy Initiative. <https://climatepolicyinitiative.org/wp-content/uploads/2013/09/World-Bank-Group-Risk-Mitigation-Instruments-for-Climate-Change-Brief1.pdf>.

²³⁰ Global Innovation Lab for Climate Finance (2017). 'Climate Investor One'. San Francisco, CA: Global Innovation Lab for Climate Finance. <https://www.climatefinancelab.org/project/fmo-climate-development-finance-facility/>.

²³¹ Global Innovation Lab for Climate Finance (2017). 'Instrument Analysis: Renewable Energy ScaleUp Facility'. San Francisco, CA: Global Innovation Lab for Climate Finance. <https://www.climatefinancelab.org/wp-content/uploads/2017/09/Global-Lab-Instrument-Analysis-RESF-1.pdf>.

GETTING BLENDED FINANCE TO WORK IN LDCs: THE NEED FOR COORDINATED STRATEGIES TO SUPPORT LONG-TERM PRIVATE-SECTOR DEVELOPMENT

(Cecilia Caio, Senior Analyst, Development Initiatives)



Blended finance can be an effective addition to the development financing toolbox and presents an important opportunity to expand the range of resources available to meet the SDGs. Through a variety of mechanisms, blending enables development partners to mobilize commercial capital into specific investment projects, thus contributing to the reduction of financing gaps in particular sectors and contexts.

The importance of building pipelines and supporting the underlying enabling environment for private-sector development

Blended finance is just one of a number of ways international public finance can engage with the private sector (see Figure 26). Supporting the enabling environment for private-sector development is another one, with a long history in aid policy discourse, going back to the 1986 Nairobi Enabling Environment Conference. It has been recognized as an important form of catalytic support for development in several international agreements, including the 2002 Monterrey Consensus, the 2011 Istanbul Programme of Action for the Least Developed Countries, and the 2015 Addis Ababa Action Agenda. However, recent momentum in the blended finance market is pushing donors to focus on more direct approaches to catalyse private-sector resources for development.

To date, MICs have been benefiting the most from this type of finance,²³² but there are increasing calls to scale up blending in less developed and more fragile contexts. This should not be taken lightly. In addition to potentially crowding out local investors,²³³ there is also a risk that unless considered alongside more systemic support to encourage long-term private investment and a thriving private sector more widely, blending could remain a short-term solution that bypasses the underlying causes of lagging private investment.²³⁴ This deserves particular consideration in LDCs, where the enabling environment for private investment (including safeguards for social and environmental risks) may be weaker, and where, therefore, the risk of blending only having a temporary, short-term impact, and benefiting only those directly involved in the deal, may be greater. The potential for broader and sustained market development and poverty reduction outcomes under such scenarios may, therefore, be limited.

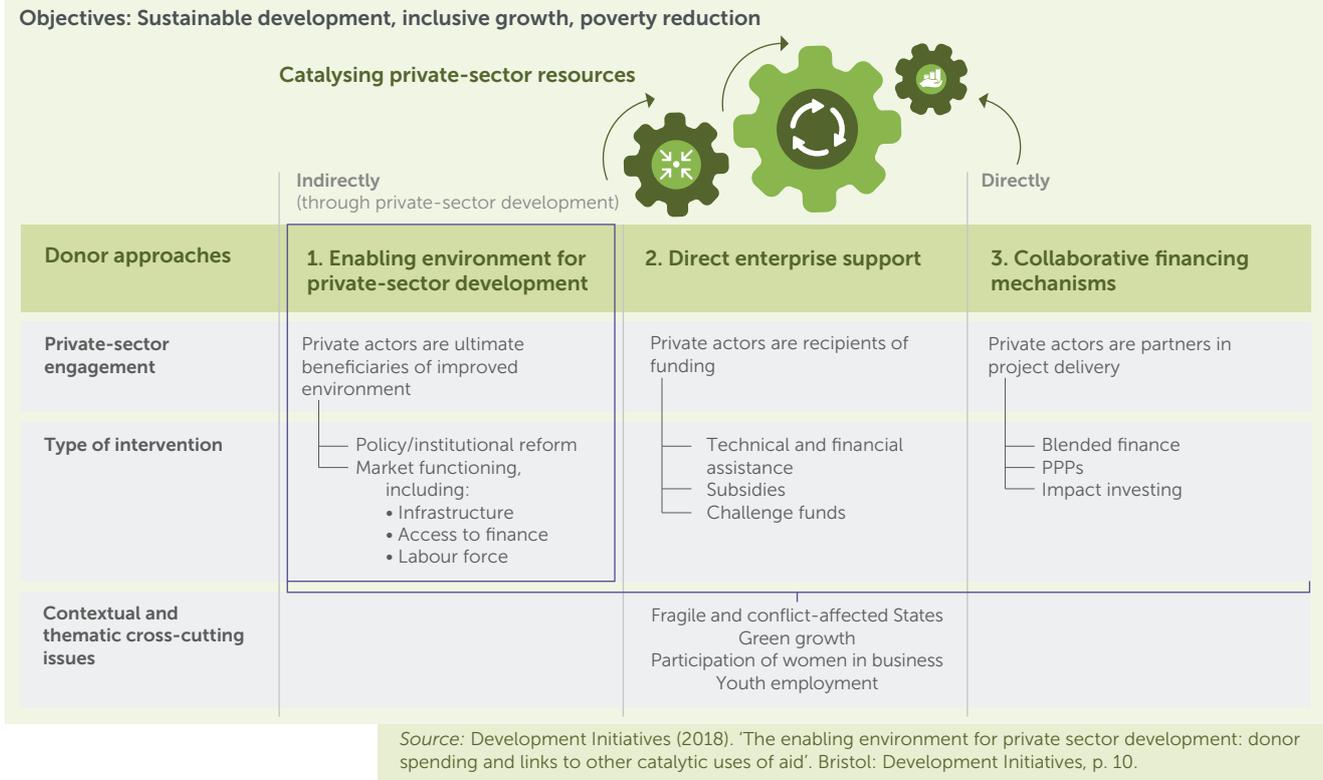
²³² Development Initiatives (2016c). 'Blended Finance: Understanding its potential for Agenda 2030'. Bristol: Development Initiatives. <http://devinit.org/post/blended-finance-understanding-its-potential/>; and, more recently, Organisation for Economic Co-operation and Development (2018b). 'Making Blended Finance Work for the Sustainable Development Goals'.

²³³ For example, see Development Initiatives (2018a). 'Will blended finance lead to private sector growth in developing countries?' Bristol: Development Initiatives. <http://devinit.org/post/will-blended-finance-lead-private-sector-growth-developing-countries/>.

²³⁴ Development Initiatives (2018b). 'The enabling environment for private sector development: donor spending and links to other catalytic uses of aid'. Bristol: Development Initiatives. <http://devinit.org/post/enabling-environment-private-sector-development/>.

FIGURE 26.

Supporting the enabling environment for private-sector development is an important form of catalytic aid to be considered alongside others, such as blended finance



While direct approaches such as blending may work in certain contexts, such as MICs, they may face increased hurdles to be as successful in less developed and more fragile situations, such as LDCs, where the supply of 'bankable' or commercially viable projects may be more limited and/or deal sizes may be too small relative to the transaction costs.²³⁵ Therefore, especially in LDCs, support aimed at expanding the 'pipeline' may be an important prerequisite, or at least a complementary measure, to scaling up investments in mechanisms that directly engage private actors as investing partners (such as blending).

Data show that there is an opportunity for donors to improve targeting of this more systemic type of support and to increase investments in LDCs. In 2015, \$9.9 billion of ODA was spent on strengthening the enabling environment for private-sector development. Most of the amount that was allocated to individual countries (\$6.4 billion) went to MICs that are not LDCs—which are also those most benefiting from blended finance investments.²³⁶

In addition to creating the conditions for expanding the supply of viable investment projects, interventions aimed at

strengthening the enabling environment for private-sector development tend by design to engage domestic stakeholders, including domestic governments, more than might be the case with approaches such as blending²³⁷—with positive implications for country ownership and alignment of development cooperation efforts with country needs. This means that they may benefit a wider range of actors, including but perhaps less limited to the large international investors with whom donors and international DFIs have tended to partner in blended finance deals to date.

The need for coordinated strategies

For blended finance to contribute to achieving the SDGs, its impact needs to go beyond individual deals and spread to more systemic improvements in the conditions necessary for both domestic and international private investment to flourish. This is echoed, to some extent, in initial guidance for donors and DFIs on how to do blending well. For example, the OECD DAC Blended Finance Principles call for blended finance investments to be tailored to the local context and to be used alongside efforts to promote a sound enabling environment

²³⁵ It should be noted that although the ultimate objective of blended finance is the achievement of the SDGs, deals must be commercially viable for private-sector participation (this is recognized in both the OECD DAC Blended Finance Principles and the DFI Working Group Enhanced Principles for Blended Concessional Finance).

²³⁶ Development Initiatives (2018b). 'The enabling environment for private sector development: donor spending and links to other catalytic uses of aid'.

²³⁷ Even though it is important for developing countries to be involved in decisions regarding how scarce concessional resources are deployed, there is a concern that this does not always happen and that blended transactions may weaken country ownership.

(Principle 3);²³⁸ the DFI Working Group Enhanced Principles highlight the importance of blending to reinforce local markets (Principle 4).²³⁹

It is crucial that, going forward, the link between blending and other donor interventions that are aimed at supporting long-term private-sector development is strengthened. Especially in LDCs, donors need to adopt coordinated, long-term strategies to mobilize private capital for development. Ongoing policy dialogue around blended finance, including the call by the Inter-Agency Task Force on Financing for Development to consider blended finance principles in relation to already existing commitments made in the Addis Agenda,²⁴⁰ presents an opportunity to promote such an approach, by revitalizing commitments aimed at strengthening the underlying conditions for private-sector development, alongside the drive to increase blending.

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HOW WOMEN AND MILLENNIALS,

BLENDED FINANCE AND THE SDGs CAN IMPACT LDCs

*(John Morris, Co-Founder and Managing Partner,
Good Capital Project)*

“**Good Capital Project (GCP) focuses on generating innovative and sustainable solutions that align capital markets with the human needs of tomorrow. Two of the most powerful agents of change influencing the future of capital markets are women and millennials.**”

In this paper we explore the importance of attracting the attention of these investor bases and the role that both the SDGs and a blended finance structuring approach play in connecting these investor cohorts to the world's LDCs.

There are currently 47 LDCs; they represent more than 13 percent of the world's population but less than 1 percent of global trade in goods. Since the categorization of LDCs in 1971, there has been limited success in attracting private investment at scale in those markets, as they have been deemed too risky to explore. In the mid-2000s, major

banks were increasingly active in structuring products (mostly in commodities and extractives) in these markets, but pulled back after the financial crisis of 2008, and have been slow to return.

Today, developing markets are just returning to the levels of foreign investment equal to the 2007 level, but this time primarily fuelled by the growth of regional commercial banks that have the benefit of local expertise. Much of the funding coming from these regional banks is subsidized by guarantees coming from international development agencies and is not being followed by investment looking for market-rate returns. There is an unfortunate absence of long-term sustainable investors in these markets. We must attract a new investor base and provide advice frameworks and products that include the LDCs in the broader capital markets.

Women and millennials

Women and millennials are the key decision-makers of tomorrow's capital. Successful financial intermediaries and advisers are beginning to recognize their investment power and are designing products and advice frameworks to serve them. Today, millennials hold \$17 trillion in private wealth and will benefit from the largest intergenerational wealth transfer in history. Women are spearheading the world of impact investing, and are actively seeking investment tools that align with their social missions.

Countless surveys report that the preferences of both millennials and women differ from others when it comes to investing. They have a substantially higher commitment

²³⁸ Organisation for Economic Co-operation and Development Development Assistance Committee (2018). 'Blended Finance Principles for Unlocking Commercial Finance for the Sustainable Development Goals'.

²³⁹ DFI Working Group on Blended Concessional Finance for Private Sector Projects (2017). 'Summary Report'.

²⁴⁰ United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects, 2018', p. 88.

to socially responsible investments or impact investing. This is, therefore, a critical moment to influence change.

As a result, we need the innovative financial tools, research, products and advisers that allow investors to construct portfolios around their social and environmental goals. Additionally, they should have LDC opportunities available within their investment framework.

SDGs as an investment framework

We believe the 2030 Agenda is consistent with the ethos of this powerful new investor segment, and that the SDGs have enormous potential to be converted into an investment framework. The Business and Sustainable Development Commission estimates that incorporating the SDGs into growth strategies could increase forecast global GDP by about 10 percent by 2030.

By incorporating the SDGs into investment frameworks that advisers and financial intermediaries can use with clients, the private sector can help guide capital allocation for the construction of well-rounded and purpose-driven portfolios. These advice frameworks will enable financial professionals to target different investor bases with approaches consistent to their client demands.

The SDGs can also be used to measure the impact of investments on a system-wide level by setting specific targets and detailed indicators for each SDG. By increasing accountability, investors can further mitigate risk and accelerate scale through the standardization of impact. This solves one of the most common risks associated with impact investment: the difficulty in measuring and cross-comparing impact that arises from the misalignment of diverse definitions.

By laying out a clear and comprehensive menu of global goals, the SDGs allow investors to build a diverse portfolio around their investment choices. Institutional investors such as sovereign wealth funds, pension funds, endowments and large family offices are increasingly realigning their portfolios to reflect and overlay the SDGs as an objective within their investment policy statements.

The SDG investment framework can be leveraged to include LDC investment in the broader markets. For this inclusion to occur, there needs to be LDC product choices available, and this is where blended finance becomes important as an approach to product creation.

Blended finance

The growth of impact investing has allowed investors to combine their social purpose with their financial returns, bringing philanthropy and investment together. However, it is rare that large-scale investment banking activity embeds grants or concessional lending as part of the products they structure for distribution. Therefore, the majority of the options available to investors today are traditional investment products that do not connect to a social framework such as the SDGs or LDCs. Just as 'impact investment' has acted as a catalyst for the investor to achieve social and financial returns, 'blended finance' has the potential to be that catalyst for investment banking effort in product origination.

While blended finance enables financial intermediaries to embed social returns within financial structures, not enough attention is being paid to the LDCs. Recently, as this report highlights, only 7 percent of private finance mobilized by official development finance is in LDCs. To accelerate the flow of capital to the LDCs, a concerted effort by the private and public sectors is required to create LDC-inclusive products that redistribute risk and that build a pipeline of investable opportunities for private and institutional investors in these markets.

There are many different definitions of blended finance. At Good Capital Project we refer to 'SDG-Blended Finance' as combining both donor and market-based capital sources to achieve sustainability. This results in future funding from the traditional capital markets and establishes fiscal sustainability. By attracting investments seeking market-rate returns to supplement aid capital, SDG-Blended Finance can scale social progress.

Advisors are facing increasing demand for purpose-driven investments from their clients. Financial intermediaries, such as banks or money managers, can use SDG-Blended Finance to create LDC investment opportunities for a more socially minded consumer base. SDG-Blended Finance can provide advisers with more innovative products within the SDG framework.

Conclusion

The investment preferences and expectations of women and millennials are aligned with the SDGs. Providers of concessional finance and UN agencies should leverage this consumer demand to focus the attention of financial intermediaries, advisers and family offices on the opportunity presented by SDG investment frameworks and blended finance products. Towards that goal, we offer four points for consideration:

- Investor potential to drive capital to the LDCs is substantial. This is the time to act! Concessional providers need to develop an integrated action plan to tap into investor segments such as value-aligned women and millennials.
- The SDGs can provide an investment framework for investors and advisers to build and monitor their portfolios. Intermediaries need to champion this as an opportunity for the socially responsible investor by creating tools and including LDC-inclusive products. A task force is needed to better connect development agencies and concessional providers with financial intermediaries to this end.
- Blended finance can be used to design scalable LDC-focused products, allowing investment aligned with the SDGs. Development agencies and providers of concessional finance should coordinate their efforts and actively include long-term asset owners in the process.
- Global financial intermediaries need to focus more on the investment and social opportunities that the LDCs hold, building on the work UNCDF is already doing in this regard. UNCDF and concessional providers need an investment promotion campaign to highlight LDCs as an investment class in conjunction with frontier markets.

John Morris is the Managing Partner of Intentional Media, parent company of SOCAP, Conscious Company Media, Good Capital Project and other aligned brands. Previously, John co-founded Snowden Lane Advisors, a wealth management firm currently with \$3.5 billion in assets. He also co-founded Clearbrook Global Advisors, an institutional asset management advisory firm that

grew assets to over \$20 billion in assets under advice. Earlier, John spent 23 years at Merrill Lynch, 15 years working with clients in London and Dubai, then New York where he was Chairman of Latin America and Head of International Product and Marketing. He and his wife live in Princeton, New Jersey, and are thrilled about the newest edition to their family, a grandbaby.

POLICY CONSISTENCY, CAPABILITY TRAPS AND DEVELOPMENT FINANCE INSTITUTIONS: AN IMPORTANT NEXUS

(Aniket Shah, PhD candidate, University of Oxford)

Domestic development finance institutions (DFIs)—national institutions that are established to support national development initiatives, such as the BNDES of Brazil, the China Development Bank and the Uganda Development Bank—are important and sometimes overlooked parts of the development finance architecture. To be most effective in delivering on their mandate, they require consistency in the public policy within which they operate. In some cases, however, domestic DFIs are unable to build the internal capacities, legitimacy and track records of success that are needed to be successful due to policy regimes which change approaches towards economic management.

This observation would imply that DFIs, particularly at the national and subnational levels, should not just be implementing agencies of public systems, but that they should also be in the business of proactively forming public policy and ensuring its consistency over a long period of time. The optimal linkages and interactions between domestic DFIs and broader public policy are underexplored areas of development finance and the political economy more generally. Getting these linkages right is particularly important for domestic DFIs to attract additional sources of public, private and concessional finance from both domestic and international sources of capital, including pension funds, sovereign wealth funds and insurance companies.

The consistency of public policy refers to the general harmony, agreement or coherence of a policy framework. Public policy consistency can be analysed in one of three ways: the consistency and synchronization of various

government policies—for example, fiscal, monetary, social and development policies—at one period of time; the consistency of public policy versus public opinion; or the consistency of one particular set of public policies over an extended period of time. Each of these approaches towards understanding public policy consistency has its own set of metrics and frameworks of analysis from a policy analysis perspective. Given that domestic DFIs are in the business of long-term financing, I believe that there is particular importance in ensuring that the third approach—the consistency of one particular set of public policies over an extended period of time—is a particularly valuable perspective from which to approach this topic.

The concept of consistency of public policy over time has its foundation in the theory around rational expectations and optimal policy design of economic policy. This field of study, housed mainly in the economics literature, focuses on the implications of the changing preferences of economic agents over time. A core concept within this framework is that actors in an economy base their decisions on their expectations of the policy environment in the future. If individuals or businesses are uncertain about government policy, it will impact major capital and entrepreneurial decisions, due to increased variability in potential outcomes. One significant implication of this field of study has been the perceived benefits of protecting public policymaking, including economic management, from short-term policy pressures and variations in approach and ideology. The notion of a ‘commitment mechanism’ has had significant resonance in monetary policy, whereby central banks operate, to varying degrees, independently of political administrations. The concept of credibility of public policy is central to this theory. It has led certain scholars to argue that unalterable policy rules may be needed to ensure the optimal long-term welfare of citizens.

During the past four decades, we have experienced significant shifts in dominant ideologies around development policy in developing countries, particularly for the African continent. No shift in thinking is starker than the Washington Consensus ideology that fundamentally altered the relationship between the relative power of the State

and markets in various countries in Africa. Although a full examination of the impacts of structural adjustment policies is beyond the scope of this article, it is fair to say that the 1980s and 1990s witnessed a significant reorientation in many African economies away from State-driven development and towards a more market-driven approach. This transition led many LDCs, including Uganda, Tanzania and others, to precipitously shut down and/or privatize many State-owned enterprises. For the development finance architecture in Africa, this meant a de-prioritization of DFIs within domestic financial ecosystems.

As the policy regime and approach shifted, many of the dozens of DFIs across Africa lost much of their human capital. This has led to negative feedback loops, whereby many national DFIs do not have the human capital and internal capabilities to prove their success within their broader financial systems, and, as a result, they are unable to attract the necessary financial resources and credibility to build the human capacity and internal capabilities to be successful institutions. This is an unfortunate state of affairs, as well-functioning and well-respected national DFIs could be a significant source of support for long-term projects that are unable to attract commercial capital on their own.

DFIs have the ability to leverage all forms of capital—public and private, domestic and international. Domestic public resources from national governments, which provide the initial equity to form the institution and provide a capital base, most often capitalize domestic DFIs. From this initial source of capital, domestic DFIs can attract intermediate capital from domestic public resources, in the form of outlays from national budgets. DFIs can also attract intermediate capital from domestic private sources, by issuing bonds that are purchased by local banks, pension funds and insurance companies. Domestic DFIs often receive capital from international public sources of financing, including multilateral development banks, international DFIs, and development agencies of aid-providing countries. Finally, domestic DFIs can also attract intermediate private capital if international investors purchase their bonds, as is the case with large DFIs, or if they provide co-financing opportunities for specialized investment firms, including private equity firms and venture capital firms. By blending these different forms of capital, well-functioning national DFIs can provide capital at below market rate to industries and projects in LDCs that are capially starved but unable to get financing from purely private sources of capital. Therein lie the importance and process of national DFIs for LDCs: their ability to attract and combine different sources of capital is particularly important for these riskier markets that need creative development finance structures to support long-term economic growth.

The dynamics between DFIs and public policy consistency leads me to three broad observations.

- First, DFIs must be made independent and insulated from short- and medium-term oscillations in government policies. This is not a simple dynamic, given that DFIs are generally owned by the government and receive much of their financial support and credibility by their association with the government. The DFI community can learn a lot from the history, evolution and structures of central bank relationships with federal government.
- Second, major changes in public policy should be undertaken only after an assessment is made on the impacts they would have on underlying institutions in an economy. Changes in public policy often focus on short-term perceived benefits of one approach versus another, but very rarely are assessments made on how a major policy shift can impact the health, capacity and potential of the organizations and institutions within a setting.
- Third, capacity-building programmes and approaches at the institution level should focus on ensuring broad stability in policy outside the institution itself. Capacity-building programmes for DFIs should focus on how they can play a clearer and more strategic role in ensuring that broader public policies are conducive to the work on which they are focused.

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EFFICIENT FUEL FOR EARLY-STAGE IMPACT PIONEERS

(Bjoern Struwer, CEO, and
Christina Moehle, Advisor, Roots of Impact)

Pioneering models for impact

When Stewart Craine founded Village Infrastructure Angels²⁴¹ in 2012, he had more than 15 years of experience in rural electrification projects. Having worked in solar since 2005, he knew how difficult it can be to provide safe, affordable and renewable energy to the poorest households. A related challenge was to attract the financial resources to achieve real impact at scale. The market for low-cost solar-powered lamps was in its infancy then, making Stewart a pioneer in what today has become a huge market and a highly sought-after impact investment sector.

With Village Infrastructure Angels, Stewart decided to embark on an ambitious journey: pushing the boundaries in the solar home market in Honduras, a country with one of the lowest electrification rates in the Americas. Piloting the model in the Gracias a Dios region, which is characterized by one of the highest levels of poverty in Latin America, made this step even more demanding. Village Infrastructure Angels introduced some innovative features, such as solar-powered agro-processing, an explicit focus on women's empowerment, pay-as-you-go technology and the possibility for clients to pay with products and goods.

From the investors' standpoint, however, too much innovation is not necessarily a plus. The majority of private capital providers today are rather risk-averse and prefer more established geographies and business/impact models.²⁴² While donors and development agencies are increasingly keen to make the most effective use of their budgets, getting the private sector involved remains challenging. What investors generally want to achieve is an efficient risk–return ratio for their monies. In other words: if they perceive “the risks to be too high or their expected returns to be too low, then they will invest elsewhere”.²⁴³

A working paper by the Center for Global Development on catalytic instruments²⁴⁴ concludes: “If a public-sector actor, such as a government or donor, wishes to encourage commercial investment in an activity perceived by the private sector to be below the risk–return frontier, then the policymaker either has to find a way to increase the expected returns, or reduce the risk, or some combination of the two.”

Therefore, for pioneer models such as Village Infrastructure Angels, de-risking alone usually will not do the trick. The financial return potential has to be improved to successfully crowd in investment. After Village Infrastructure Angels was able to secure investment to benefit poor communities in Honduras, roll-out will begin later this year.

Attracting investors: the novel way

In our view, the factors that enable investors to operate in the delicate area between grant-type returns and market-rate returns are:²⁴⁵

- monetizing the value that social enterprises create for society, straightforwardly, in a single contract, without the need for a complicated structure;
- convincing development actors and philanthropic funders that they have much larger leverage and additionality with their monies when they pay premiums for verified positive impact and thus attract private capital; and
- selecting suitable social entrepreneurs and carefully designing the payment mechanisms that are related to outcomes.

This line of thought led to the creation of Social Impact Incentives (SIINC)²⁴⁶—a novel way to incentivize impact and mobilize private investment. SIINC acts as a funding instrument that rewards market-based social enterprises with premium payments for achieving social impact. These additional revenues are paid directly to the enterprise, enabling them to improve profitability and attract the investors they want to help them scale. SIINC effectively leverages public or philanthropic funds to catalyze private investment in underserved markets with high potential for social impact.

²⁴¹ See <http://www.villageinfrastructure.org/>.

²⁴² See the latest Impact Investor Survey 2018 by the Global Impact Investing Network regarding impact investor preferences and allocations: <https://thegiin.org/research/publication/annualsurvey2018>.

²⁴³ Barder, Owen, and Theodore Talbot (2015). ‘Guarantees, Subsidies, or Paying for Success? Choosing the Right Instrument to Catalyze Private Investment in Developing Countries’. CGD Working Paper 402. Washington, DC: Center for Global Development. <https://www.cgdev.org/sites/default/files/CGD-Working-Paper-402-Barder-Talbot-Supporting-Private-Sector.pdf>.

²⁴⁴ Ibid.

²⁴⁵ Our thinking draws on Etzel, Michael (2015). ‘Philanthropy’s New Frontier—Impact Investing’, Stanford Social Innovation Review, 9 November. https://ssir.org/articles/entry/philanthropys_new_frontierimpact_investing.

²⁴⁶ See <http://www.roots-of-impact.org/wp-content/uploads/2017/05/Social-Impact-Incentives-SIINC-White-Paper-2016.pdf>.

In essence, SIINC resembles a social/development impact bond, but there are fundamental differences. SIINC is an entrepreneurial adaptation with appropriate attributes: (1) rapid and straightforward structuring (only one contract required); (2) payments are made directly to impact-generating enterprises; while investor(s) and investment instrument(s) are not predefined. Thus, SIINC translates the major principles of outcomes-based funding from the world of governments and non-profits to the world of markets and businesses. This important twist can be an efficient channel for entrepreneurial creativity and innovative solutions for impact in LDCs. Figure 27²⁴⁷ illustrates how SIINC works.

Implementation in LDCs

The pilot programme for SIINC started in 2016 as a public-private development partnership in the Latin America and the Caribbean region between the SIINC co-creators Roots of Impact and the Swiss Agency for Development and Cooperation (SDC)—which also supported Village Infrastructure Angels. Based on initial successes, SIINC will now expand its reach. Currently, negotiations are under way to structure a SIINC transaction for another pioneering social enterprise, Sustainable Organic Integrated Livelihoods (SOIL). This enterprise aims to promote dignity, health and sustainable livelihoods in Haiti through the transformation of waste into resources. SOIL currently generates two lines of revenue: (i) toilet rental to low-income households; and (ii) selling fertilizers produced from the waste. This is a promising test case to demonstrate that the mechanism can be as powerful in LDCs as elsewhere in attracting private capital for high-impact social enterprises.

The Haitian social enterprise is in a similar situation as Village Infrastructure Angels was more than a year ago: SOIL would like to attract investment to scale its operations and is convinced that through economies of scale and public service contracts it will achieve profitability. It is quite aware that the perceived risk for investors is very high, but it wishes to establish itself as a market-based enterprise. Therefore, the team decided to employ the SIINC model, and entered into negotiations with both multilateral outcome payers and impact investors.

For SOIL, a set of relevant outcome metrics—such as the amount of waste sustainably treated—is currently being developed between the enterprise and the outcome funder (donor). The local sanitation department is engaged in this process but does not have to make any commitments at this stage. In a next step, the outcome funder will agree to pay SOIL for the positive impact that the enterprise generates. These premium payments will be triggered by reported outcomes and supplement the projected earnings from its revenue-generating activities. This, in turn, greatly improves the enterprise's financial projections and will empower it to secure the necessary investment to scale.

One may ask what will happen after the 'exit', when impact-related payments have come to an end. The plan is that, based on the track record and greatly reduced costs established through the SIINC intervention, the local sanitation department will be enabled to continue paying SOIL to offer sanitation solutions. In this case, the enterprise will no longer need donations, and will be able to service the investment and grow sustainably.

A bottom-up approach to blended finance

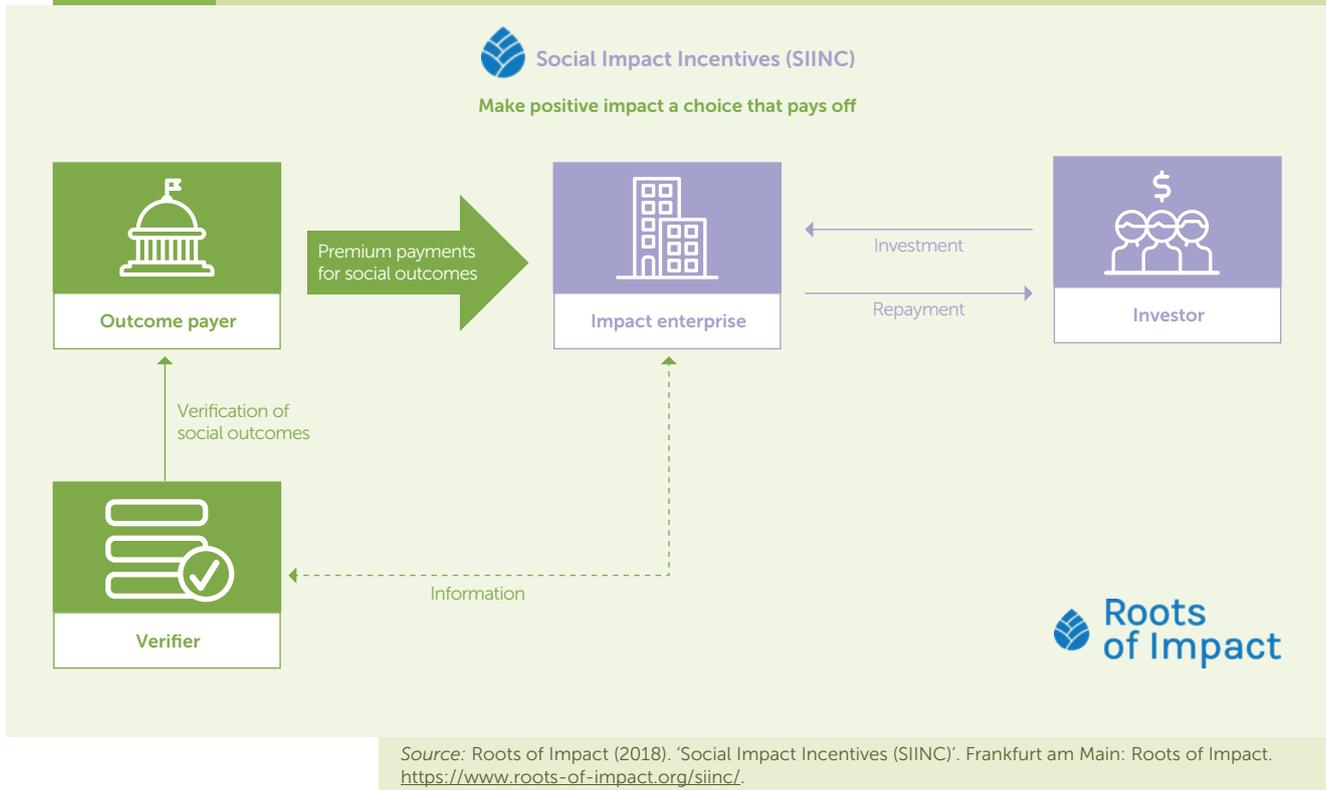
As the examples show, empowering high-impact enterprises with a bottom-up approach to blended finance is a promising path. Customized solutions and sufficient investment are both critical to expand the reach of basic goods and services in LDCs. Whether it is the public sector or private households that are paying, they must be able to afford these services. Getting social enterprises to the point where economies of scale or public-sector contracts lead to sustainable business models can be achieved through outcome payments. Only one precondition prevails: the social enterprise has to produce valuable outcomes that will be verified by an independent party. As compared to facing the financial 'valley of death', this should be a much better option—for all stakeholders.

Bjoern Struwer is the CEO and Founder of Roots of Impact, an impact finance advisory firm working with public funders, philanthropists and impact investors globally to finance private-sector innovations and enterprises with strong potential for positive impact. After leaving the traditional finance sector, he dedicated his work to designing and implementing effective solutions for financing social impact at scale. With his team at Roots of Impact he developed pioneering solutions and platforms such as Social Impact Incentives (SIINC) and the Social Finance Academy. Bjoern is Senior Fellow at the Center for Sustainable Finance and Private Wealth at the University of Zurich and mentor at the Harvard Kennedy School's Impact Investment for the Next Generation Program.

Christina Moehrle is an adviser at Roots of Impact. After many years in the finance sector, most recently as a partner/investor relations manager in the venture capital industry, supporting the evolution of the social finance ecosystem has become her passion and profession. She mainly focuses on developing learning material and trainings for the Social Finance Academy to empower social entrepreneurs, donor organizations and impact investors to find a common 'language'. As a freelance communications expert, writer and journalist, she also works with several other European pioneers in the field. Christina is a member of the German journalists association DFJV.

²⁴⁷ Here the outcome payer is a development agency or philanthropic organization, while the verification is completed by an external auditor.

FIGURE 27. The main functionality of SIINC



THE POWER OF GUARANTEES IN MOBILIZING PRIVATE FINANCE

*(Malena Rosman, Deputy Head, Loans and
Guarantees Unit, Sida)*

Guarantees offer important ways of mobilizing private capital for development purposes and play an important role in development cooperation. Guarantee portfolios can complement grant portfolios and attract additional private funding for new ways of creating impact, and they can encourage innovative ways of private-sector engagement for global poverty reduction.

With a guarantee, providers such as Sida can share the credit risk with a financial institution by, for example, covering half of the defaults in a loan portfolio. The guarantees enable and incentivize the financial institutions to lend money to an identified target group—for example, farmers or entrepreneurs. The guarantees relieve part of the credit risk and capital needed, lower collateral requirements and may extend loan tenors and/or interest rates so that they can be made more attractive for underserved groups. More than half of the guarantees in the Sida portfolio are given to local banks for lending in local currency to MSMEs in diverse sectors, including agriculture, health and renewable energy.

Improving agricultural productivity is a priority for LDCs. Farmers in LDCs face a number of significant hurdles, including access to markets and to finance. Agriculture remains a key economic activity in Africa, employing about 55 percent of the population, yet only approximately 1 percent of bank lending goes to the agricultural sector.²⁴⁸

Banks often find it too risky to offer loans to farmers, so they focus on larger corporate and government clients. Without access to credit, farmers cannot start or grow their businesses. Women are often particularly disadvantaged. It is not just farmers of course; entrepreneurs and SMEs in a range of sectors from health to media also require additional access to finance and yet often find it impossible to borrow money.

Guarantees provide increased security for banks, enabling them to lend to borrowers that typically have limited experience in the formal financial sector and little business management training. This means businesses grow and jobs are created, and it also helps build banks' experience in lending to these types of enterprises. The individual entrepreneurs are able to build a credit history, which means that banks will be readier to lend money to them in the future.

To support a sustainable change in banks' behaviour, technical assistance can be provided to increase their awareness of new target groups or methods for assessing new types of businesses. Sida aims to use guarantees alongside other instruments in larger programmes. Guarantees are likely not sufficient to create a systemic change by themselves, but they can play an important role when combined with grant funding to help improve the enabling environment, education, training etc.

One recent example is Sida's guarantee to Private Agriculture Sector Support (PASS) in Tanzania, which supports farmers with insufficient collateral to obtain bank loans. The potential borrowers provide their business plans to PASS, and viable projects that are not yet considered 'bankable' can be supported by a fixed deposit with partner banks. After two years, the deposit is replaced by an indemnity fund, guaranteeing a portion of the loan. Sida's re-guarantee of \$20 million increases PASS's capacity to provide guarantees to local banks and is estimated to provide additional access to loans of \$60 million to local farmers to improve their businesses. The provision of guarantees is expected to contribute to a reduction of the financial risks of cooperating commercial banks of providing increased inputs to investments in agricultural operations.

In addition, the business development services of PASS are expected to contribute to the target group's increased commercial competitiveness and viability, leading to increased and sustainable incomes for underserved businesses, households and individuals. Women may be provided with a higher guarantee coverage on their loans, thus providing a higher risk reduction and an incentive to lend to women.

PASS's strategic plans are to design and implement specific products and programmes targeting what are also Sida priorities: specific groups at risk of being left behind, notably women and youth, as well as sectors which need more support, such as renewable energy and water efficiency projects that tackle environmental and climate change challenges.

Another example is a guarantee Sida and USAID issued to Enat Bank to increase lending to SMEs owned or managed by women in Ethiopia. Low access to credit is a major development challenge in Ethiopia. Small enterprises are disadvantaged owing to their shorter credit history, fewer collateral assets and often informal structure. Women-owned SMEs are particularly disadvantaged, since women less frequently own land, property or other types of assets that can be used as collateral. Enat is a niche bank focusing on lending to SMEs owned or managed by women. It was founded in 2013 by women and for women, and is still majority-owned by women. The borrowers that the guarantee targets typically have limited experience in the formal financial sector and little business management training.

In case of defaulting loans, Sida and USAID will cover 50 percent of the loss for the bank. The remaining risk stays with the bank to promote the use of sound credit decision-making and sustainable business models. Thus, the Sida/USAID guarantee is leveraging twice the guaranteed amount in private capital. The bank is also charged a fee for the benefit of the guarantee. The aim is to create a sustainable change in risk perception and not create negative market distortions. If Enat Bank succeeds in making financial services to women profitable, other financial institutions in the Ethiopian banking market may follow.

Guarantees can also be used to support large-scale projects and innovation. For example, by sharing the risk, Sida has encouraged investors to invest in sustainable infrastructure in challenging markets. Sida has also used a guarantee to increase access to affordable contraceptive implants in developing countries. By guaranteeing sales volumes, new products could be introduced at an affordable price and create a demonstration effect for others.

Grants remain the most suitable way of providing assistance in many cases, but there is great potential for expanding the use of guarantees to overcome challenges with access to finance, strengthen local financial systems and engage private capital. Guarantees are cost-efficient alternatives to grants, and there can be a lower risk of negative market distortion.

In conclusion, guarantees have the direct effect of enhancing credit to underserved groups so that they can develop their business, create jobs, increase incomes and find a way out of poverty. The long-term objective of guarantees is to help develop the market and bring perceived risks closer to actual risks, including by helping financial institutions build up competence in an area they have previously neglected.

²⁴⁸ The Global Findex database, the world's most comprehensive database on financial inclusion, provides in-depth data on how individuals save, borrow, make payments and manage risks.

BOX 17. What is a Sida guarantee, and how does it work?²⁴⁹

A guarantee is similar to an insurance policy that, for a fee, promises to provide financial compensation in the instance of an event that results in harm or loss. A guarantee reduces the risks for the lending party to lend to risky projects. If the borrower does not manage to repay its loan to the bank, Sida pays under the guarantee a part of the default to the lender instead of the borrower. The entire guaranteed amount is never meant to be paid out.

Risk is shared with others to unlock financing and investments that promote growth and create jobs in Sida's partner countries. Sida does not accrue any expenses as long as the guaranteed investments continue to perform and repay their loans.

A guarantee by Sida is a Swedish sovereign guarantee, backed by an unlimited credit with the National Debt Office, which gives it an AAA rating. Sida charges a risk-based fee for the guarantee to cover the expected loss. The expected loss amount is paid to Sweden's guarantee service account. The funds from the service account are used for the payments in case of defaults. No other Sida resources for grants are used for the repayment of defaults. Given its credit rating, Sida's cooperation partners have high confidence in the repayment ability in case of defaults.

The use of Sida guarantees is regulated in a government ordinance and is limited to debt financing. Within those limitations, the structure of the guarantee can vary. In most cases, Sida shares the loss, side by side, with the counterpart, but a guarantee can also be applied as a first or second loss layer in a fund structure.

Malena Rosman is Deputy Head of the Loans and Guarantees Unit at the Swedish International Development Cooperation Agency (Sida). She has worked in development cooperation for the past 10 years, previously as Director for Corporate Management at Sida and with private-sector development at the Swedish Embassy in Tanzania. She is also one of the initiators of the network Swedish Investors for Sustainable

Development, engaging major investors and pension funds around Agenda 2030. Previously, Malena worked in corporate finance functions and business development in the multinational IT group Tieto in Europe and South East Asia, and with labour-market policy and EU relations within the Confederation of Swedish Enterprise.

NATIONAL DEVELOPMENT BANKS:

THE VIEW FROM KAMPALA

(Patricia Ojangole, Managing Director, Uganda Development Bank)

Ranked 162nd out of 189 countries on UNDP's Human Development Index, Uganda's development aspirations are enshrined in Vision 2040. It provides a development path for the country to become a competitive Upper MIC in the next 20 years. It also has five-year national development plans, the second of which is currently being implemented. Priorities in the national development plan include agriculture, infrastructure, tourism, minerals, oil and gas, and human capital development.

The Uganda Development Bank Limited is the only domestic DFI in Uganda. It is expected to play a key role in mobilizing public and private resources, and in coordinating the flow of resources to development projects aligned with national priorities and the SDGs.

The Bank is 100 percent government owned, and funded by its shareholder equity and concessional loans from bilateral and multilateral DFIs. With its instruments—loans, equities and guarantees—it can provide concessional finance such as low-cost investment capital and longer tenor of capital to SMEs, and attract the private sector to new market segments that are perceived as too risky. It also provides equity and venture capital to start-ups, thereby increasing their chances of accessing private capital.

²⁵⁰ Sida (2018). 'Guarantees: Unlocking capital for development efforts'. Stockholm: Sida. <https://www.sida.se/English/publications/160271/guarantees/>.

To the extent that the Bank has engaged with blended transactions using international donor funds, it has mainly been in the area of agriculture finance. Developing the agricultural sector, after all, is essential to reduce poverty and create jobs, yet it is a sector that receives insufficient private-sector credit, as it is perceived as too risky. In this case, concessional resources provided by donors have helped to de-risk the sector, making it attractive for private investors.

For instance, blending grant funds from the Kuwait Fund for Food Security with the Bank's own concessional capital has resulted in affordable financing for smallholder farmers and consequently in support to agribusiness development. To give one example of its role in a blended transaction, the Bank has provided financing to development projects that other entities have helped make bankable. For example, the Bank provided a loan of some \$1.7 million to a coffee processing factory in central Uganda that UNCDF supported with technical assistance and a seed grant. The Bank is a beneficiary of the Agricultural Credit Facility, a government line of credit extended to support agribusinesses, and was able to utilize those resources for this project, in line with national priorities.

While the Bank is expected to play a key role in mobilizing resourcing and coordinating the flow of resources to development projects, it faces a number of challenges to engage more in blended finance transactions. These include the need to scale up its financial assets and skills related to project finance and preparation. The Bank is working to address these challenges, such as by setting up a project preparation unit to support the government and the private sector to prepare bankable proposals.

Beyond Uganda, national development banks in LDCs in Africa are well positioned to occupy an important space in the development finance architecture: helping attract private finance and mobilize resources in a way that is sensitive to local needs and aspirations by bringing together government, donors and the private sector.

This role becomes important in the context of discussions around ownership. For example, some concessional finance providers require that some project components or contractors originate from their countries, limiting the participation of the local private sector in projects. In compliance with local laws, the Uganda Development Bank Limited engages domestic firms in projects, helping to develop local markets.

As donor governments increasingly engage in blending, national development banks such as the Uganda Development Bank Limited provide an excellent way forward for bringing relevant stakeholders around the table and for mobilizing private finance in ways that are aligned with national development priorities. With the right support, resources and capacities, such banks can deliver important results for their countries.

Patricia Ojangole is currently the Managing Director of Uganda Development Bank Limited. She is a professional accountant with 16 years' international experience in banking and finance. She holds an Executive Master's Degree in Business Administration from Eastern and Southern Africa Management Institute, Tanzania, and a Bachelor of Commerce (Hons) Degree from Makerere University, Uganda. Patricia is completing her Master's of Philosophy in Development Finance at the University of Stellenbosch, South Africa. She is also a fellow of the Association of Certified Chartered Accountants (UK), and a member of the Certified Public Accountants and the Global Institute of Internal Auditors of Uganda.

TARGETING BLENDED FINANCE TO HELP THE POOREST 20 PERCENT

(Jorge Moreira da Silva, Director of the Development
Co-operation Directorate, OECD)

The 2030 Agenda funding shortfall resulted in a sharpened focus on the potential of the private sector and the role of other development actors—including ODA providers and MDBs—to mobilize new private investments. Three years after the Addis Ababa Action Agenda on financing for development was agreed, new private actors populate the development finance landscape, offering an opportunity to use well-targeted blended finance to play a more strategic role. More than an opportunity, we have a moral imperative to realize the full potential of all development finance to help countries most in need achieve sustainable development, especially as many of them face unique, evolving crises related to conflict and climate threats.

When effectively applied, blended finance can help fill significant gaps in development finance. The OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the Sustainable Development Goals provide guidance for ensuring effective provider engagement in blended finance.²⁵⁰ The policy principles strive to ensure that blended finance: (i) maximizes development outcomes; (ii) mobilizes additional commercial finance; (iii) is in line with local development objectives; (iv) strengthens partnerships between developmental and commercial actors; and (v) delivers value for money.

However, incentivizing new financial flows challenges the ability to maintain the integrity of development finance.

The OECD's work demonstrates that, while blended finance has significant potential to contribute to the 2030 Agenda—making otherwise unviable projects possible in the most challenging country contexts—we must better understand how it can best be targeted to countries and sectors most in need. OECD analysis captured in this report found that only a small share of finance that has been mobilized from the private sector by development finance providers has been in LDCs. Only 7 percent of the \$81.1 billion in blended finance operations by private investors went to LDCs—i.e. \$5.5 billion over four years.

Why is there a blended finance gap in LDCs? These countries face severe structural obstacles to sustainable development which increase the perception of risk. Indeed, many stakeholders are wary of investing in LDCs,

given concerns over absorptive capacity, risk, low returns and sustainability. As a result, guarantees are a growing and important part of the development finance landscape, standing out as the instrument that has mobilized the most blended finance, particularly in LDCs and in Africa.

Development cooperation must help steer private finance to where it is most needed. At present, the private finance mobilized by ODA, much like FDI, is going where national GNI per capita is higher. At the same time, the 2030 Agenda calls for a commitment to 'leave no one behind', but business as usual with blended finance will bypass the world's poorest people. To address this, the OECD is investigating the factors of risk and dimensions of fragility that may influence the mobilization of additional private finance, in collaboration with the International Network on Conflict and Fragility.

To remain credible, we need to fortify the mobilization imperative with evidence on development results. In other words, while we should continue to focus on 'turning billions into trillions', we should put even more focus on targeting the trillions to the billions of people who remain in poverty. Maintaining a critical approach, developing an international blended finance data- and evidence base, engaging in analyses and standard setting, and ensuring blended finance is effectively targeted and applied in LDCs will be the key ingredients for the success story of the effective use of ODA in private finance mobilization.

Our central guiding question should be: how can private finance be strategically targeted where it is needed most? We must avoid a system where ODA targets LDCs while private finance is applied to less-challenging contexts. There is no time to lose in working together to tackle this challenge: we need to double the pace of poverty reduction—from 48 to 96 people per minute—to eliminate poverty by 2030.

Since 2016, Jorge Moreira da Silva has been the Director of the Development Co-operation Directorate (DCD) at the OECD, where he plays a key role in positioning the OECD's work on development cooperation and in support of the SDGs. From 2013 to 2015, he was Portugal's Minister of Environment, Energy and Spatial Planning. Prior to that, Jorge held several senior positions in government in Portugal and was a Member of the Portuguese Parliament and of the European Parliament. Since 2011, he has also been a Visiting Professor at Lisbon University.

²⁵⁰ See <http://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/OECD-Blended-Finance-Principles.pdf>.

THE EU'S EXTERNAL INVESTMENT PLAN:

ATTRACTING MORE INVESTMENT TO THE WORLD'S LDCs

(Marjeta Jager, Deputy Director-General of the European Commission's Directorate-General for International Cooperation and Development)

The world's LDCs are a top priority for the EU's international cooperation and development agenda. Our approach to engaging with LDCs is multifaceted, combining aid, trade, policy dialogue and investment. In 2016, LDCs received EUR16.6 billion in ODA from the EU and its Member States. In 2017 the EU adopted the European Consensus on Development. This targets our development aid "where the need is greatest and where it can have most impact, especially in LDCs and in situations of fragility and conflict".

In trade, LDCs enjoy duty- and quota-free access to the EU market through either Economic Partnership Agreements with the EU or our Everything but Arms trade scheme. They also benefit from substantial aid for trade. And we support partnerships such as the Enhanced Integrated Framework, which helps LDCs use trade as an engine for growth. We also engage in policy dialogue with LDCs through, for example, the Global Climate Change Alliance.

The EIP's three central innovations:

- An integrated, three-pillar approach that will help improve the investment climate and business environment in partner countries
- A single entry point and one-stop shop for submitting proposals for financing investments
- A flexible new guarantee to mitigate investment risks in difficult environments

The EIP also puts in place technical assistance to help in particular with the preparation of projects (see Figure 28). And it establishes regular, formal dialogue with business and governments in partner countries—activities in which EU Delegations are closely involved.

Much of its funding will go to fragile and conflict-affected countries, landlocked countries and LDCs. Of course, funding for the EIP complements traditional development assistance—but in no way takes away from it.

It is especially well suited to LDCs for at least three reasons:

Overcoming investors' perceived risk

First, it addresses what is known as perceived risk—the risk that investors fear they may be taking when considering whether to enter a particular market. Perceived risk is a major barrier that LDCs face when seeking to attract investment. Guarantees give comfort to private investors and encourage them to go where they otherwise would not.

That is why the innovative EFSD Guarantee will allow us to go into higher-risk environments such as LDCs and de-risk our operations. It will support investments that can address market failures and set into motion market development. And by doing so it will allow us to carry out sustainable and inclusive development projects which otherwise may not be possible or would be significantly smaller.

The Guarantee could also be heavily discounted for investments in LDCs, since this is a pre-condition for private-sector funds to flow to LDCs, where they will have significant development impact.

Indeed, the entities entrusted to manage EU funds, which we had asked to develop investment pipelines covering LDCs, can create financial instruments designed for or adapted to difficult markets. Financial investors can use the Guarantee to strike a balance between more or less risky investments in diversified portfolios.

Investing in the SDGs: The challenge of our times

Public aid and free trade assist sustainable development, but can only do so up to a point. There is still a huge investment gap to cover if we are to achieve the SDGs, which 193 countries signed up to in 2015. To bridge that gap, we need responsible partners from the private sector to join forces with public actors in funding development.

LDCs face particular challenges in attracting investment. These include higher risks for investors, fewer potential entities or partners with which to operate, weak local capacity, a difficult operating environment for businesses, and a lack of bankable projects.

The EU's response: The External Investment Plan

That is why we are now deploying our biggest investment programme ever—the External Investment Plan (EIP)—which covers 18 LDCs in Africa. By leveraging public and private funds, the EU budget contribution of EUR4.1 billion could unlock up to EUR44 billion in sustainable investment by 2020. For the first time we put together a European Fund for Sustainable Development (EFSD) Guarantee of EUR1.5 billion.

The European Commission aims to sign guarantee agreements with entrusted entities in the second or third quarters of 2018. And in these we may stipulate a minimum share of the EFSD Guarantee that must support investment in LDCs. Of course, such guarantee products are complex, and they must—and will—be designed carefully.

Crowding in investment without distorting markets

Second, the EIP aims to crowd in private investment in a way that does not distort the market—something that is more likely to happen in LDCs. When we screen investment proposals, one of the main criteria we consider is whether the investment would happen without EU support. If this is clearly not the case, then the investment is unlikely to distort the market.

The EIP has three main aims:

- Contribute to the UN's SDGs
- Help to generate jobs and growth
- Unblock bottlenecks to private investment by addressing actual and perceived risks

Supporting women, young people and small businesses

Third, the EIP is a powerful tool to achieve the EU's broader development goals. Through it, we can support more local entrepreneurs and small businesses, which are vital for creating jobs and expanding economies. And we can focus in particular on women and young people, giving them a hand up so they can join the labour market or set up their own businesses.

For example, one of the Guarantee's five focus areas ('windows') is financing for MSMEs, which our partner financial institutions and local banks will support. Another one is agriculture and agribusiness. Here the EIP could back the development of value chains and help diversify agricultural production. It could strengthen local skills and promote environmentally and socially sustainable farms and agri-enterprises, including smallholders, cooperatives and agricultural MSMEs.

A promising start in LDCs

In 2017 we agreed to invest around EUR900 million in sub-Saharan Africa as part of the EIP blended finance operations. This will help leverage a total investment of around EUR5.6 billion in 30 major projects. Over 80 percent of this investment will go to transport, energy and agriculture projects in 18 LDCs in sub-Saharan Africa.

The EIP is leveraging investment in 18 LDCs in sub-Saharan Africa:

- | | |
|-----------------|--------------|
| • Benin | • Malawi |
| • Burkina Faso | • Mali |
| • Burundi | • Mozambique |
| • Chad | • Niger |
| • DRC | • Rwanda |
| • Guinea | • Senegal |
| • Guinea-Bissau | • Togo |
| • Liberia | • Uganda |
| • Madagascar | • Zambia |

Our proposal screening process includes extensive discussions with staff in EU Delegations in partner countries and with teams in headquarters in Brussels. This ensures that projects are aligned with national priorities. To promote national ownership, EU Delegations also closely coordinate with financial institutions and national governments in partner countries.

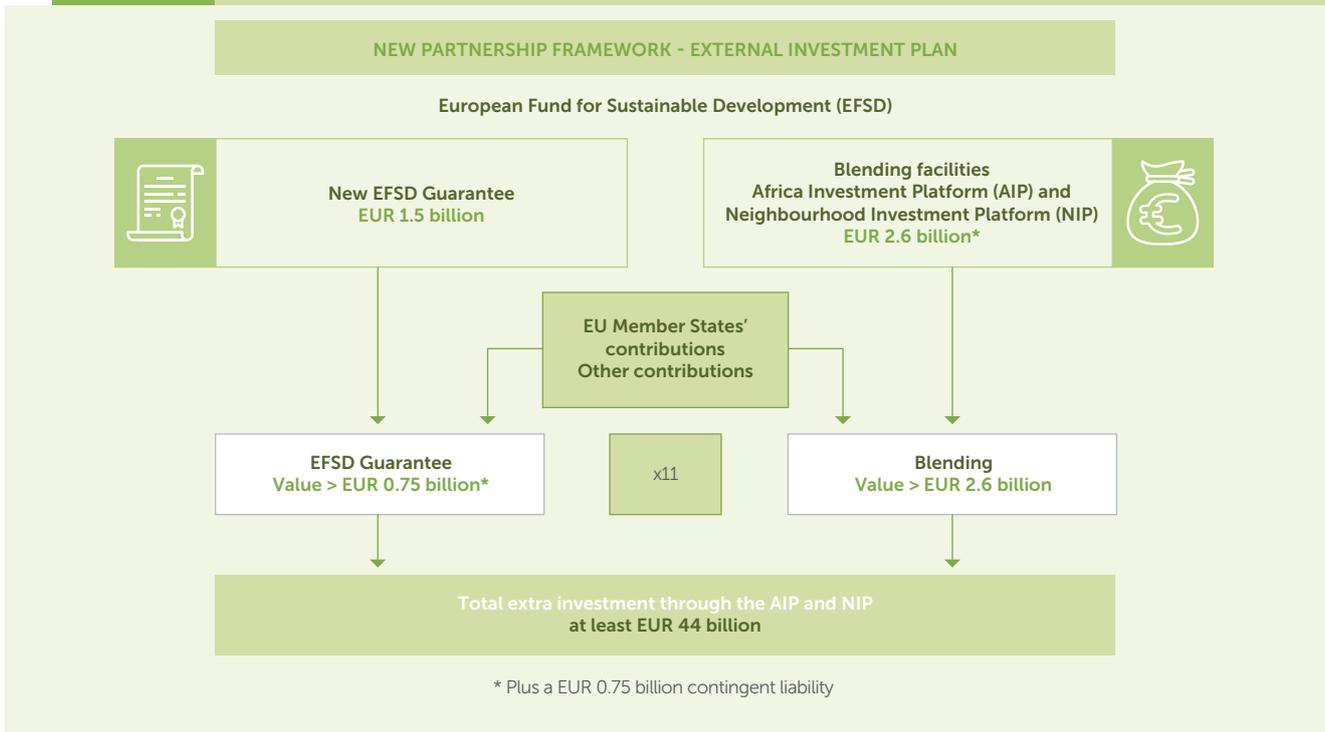
We have good reason to be optimistic about the Guarantee component too. The response to the Commission's call for the Guarantee was exceptionally strong. Twelve international finance institutions and other entrusted entities submitted 48 proposed investment programmes for the EFSD Guarantee under the 5 investment windows. The combined value of the proposed investment programmes is EUR3.6 billion. With EUR1.5 billion currently available in the Guarantee, we will carefully select from these.

A good number of proposed investment programmes include activities in LDCs, even if not all of them will result in Guarantee agreements at this stage due to the limited budget capacity.

One example of a project taking an innovative approach is Climate Investor One. This is an investment fund managed by the Netherlands Development Finance Company, FMO. It aims to deliver sustainable energy at affordable prices in emerging markets. The fund supports energy projects from beginning to end, addressing market failures and inefficiencies at every step. The EU contributed EUR30 million in the form of risk capital and reimbursable technical assistance. The EFSD Guarantee will help expand projects such as this.

If EU Member States and other donors and investors were to match our ambition and top up funds for the EIP, we could double the investment leveraged to EUR88 billion by 2020.

The next step will be to apply the experience gained with the EIP to projects globally. By doing so, we can pave the way for even more sustainable investment that could accelerate LDCs' development—and help take a major step towards achieving the SDGs.

FIGURE 28. New partnership framework, the External Investment Plan

Marjeta Jager is currently Deputy Director General for the Directorate-General for International Cooperation and Development (DG DEVCO). Ms. Jager has been working in the European Commission since 2005, starting as Director for Security in DG Energy and Transport and later as Director for international energy and transport files and coordination, as well as being Head of Cabinet of the Transport Commissioner.

Before joining the Commission, Ms. Jager worked for more than a decade at the Ministry of Foreign Affairs on Slovenia's accession to the EU. She was also Slovenia's first Coreper I Ambassador to the EU.

04

PART IV

An action agenda



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.

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