

MARCH 2018

Blended Finance and Aligning Private Investment with Global Development

Two Sides of the Same Coin

PROJECT DIRECTOR
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CSIS

CENTER FOR STRATEGIC &
INTERNATIONAL STUDIES

A Report of the
CSIS PROJECT ON PROSPERITY AND DEVELOPMENT
and the ROYAL EMBASSY OF DENMARK

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Executive Summary

Over the past few decades, the composition of development finance has flipped from being primarily funded through public-sector resources, to intensified interest and investment from the private sector. A combination of phenomena has diversified the mix from which global development deals receive funding. At once, rising tides of official development assistance (ODA), having consistently risen to triple its amount from 1960 to 2012, is plateauing as interest from the public sector in the major donor countries wanes. The appetite for publicly funded foreign assistance seems to have eroded in response to ongoing and perceived worsening global stability. ODA continues to rise, but it also continues to be a smaller portion of a country's economy and engagement with the developing world. The role of ODA is also shifting, from that of operational capacity, to an agenda setter responsible for catalyzing private investment. Increasingly, development and economic engagement is characterized through private investment. The public sector has a chance to channel this rising tide for development impact.

At the same time, there are calls for exponentially increasing global development funding. The global community has embraced the new Sustainable Development Goals (SDGs), but achieving these principles will require moving from “billions to trillions” in development funding. Now, traditional development donors are looking to supplement diminished public finance with diversified resources.

The private sector—in its diverse forms from large multinational corporations, private equity funds, foundations, and nongovernment-controlled financiers—is playing an increasingly central role in global development. Seen as one path for unlocking the trillions necessary for reaching the SDGs, there is increased focus globally on encouraging private-sector engagement, investment, and market and capacity creation in the developing world.

Across the many avenues and tools for the private sector to become active in the developing world, blended finance is one method to unlock private capital for development. Blended finance refers to structuring global development investment deals with a mixed portfolio of public and private funds to spread and smooth risk-reward profiles, increase catalytic private investment in sustainable financing, and create markets in developing and new contexts. Blended finance aims to “crowd in” private capital by managing, transferring, or mitigating the risk inherent or perceived in the developing world, while also producing a return and creating jobs and growth through investments that otherwise would not exist. While blended finance is a somewhat nebulous term referring to decades of public-private partnerships, the increased focus and popularization comes at a time for development when more money is needed for development as interest simultaneously fades.

Private-sector involvement in development is on a rapidly upward trajectory. But increased amounts will not necessarily result in increased impact. The public sector must work to partner with and understand the private sector if it wishes to channel these expanding sources of investment for development impact. The challenge will be how to scale up these kinds of activities

to be easily replicable on a global scale rather than for boutique operations. But overall, there are not enough development deals to be easily scaled to have a global impact.

Blended finance, while existing for decades in various forms, is a relatively new strategy for mobilizing private capital in developing countries. This report aims to survey the modern landscape of global development finance, finding points of utilization for blended finance, and posing questions for its future.

01

Introduction

Blended finance is one approach for development agencies to mobilize private capital. In a recent report, the Organization for Economic Cooperation and Development (OECD) defined it as “the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries.”¹ In comparison, the Development Finance Institution (DFI) Working Group recently narrowed the definition of blended finance to refer to “combining concessional finance from donors or third parties alongside DFIs’ normal own account finance and/or commercial finance from other investors, to develop private-sector markets, address the Sustainable Development Goals (SDGs), and mobilize private resources.”² More specifically, blended finance is an approach by donors that mixes or aligns official development finance or philanthropic monies with private capital to mitigate risk, rebalance risk-reward profiles, and achieve development impact.³

By using development assistance to reduce risk, the intent is that greater volumes of private capital—and the expertise the industry brings—will flow to the countries and regions most in need of it.⁴ Blended finance is not new and in some ways DFIs such as the Overseas Private Investment Corporation (OPIC) and International Finance Corporation (IFC) can argue that as publicly backed institutions, their day-to-day operations are a form of “blended finance.”⁵ As donors have embraced a “billions to trillions” agenda to finance the SDGs, many have sought new ways to use development assistance to catalyze more private investment. The OECD found that 17 bilateral donors who are members of the Development Assistance Committee (DCA) currently use some type of blended finance mechanism; 10 have well-established programs in place; and 6 have an explicit strategy around blended finance.⁶ Blended finance has emerged as one way in which donors have sought to maximize aid dollars by using it strategically to mitigate risk and improve returns through rebalanced risk-reward profiles for the private sector.

¹ Organization for Economic Cooperation and Development (OECD), “Making Blended Finance Work for the Sustainable Development Goals,” January 29, 2018, 13, http://www.keepeek.com/Digital-Asset-Management/oecd/development/making-blended-finance-work-for-the-sustainable-development-goals_9789264288768-en#.WoHxtujwbcs.

² International Finance Corporation (IFC), “DFI Working Group on Blended Concessional Finance for Private Sector Projects,” October 2017, http://www.ifc.org/wps/wcm/connect/30635fde-1c38-42af-97b9-2304e962fc85/DFI+Blended+Concessional+Finance+for+Private+Sector+Operations_Summary+R....pdf?MOD=AJPERES.

³ IFC, *Annual Report 2016: Experience Matters* (Washington, DC: IFC, 2016), http://www.ifc.org/wps/wcm/connect/bf1bfb0b-216b-4cde-941b-dd55febe9d3a/IFC_AR16_Full_Volume_1.pdf?MOD=AJPERES.

⁴ Convergence and the Business and Sustainable Development Commission, “The State of Blended Finance: Working Paper,” July 2017, http://s3.amazonaws.com/aws-bsdc/BSDC_and_Convergence_The_State_of_Blended_Finance_July_2017.pdf.

⁵ However, the newly agreed-upon definition by DFIs and IFC will not include own account operations.

⁶ OECD, “Making Blended Finance Work for the Sustainable Development Goals,” January 29, 2018, 24, http://www.keepeek.com/Digital-Asset-Management/oecd/development/making-blended-finance-work-for-the-sustainable-development-goals_9789264288768-en#.WoHxtujwbcs.

Historically, official development assistance (ODA)—bilateral and multilateral aid—provided most of the financing for development projects in frontier markets and economies mostly, or exclusively, in the form of grant financing. The public sector—through bilateral development agencies and the multilateral development banks—financed and managed infrastructure, health, energy, and other sectoral projects across the developing world. Meanwhile the world changed as countries became richer, freer, and more capable of managing their own development. Over the past 20 years the composition of financial resources flowing to developing and emerging market countries fundamentally shifted from public-sector resources to private-sector investment and remittances. ODA now represents less than 10 percent of U.S. financial flows—including FDI, grants, and other transactions—down from 70 percent in 1960.

Though initially slow to recognize these changes, the international development community has embraced the need to rethink the role of ODA. The UN SDGs and the outcome document from the 2015 Financing for Development (FFD) conference called for a diversification and drastic increase in funding to achieve these goals and to meet the appetite for capital in the developing world. More importantly, the SDGs and FFD argued that aid needs to play a *catalytic role in mobilizing additional capital*, including both domestic resources in developing countries and private capital from abroad. Moreover, there was a broader recognition that the private sector had a vital role to play in generating jobs and economic growth, both critical to long-term development.

With the recognition that private investment dwarfs ODA, there has been an increased focus on how development agencies could “crowd in” this money and help close the financing gap toward achieving the SDGs. But private finance is cautious. Former Secretary of State Colin Powell famously said, “capital is a coward.” These private financial flows and private investors have other interests and different levels of risk appetite. So how could more private capital be unlocked for development? Blended finance is seen as one way to unlock this private capital for development. Blended finance aims to crowd in private capital by managing, transferring, or mitigating the risk inherent or perceived in the developing world, while also producing a return and creating jobs and growth through investments that otherwise would not exist.

ODA will continue to play a critical role in generating long-term development whether through improving governance and rule of standards or helping to strengthen local health systems. The private sector cannot and will not take on these missions, but it can and should play a central role in generating the long-term, sustainable growth needed to ensure that countries can achieve their full potential. After all, the private sector is better at identifying growth opportunities, measuring risk, intermediating between investors and opportunities, and generating jobs and economic growth. However, all involved should recognize that the main reason for blended finance is because of the inherently weak investment climates in many of these countries; in addition to deploying resources through blending facilities, this should also lead to a renewed focus on breaking down these barriers to investment by improving the overall investment climate through policy reforms, capacity building, and technical assistance interventions. Economically, the key rationale for blended finance is the existence of externalities, asymmetric information, market failures, and affordability constraints.

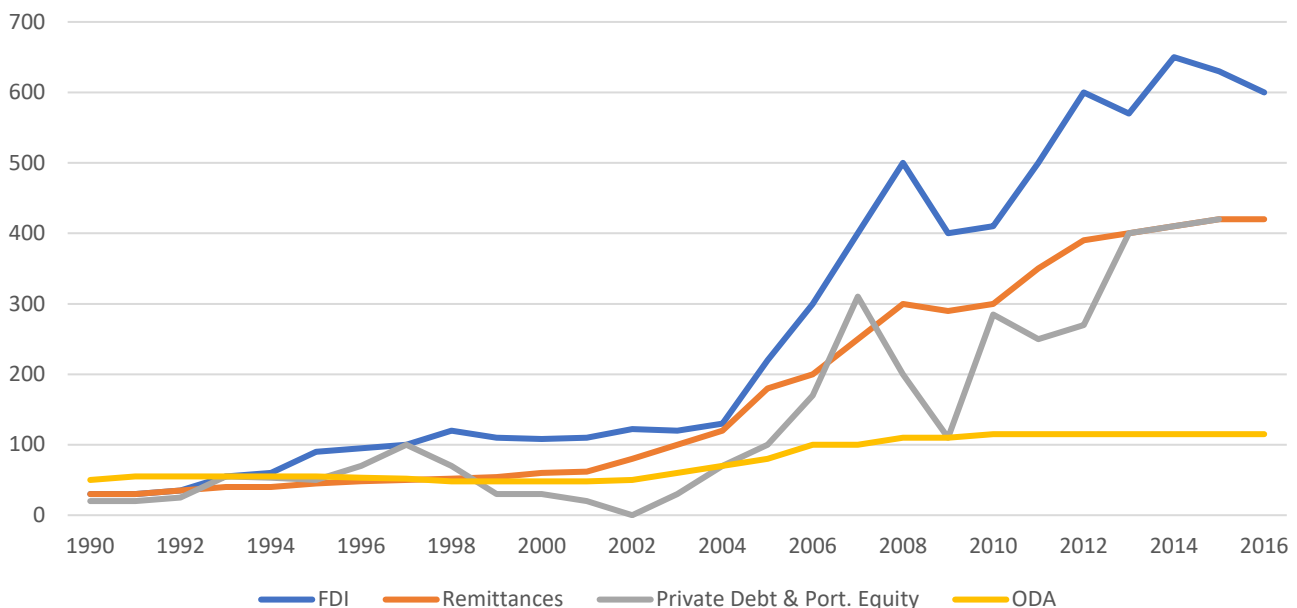
Blended finance is one approach that could transform how private capital is mobilized for development, but there are many questions regarding barriers, limitations, deployment, and execution before it can reach scale. There are many barriers to scaling blended finance, incentivizing the private sector to become involved, and replicating successes. Blended finance is not a “silver bullet” for development; rather, it is part of a toolkit of tools and approaches by which the development community can convene or work with new and diverse partners internationally and locally. Ultimately many of the barriers to investment must be solved through improved governance, rule of law, and other programs that ODA will support, not private investors.

02

The Shifting State of Development Finance

Development finance has undergone a fundamental shift over the past 20 years. ODA once accounted for most financial flows from developed to developing countries; foreign direct investment and remittances now dominate. At the same time, development goals require more funding than ever. There is an estimated \$2.5 trillion total annual investment gap between what goes toward achieving the SDGs now and what is required to achieve them.⁷ Private finance will never align perfectly with the SDGs, but the additional capital and diverse expertise of the private sector will be instrumental in meeting discrete development objectives. To bridge the gap, the world will need to move from “billions to trillions” in financing, and to do so will need to leverage private-sector investors such as pension funds, equity funds, corporations, and insurance companies.

Figure 1: Changing Global Economic Engagement with the Developing World, 1990–2015⁸



Private-sector financial flows to developing countries are now larger than bilateral and multilateral ODA. The international donor community recognized the growing role of private-sector-led economic growth in the Financing for Development conference in Addis Ababa in July 2015, a

⁷ Gavin E.R. Wilson, “There’s a \$2.5 trillion development investment gap. Blended finance could plug it,” World Economic Forum (WEF), July 18, 2016, <https://www.weforum.org/agenda/2016/07/blended-finance-sustainable-development-goals/>.

⁸ Dilip Ratha et al., “Trends in Remittances, 2016: A New Normal of Slow Growth,” World Bank, October 6, 2016, <http://blogs.worldbank.org/peoplemove/trends-remittances-2016-new-normal-slow-growth>.

conference focused on defining the post-2015 development agenda. In the outcome document, donors acknowledged that ODA needed to play a more “catalytic” role in mobilizing other sources of financing to achieve development outcomes, including private investment, through unlocking additional finance.⁹ Private capital accounts for almost 90 percent of financial flows to developing countries. But while the private sector is now a majority player, the public sector plays a vital role in providing market and international understanding for new countries and sectors using preexisting knowledge and relationships.¹⁰ Institutions like the U.S. Agency for International Development (USAID) could catalyze private-sector investment by playing the role of a facilitator and enabler for actors entering new markets, in turn helping to reach new populations or sectors in existing markets.

Yet, to do so, international donors need to improve how they attract private capital to these activities and investments. **The role of publicly funded development assistance is shifting from operational capacity to that of an agenda setter that catalyzes and guides privately fueled investment.** That role will be defined with eliminating, mitigating, or sharing risk inherent to development deals, constructing those deals to resemble a commercial deal that would be attractive to new sectors and players, and facilitating the investment using their unique technical, sectoral, and market expertise. **The challenge will be how to scale up these kinds of activities to be easily replicable on a global scale rather than for boutique operations.** To do so, publicly funded development and foreign policy both need to change to understand and appeal to private interests. This may not mean higher ODA and foreign assistance budgets, but leveraging expertise to facilitate investment rather than making those investments themselves.

The Role of the Private Sector

To generate long-term economic growth, the private sector needs to be supported to allow it to create the jobs and growth that will lift individuals out of poverty. As the World Bank has noted, 9 out of 10 jobs are created by the private sector.¹¹ Ensuring that the private sector is well supported by a full range of investment, by the right policy framework, and by support for capacity building necessary to allow job creation and growth. Moreover, if done equitably it will also help countries achieve the SDGs.

The advantage for the private sector is the financial capital, expertise, and networks that they can deploy to meet the investment demands of the developing world. Development is not the primary goal for private investors, nor are all these institutions used to operating in developing country contexts. These corporations, banks, and funds focus on commercial returns, dividends for shareholders, or investing in a project with future growth potential. Donors and DFIs, on the other hand, have technical skills in that they understand country context, supply chains, and the challenges of developing countries better than private investors.

⁹ United Nations, “Addis Ababa Action Agenda of the Third International Conference on Financing for Development,” July 2015, https://sustainabledevelopment.un.org/content/documents/2051AAAA_Outcome.pdf.

¹⁰ U.S. Agency for International Development (USAID), “Catalyzing Private Investment,” <https://www.usaid.gov/what-we-do/economic-growth-and-trade/catalyzing-private-investment>.

¹¹ World Bank, *World Development Report 2013: Jobs* (Washington, DC: World Bank, 2013), xiii, http://siteresources.worldbank.org/EXTNWDR2013/Resources/8258024-1320950747192/8260293-1322665883147/WDR_2013_Report.pdf.

Development finance has evolved considerably in the last 15 years and donors and others need to look at it as a spectrum. On one side you have projects that can be funded solely by grant financing from bilateral and multilateral donors and on the other you eventually have commercial financing that will seek market returns. Grants may be more simply structured, but a blended finance deal involving debt, equity, or a guarantee instrument may have better alignment of interest and allow the ODA to stretch further and be recycled into future projects and other areas, garnering crowding in of the private sector. This spectrum applies broadly to development finance, but not all development projects will move along it; some, such as interventions that focus on rule of law or policy reforms, may only ever rely on grants, ODA, or government revenue to fund. Others, such as an entrepreneur with an innovation, will likely move along the spectrum over the lifetime of their business.

- **Grant financing/ODA/government revenue:** Primarily concerned with the financing of social goods such as primary education, public health, and capacity building of local actors. Financing for improvements to the investment and business climate will largely come from this area but input and engagement with the private sector will be key to success of these types of projects and interventions. Donors may also provide a certain amount of grant financing to test new ideas or innovations that are pre-proof of concept acting to provide venture-style support. Risk capital could also be a deployable tool that allows for downside protection to the innovator, but also shares some of the upside dependent on success.
- **Blended finance/risk mitigation:** Blended finance and other risk mitigation tools that donors or DFIs might deploy falls after grant financing on the development finance spectrum. As described above, this is when donors use grant money to help rebalance risk-reward profiles or mitigate risks associated with investment in countries or areas that private investors might be unwilling to invest on their own. Demand for investment frequently exists, but local institutions cannot meet the needs of the private sector, and foreign investors are unwilling to invest for risk-associated reasons. Blended finance can support a variety of private-sector investments including support for small and medium-sized enterprises (SMEs), infrastructure financing, climate-smart projects, development of the local financial market, agribusiness, and others.
- **DFIs:** Institutions such as the IFC, OPIC, and CDC Group are all critical to mobilizing private-sector investment in developing countries through their own account and mobilization programs, as well as through intermediating through their blended concessional finance activities. DFIs have long played an important role in helping to facilitate finance for the private sector in developing and emerging market countries—often helping to seed local financial markets and stepping in during economic downturns to ensure that credit continued to flow.
- **Commercial finance:** At the other end of the spectrum lies commercial finance and investment where entities seek market returns and likely do not need support from donors or DFIs to execute a deal. Commercial finance is most active in countries and markets that are more advanced; donors should consider how and why commercial finance operates in one area and not enough in another, seeking to identify lessons learned that could help reduce barriers in other contexts.

The injection of private capital into specific types of development projects can help to address the large financing gap for development. By sharing or reducing risk, donor funds can help crowd in this private investment. This blended finance approach could unlock trillions of dollars for building capacity, infrastructure, and stability in new markets while generating social and financial return for investors.¹² Private capital generally represents a flexible force multiplier, but for all blended finance's potential, there are limitations to its scalability. GuarantCo—a part of PIDG (Private Infrastructure Development Group)—for example, attracts \$13.50 in private money for every public dollar it invests. These positives should not be limited or hampered. **But overall, there are not enough development deals to be easily scaled to have a global impact.**¹³ Blended finance has not been able to scale or replicate successes quickly across markets, sectors, and borders.¹⁴

¹² World Bank, "From Billions to Trillions: Transforming Development Finance Post-2015 Financing for Development: Multilateral Development Finance," April 2, 2015, [http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23659446/DC2015-0002\(E\)FinancingforDevelopment.pdf](http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23659446/DC2015-0002(E)FinancingforDevelopment.pdf).

¹³ "Trending: blending," *The Economist*, April 23, 2016, <https://www.economist.com/news/finance-and-economics/21697263-fad-mixing-public-charitable-and-private-money-trending-blending>.

¹⁴ Ibid.

03

Blended Finance

As defined earlier, blended finance is an approach where international donors mix concessional terms with private investment to reduce or mitigate risk, adjust risk-reward profiles, and attract needed private investment into certain regions or countries. In recent years, most development institutions have used some type of blended finance, but these approaches are limited in geography, scale, value, and capacity. USAID, for example, has the Development Credit Authority that uses loan guarantees to help mobilize private investment; despite being nearly 20 years, it has “only” mobilized approximately \$4 billion in private capital—a big number and a great achievement but given the scale of the challenges not sufficient. This is similar to OPIC’s annual investment commitment of \$3 billion to \$4 billion. The OECD recently estimated that since 2000, donors have used 167 blended finance facilities to mobilize \$31 billion in private investment with approximately \$9.5 billion raised in 2017.^{15,16} Some estimates place the blended finance market size at \$50 billion globally, with projections for that number to double in three to four years.¹⁷

Beyond the challenges to scaling leveraged private dollars to align with public goals, there are perceived negatives to blended finance. Some criticisms of blended finance include bias toward middle-income countries, support for foreign investors over local investors, and a lack of transparency.^{18,19} There is also an existential perception that blended finance is “subsidizing” risk at the expense of tax payers, creating a moral hazard situation. These negatives do not mean that blended finance is inherently a negative tool for development. They mean that blended finance should be employed in specific situations where it is necessary for the private sector to have primary involvement. Important questions on blended finance remain on *when* to use it, *how*, and *who* decides that is the best strategy for a specific deal.

For blended finance to be successfully employed, donors will need to consider the following issues:

- **Scale:** Blended finance deals require high levels of effort and are frequently tailor made for each project, so-called bespoke deals. To be truly successful, donors need to move to a

¹⁵ OECD, *Making Blended Finance Work for the Sustainable Development Goals* (Paris: OECD, January 2018), 96, 101, http://www.keepeek.com/Digital-Asset-Management/oecd/development/making-blended-finance-work-for-the-sustainable-development-goals_9789264288768-en#.WoHyqujwbct#page26.

¹⁶ These figures vary depending on new facilities raised compared to those already deployed.

¹⁷ Fiona Harvey, “Blended’ finance is key to achieving global sustainability goals, says report,” *The Guardian*, January 23, 2018, <https://www.theguardian.com/environment/2018/jan/23/blended-finance-is-key-to-achieving-global-sustainability-goals-says-report>.

¹⁸ Javier Pereira, *Blended Finance: What it is, how it works and how it’s used* (Oxford: Oxfam, February 2017), https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/rr-blended-finance-130217-en.pdf.

¹⁹ A healthy portion of current blended finance deals focus on climate issue mitigation in MIC countries, but as the tool opens up to focusing on other sectors and themes, there has already been substantive movement toward investment in International Development Association (IDA) and fragile and conflict-affected (FCS) states.

“white tee shirt”²⁰ model that will allow for rapid scaling up by mobilizing the amount of money needed.

- **Translators/intermediaries:** The development and investment industry are both notoriously jargon-ridden communities; for them to work together, they will need to better understand each other’s approach and language. Identifying proper middle men/women to help translate and properly structure deals will be vital to the success or failure of blended finance. In countries that have development finance institutions, creating stronger linkages between the donor country’s DFI and its development agency could be one approach to bridging these knowledge gaps. In contexts where the multilateral development banks (MDBs) and DFIs have long been intermediaries of blended finance, these models should be scaled and replicated.
- **Risk:** Central to blended finance is using grant money or concessional investments to mitigate risk; understanding how the private sector evaluates risk and the different types of risk is essential to the success of blended finance. Risk could include: physical, political, fiduciary, currency, and others.
- **Timeline:** Development done right is a long-term proposition that requires donors and others to make a multiyear commitment to a country, often decades in length. Many private investors, however, rely on shorter timeframes and wish to see financial returns on a compressed timeline. This will mean identifying the right private-sector partners who can accept a more patient approach to their investments.
- **Fragile and low-income countries:** One common criticism of blended finance is that, because it focuses on incentivizing the private sector with returns, it will only be applicable in middle-income countries. This is similar to broader criticisms of DFIs.²¹ The greatest need for private investment, however, lies in fragile countries and lower-income countries where the risks are higher. Blended capital will work best in fragile and low-income countries where it can mitigate risk and play a truly catalytic role in mobilizing capital.

Models of Blended Finance

Currently, there is no standardized model for a blended finance fund or facility, but there are emerging structures and ways to use blended finance. This is certainly not an exhaustive list, but

²⁰ This term refers to a standardized, “off-the-rack” and nontailored deal, which simplifies the structure and deal process. Most deals now require substantial personalization and negotiation pertaining to a sector, region, or context. A generalized product might assist in scalability and popularity.

²¹ Charles Kenny, Jared Kalow, and Vijaya Ramachandran, *Inside the Portfolio of the International Finance Corporation: Does IFC Do Enough in Low-Income Countries?* (Washington, DC: Center for Global Development [CGD], January 2018), <https://www.cgdev.org/sites/default/files/inside-portfolio-international-finance-corporation-does-ifc-do-enough-low-income.pdf>; Benjamin Leo and Todd Moss, *Inside the Portfolio of the Overseas Private Investment Corporation* (Washington, DC: CGD, April 2016), <https://www.cgdev.org/sites/default/files/CGD-Policy-Paper-81-Leo-Moss-Inside-the-OPIC-Portfolio.pdf>; and Charles Kenny, Jared Kalow, Ben Leo, and Vijaya Ramachandran, *Comparing Five Bilateral Development Finance Institutions and the IFC* (Washington, DC: CGD, January 2018), <https://www.cgdev.org/sites/default/files/comparing-five-bilateral-development-finance-institutions-and-ifc.pdf>.

summarizes a few ways in which donors have sought to blend public sector money together with private investment:

- First Loss Guarantees

A first loss guarantee, also called first loss capital, is a deal structure in which the public sector agrees to cover a portion of financial loss incurred in an investment until that initial amount is exhausted. It is a financial tool to provide risk protection to lending facilities or in equity structures by covering capital losses of a calculated risk that enable lenders to supply loans, for example, to local businesses in developing countries. First loss guarantees alleviate the challenges of accessing finance by providing credit availability to local businesses or SMEs.^{22,23} This financial instrument stimulates involvement with the private sector by reducing risk and therefore increasing the viability of an investment opportunity. First loss guarantees could be used as a core component for a standardized set of blended finance instruments. Standardizing contract terms and conditions of these risk-mitigation instruments would reduce the complexity of blended finance deals and increase operational efficiency.²⁴ In addition to the private sector, first loss guarantees can help U.S. development agencies or DFIs to accomplish development goals without increasing their expenditures.²⁵

First loss guarantees do raise certain issues, primarily around the idea of moral hazard. The OECD defines **moral hazard** as a “**behavior** of agents who do not bear the full cost of their actions and are thus more likely to take risky actions because they are protected.”²⁶ Agents take more risks because they know that somebody else bears the cost of those risks. This is one method to transfer risk away from private investors to the public sector, since the main concern for many funds is the loss of capital. But first loss deals, it has been argued, encourage reckless investing and reduce incentives for performance from the private sector since there is no way they take a hit to the balance sheet.²⁷ Since often the private actor is responsible for implementing some portion of the project, reducing the financial negatives associated with abandoning that project could incentivize incompleteness.

The private sector and public sector invest their capital together; if a project succeeds, then both groups receive their returns at a certain rate. But if the project or investment fails, the public sector repays the initial investment to the private actor to cover their initial risk. Even if the investment fails, though, the public sector can still realize social benefit and return—which was the reason for taking on risk in the first place. The three defining features for first loss guarantees are:

²² European Investment Bank and European Commission, “First Loss Portfolio Guarantee—Case Study,” 2015, https://www.fi-compass.eu/sites/default/files/publications/case-study-first-loss-portfolio-guarantee_0.pdf.

²³ Most guarantees are not first loss, especially those structures with USAID. Most are *pari-passu*, meaning the creditors are regarded equally and paid at the same time.

²⁴ Jeremy Oppenheim and Katherine Stodulka, “G20 Brainstorming Workshop: Mobilizing Private Finance for Sustainable Infrastructure,” Brookings Institution, September 2017, <https://www.brookings.edu/wp-content/uploads/2017/11/mobilizing-private-finance-for-sustainable-infrastructure-brief.pdf>.

²⁵ Daniel Runde et al., *Sharing Risk in a World of Dangers and Opportunities: Strengthening U.S. Development Finance Capabilities* (Washington, DC: CSIS, December 2011), https://csis-prod.s3.amazonaws.com/s3fs-public/legacy_files/files/publication/111205__Runde_SharingRisk_Web.pdf.

²⁶ OECD, “Sources and Methods of the OECD Economic Outlook,” <http://www.oecd.org/eco/outlook/sources-and-methods.htm>.

²⁷ Key informant interview. All key informant interviews were off-the-record with industry experts.

- There is one party that will cover the amount of the loss;
- By agreeing to cover that loss, the provider catalyzes additional investment that would have otherwise not been invested;
- The reason for involving the new investor is to channel private capital toward development goals that may ultimately prove viability of those new markets.²⁸

These can be structured to include combinations of grants, equity, debt, and guarantees; however, they might be appropriate for covering mostly loan portfolios. There is also a capital component to risk insurance. Almost 30 percent of blended finance deals, for example, employ junior or subordinate—or concessional—capital where the public investor accepts a lower rate of return than the private investor, but each share the same risk profile.²⁹

- “Waterfall” Model³⁰

One creative model for combating the perceived low incentive for performance in first loss guarantees is called the “waterfall” model. In a waterfall model, the losses and gains for the public and private investors would eventually balance out. For example, the return or yield on a development project could be 6 percent annually, lower than a commercial rate of 12 percent that the private investor is used to. But the public sector is responsible for convincing a private investor to invest capital despite high risk and low return. The waterfall model works differently, with both groups being paid back, just at different times and rates. In this deal, if the project is a success, any extra money that comes in is sent exclusively to the private investor *until* that 6 percent rate. If the rate stays at 6 percent, then all money goes to them. So, anything less than the agreed-upon initial rate is paid back.

But the government receives a premium for taking on the risk. Anything after 6 percent goes to the public investor. In this model, the two parties can take exactly enough to reach proportionality under 12 percent return on investment. If returns rise over 12 percent, the government gets even more. The three possibilities are: 1) If the return is lower than 6 percent or 12 percent, the private is paid back with a guaranteed portion of public money in the form of their potential return; 2) if it is anything higher than 12 percent, then the private investor accepts that the government is compensated for accepting a higher risk profile; or 3) 12 percent is hit exactly and everyone balances out.

- The Cascade Approach and Maximizing Financing for Development (MFD)

The MFD, developed by the World Bank Group, is an approach to determine the best instrument for development financing. It functions as a decision tree for assessing appropriate financing tools

²⁸ Global Impact Investing Network, “Issue Brief: Catalytic First-Loss Capital,” October 2013, <https://thegiin.org/assets/documents/pub/CatalyticFirstLossCapital.pdf>.

²⁹ Convergence and the Business and Sustainable Development Commission, “The State of Blended Finance.”

³⁰ Key informant interview.

WHAT IS THE “CASCADE APPROACH”?

The Cascade approach is a new concept developed by the WBG. It functions like a decision tree, guiding investment decisions that encourage private sector participation.



SOURCES: <http://changingdevelopment.com/the-world-bank-group-pivots-to-private-sector-solutions/>;
<https://publicpolicy.wharton.upenn.edu/live/news/2133-the-importance-of-public-private-partnerships-in-for-students/blog/news.php>;
<http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23745169/DC2017-0002.pdf>

given the specific circumstances of a project. The goal is to let the situation dictate the instrument. The model poses the following questions:³¹

1. Is commercial financing feasible in terms of sustainability and commercial viability?

³¹ International Monetary Fund (IMF) and World Bank, “Forward Look: A Vision for the World Bank Group in 2030—Progress and Challenges,” March 2017, 6, <http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23745169/DC2017-0002.pdf>.

2. If not, then can institutional, policy, or regulatory reforms be used to address market failures?
3. If not, then can risk mitigation instruments and credit enhancements support private investment?
4. If not, then can the objectives be fulfilled with public financing options?

The cascade approach can guide the process for determining the extent to which funds are divided between public and private finance. The decision tree delineates the appropriate types of financing for each specific development deal. The approach only uses public finance when all attempts to find an appropriate use for private finance have failed.³² A model for development deals can encourage a systemic structure for greater participation from the private sector in development operations.³³ The cascade approach could cut down on analysis and negotiation time.

- Technical Assistance

While finance is a vital element for getting a project off the ground and for initial interest, technical assistance can help to ensure the lifecycle success of a project. Technical assistance is not a direct injection of money into a capital structure or risk matrix. Rather, it is expert advice that can improve the probability for success of a project and, ultimately, financial returns. According to Convergence, over half of blended finance deals are associated with technical assistance to build capacity of investees and eventually lower origination and transaction costs. But the work level associated with improving capacity with technical assistance makes this a prohibitive model for scaling, since the basis for assistance is that every situation, market, and sector is drastically different. However, spillover, demonstration, and positive signaling effects could be worth it.

Deal Sourcing Case Studies

To help source deals for blended finance, several intermediary organizations have emerged in recent years. This includes CrossBoundary, Total Impact Capital, and Convergence Finance. Short descriptions are included below.

CrossBoundary Energy (CBE) emerged from CrossBoundary's advisory activities in sub-Saharan Africa as an investment fund to finance solar power for commercial and industrial (C&I) offtakers. CBE addresses two major obstacles preventing access to solar for African businesses:³⁴ The high upfront cost to purchase solar power assets, and the technical challenge of owning and

³² Nancy Alexander, "The G20, the World Bank's 'Cascade,' and Trump: Going to any Length to 'Crowd In' the Private Sector?," Just Governance, May 23, 2017, <http://justgovernance.boellblog.org/2017/05/23/beware-the-cascade-world-banck-to-the-future/>.

³³ Ibid.

³⁴ CrossBoundary Energy, "CrossBoundary Energy Formally Announces Raise of \$8M in Equity to Bring Solar Power to African Businesses," press release, December 7, 2015, https://assets.contentful.com/bbfdx7vx8x8r/5Sc73Z3QHumYe6UUQEI8eE/2c5319d182f2bf856222bfd7e5fbdc20/Convergence__CrossBoundary_Energy_Case_Study__2016.pdf.

maintaining independent power production.³⁵ By financing solar assets and covering ongoing maintenance in exchange for a long-term power purchase agreement (PPA) with the offtaker, CrossBoundary Energy unlocks “solar as a service” for its customers. Further, CBE provides a platform for solar developers, who can access the contracting tools and capital they need to offer African enterprises a customized PPA solution.

The fund is a two-tier equity capital structure that mobilizes private investments by investing equity through country-level special purpose vehicles (SPVs) that can leverage debt to increase the amount of capital and deploy it into solar projects.³⁶ Using this approach, CBE is able to finance on-site solar assets for customers in multiple markets, delivering power to their customers through individual PPAs. These PPAs can be structured as a typical power purchase agreement or under a lease-to-own structure, whereby the offtaker owns the asset at the end of the agreement. Over the lifetime of the PPA, CrossBoundary Energy’s technical partner—SolarAfrica—oversees the operations and maintenance of the solar asset.

Through this approach, CBE delivers both financial returns and positive environmental impact. Development agencies were compelled by the opportunity to finance clean energy.³⁷ Among CBE’s investors was USAID, which invested its first-ever subordinated capital contribution into the fund. USAID’s commitment served as a “de-risking mechanism,” helping to draw private investment into the fund at over a 5:1 ratio.³⁸ Innovative financing platforms like CBE demonstrate the possibility for successful blended financing deals in frontier markets with the proper legal structure and investment process to create mutually beneficial outcomes.

Convergence Finance attempts to fix the deal sourcing and flow dilemma via an online platform marketplace. One of the primary barriers to scaling blended finance is sourcing deals. Private investors may not have market knowledge or contacts in the developing world, and SMEs or other groups in those frontier markets may not know investors in donor countries. At the Financing for Development Conference in Addis Ababa in 2015, a new initiative was announced regarding the launch of Convergence, which serves as an innovative “deal sourcing platform for emerging and frontier market blended finance deals.”³⁹ The Convergence platform is a database that collects past blended finance deals for analysis and connects investors from philanthropy and private and public sectors, and facilitates transactions with reduced risk. Convergence provides advice for structuring and streamlining blended finance investments. This platform helps stimulate investments into developing economies and attracts private capital toward investments that support the SDGs.⁴⁰ One of the problems development investors face with blended financing is a lack of guidance and

³⁵ Ibid.

³⁶ Ibid.

³⁷ Convergence, “Case Study: CrossBoundary Energy,” October 2016, https://assets.contentful.com/bbfdx7vx8x8r/5Sc73Z3QHumYe6UUQEI8eE/2c5319d182f2bf856222bfd7e5fbdc20/Convergence__CrossBoundary_Energy_Case_Study__2016.pdf.

³⁸ Ibid.

³⁹ Convergence, “Convergence, First and Only Deal Sourcing Platform for Emerging and Frontier Market Blended Finance Deals, Announced at Financing for Development Conference,” press release, July 15, 2015, <https://www.convergence.finance/press-detail/7kwpVMvoBOqc8kKWoeGcaW>.

⁴⁰ Ibid.

understanding; this platform is designed to serve as a knowledge-base for funders to help unleash capital efficiently.⁴¹ Two of the inaugural deals were with Palladium and KOIS Invest:

- Palladium

Convergence awarded Palladium a grant to design a development impact bond worth \$35 million to fund maternal and newborn health initiatives in India.⁴² An estimated 600,000 pregnant women will receive care over the five-year duration of the bond from around 444 clinics in Rajasthan. The deal is structured so that international agencies will pay for initial outcomes, and then state governments will pay for them further into the life of the bond. Securing a government funder at the beginning of the bond is one challenge for impact investment and hybrid deal structures, so the combination of building an approach over time for results and slowly rolling participation over to the government could be a replicable process for blended finance. The structure and timeline of this deal could be a model for scalability in the future.⁴³ Initial outcome funders include Merck and USAID, while service providers include local Indian organizations, as well as Population Services International UBS Optimus Foundation as one of the lead investors. The projected investment rate of return is 7.1 percent.

- KOIS Invest

Soon after the grant for Palladium, Convergence awarded a design grant to KOIS Invest to study the feasibility of confronting welfare issues for Syrian refugees in host countries like Lebanon, Jordan, Turkey, Iraq, Yemen, and the Gulf. The project will focus on vocational training, entrepreneurial support, and linguistics and could be worth \$25 to \$35 million, the largest impact bond in an emerging market.⁴⁴ This bond is particularly unique as it focuses on a refugee context, which is notoriously nonscalable because of the tailored nature required for each population and locale.

Total Impact Capital serves as a financial intermediary, blending different sources of capital including private equity, impact debt, and public and philanthropic funds focused on sustainable impact as well as financial return.⁴⁵ They specifically focus on leveraging impact and social change through profitability, sustainability, and business models. So far, the group has built sustainable investments in agriculture (food security), healthcare, cleantech (energy, clean water, recycling, preservation), education, and financial inclusion.⁴⁶ Their blended capital operations range from high-net-worth individuals across DFIs, foundations, corporations, institutions, and other diverse development investors; however, across all they have to tailor deals to the level of assets their investors devote to positive impact. Over the past four years, blended capital has grown as a share of their portfolio while debt instruments have declined. One advantage of working with the private

⁴¹ Blended Finance Investors, "Improving Impact: Increasing Blended Finance to Achieve the Sustainable Development Goals," MEDA, October 1, 2016, <https://www.meda.org/investment-publications/286-improving-impact-increasing-blended-finance-to-achieve-the-sustainable-development-goals/file>.

⁴² Palladium, "Design of an Impact Bond to Fund Maternal and Newborn Health Interventions in Rajasthan, India," Convergence, 2016, <https://convergence.finance/design-funding/grantee-detail/7FBamUSfxmQeE2moMi8yIK>.

⁴³ Ibid.

⁴⁴ KOIS Invest, "Design of Development Impact Bond to Fund Employment Interventions for Syrian Refugees in Host Countries," Convergence, 2016, <https://convergence.finance/design-funding/grantee-detail/tQTqUn9XSoiKsYcUulqQO>.

⁴⁵ See Total Impact Capital, "What Is Investing?," <http://www.totalimpactcapital.com/investing.html>.

⁴⁶ See Total Impact Capital website, <http://www.totalimpactcapital.com/>.

sector is the urgency with which those agents deal with money that might not exist in the public sector, hence the ability for rapid growth in private blended finance deals.

IFC launched the Grassroots Business Initiative (GBI) in 2004 focused on high-impact businesses and to pilot new capacity-building methods. In 2008, **Grassroots Business Fund** (GBF) became an independent nonprofit organization spun out of GBI. GBF's goal is to reduce poverty by building companies that can provide sustainable incomes and cost-savings for poor populations in lower-income countries.⁴⁷ So, its purpose is to build "high-impact businesses" to benefit large numbers of the poor by generating income or offering affordable, quality products and services. In 2011, the firm launched a new \$49 million for-profit fund with a 10-year limited life, so far resulting in 10 exits and \$5 million in returns from early investments.⁴⁸

GBF's blended investment approach and portfolio are composed of two related entities: a "for profit" fund responsible for investing, and a "nonprofit" component utilizing grants for technical assistance. The investment arm is composed of debt, equity and quasi-equity capital from institutions, angel investors, and foundations. The investment fund composes about 80 percent of the portfolio's hybrid model, enabling better returns while allowing GBF to operate within company cash flows.⁴⁹ The donor nonprofit arm provides business advisory services. The model for GBF and how it was grown out of a development institution is a potentially replicable success story.⁵⁰

Blended Finance across Institutions

While the term "blended finance" is relatively new, DFIs and other donors have deployed similar tools for several years. DFIs employ a few forms of blended capital, one being blended concessional finance activities supported by donor-funds or philanthropic capital. DFIs are frequently government or quasi-government corporations that are backed by the full faith and credit of a national government or multinational organization. With this backing and reliance on public money, DFIs can provide financing in areas that private investors might not be willing to provide financing. What follows is a brief landscape review of how these institutions have leveraged alternative forms of finance to public and concessional funding. This is not meant to be an exhaustive summary.

- USAID and Blended Finance

USAID provides a range of support for blended finance activities; three worth highlighting are the Development Credit Authority, Office of Private Capital and Microenterprise, and the Global Development Lab.

DCA: The Development Credit Authority (DCA) is a risk-sharing financial instrument within USAID that aims to increase economic growth by providing access to credit in developing and emerging

⁴⁷ Grassroots Business Fund (GBF), *2016 Annual Report* (Washington, DC: GBF, 2016), <http://www.gbfund.org/wp-content/uploads/2014/08/GBF-Annual-Report-2016.pdf>.

⁴⁸ Ibid.

⁴⁹ See Grassroots Business Fund website, <http://www.gbfund.org/>.

⁵⁰ Ibid.

economies.⁵¹ DCA primarily uses guarantees as the financial tool to promote local lending. DCA offers a range of products, such as partial credit guarantees, transfer authority, or the underutilized first-loss guarantees.⁵² Impact assessments of DCA demonstrate the economic value, sustainability, and benefits of investing in these markets. DCA fits into the larger aim of blended finance by minimizing the share of ODA, deploying nontraditional development resources, and leveraging the private sector as a critical component for sustainable economic development.⁵³ It was one of the first guarantee programs that acted on blended financing options and has since influenced other government agencies to institute similar programs. Although it is a beneficial program to promote blended finance for development, USAID's structural challenges limit its influence. To be an effective model for blended finance options, DCA will need to build local capacity, seek a larger allocation from the USAID budget, improve country strategy implementation, utilize a sectoral approach, and gain permission to work strategically with other agencies.⁵⁴

PCM: The Office of Private Capital and Microenterprise has sought to identify ways in which USAID can help mobilize greater amounts of private investment for developing countries. It has focused on how large institutional investors such as pension funds could be encouraged to invest more in developing countries. The need to mitigate risk emerged as a way to accomplish this goal, and led PCM to consider how it could use blended finance facilities to address the risk concerns of private investors to mobilize commercial capital for development projects. PCM recently launched the INVEST project implemented by DAI and supported by CrossBoundary, Convergence, and Tideline that seeks to identify successful models for blended finance and execute projects to catalyze investment at scale.

Global Development Lab: Although the Global Development Lab is primarily focused on identifying innovative approaches to development challenges, it has supported some work that could be considered blended finance. For example, the Development Innovation Ventures (DIV) program at USAID seeks to deploy grants in a venture capital approach to support both private and public-sector innovations. Seeking to emulate this program, USAID also launched the \$200 million Global Innovation Fund (GIF) in partnership with the UK's Department for International Development (DFID) in 2014.⁵⁵ GIF has emerged as a social impact first investor that provides critical early-stage investment for innovators and entrepreneurs in underserved developing markets. Because GIF is organized as a nonprofit supported primarily by bilateral donors, it can take greater risk and deploy capital on a patient, long-term approach.

⁵¹ USAID, "Development Credit Authority: Impact Brief 2015," https://www.usaid.gov/sites/default/files/documents/1865/dca_impactbrief15_v15_link_spreads_160824b.pdf.

⁵² USAID, "Development Credit Authority," 2017, https://www.usaid.gov/sites/default/files/documents/1865/DCA_One-Pager_Financial_Partner.pdf.

⁵³ John Wasielewski, "20 Years of the Development Credit Authority," *CSIS Commentary*, July 26, 2017, <https://www.csis.org/analysis/20-years-development-credit-authority>.

⁵⁴ Daniel Runde et al., *Sharing Risk in a World of Dangers and Opportunities*.

⁵⁵ The Australia Department of Foreign Affairs and Trade (DFAT), Swedish International Development Cooperation Agency (SIDA), the Omidyar Network, and the South African Department of Science and Technology also support GIF.

- UK Department for International Development (DFID)

DFID was established in 1997 as the UK's principal development assistance agency. It implements development programs in 32 countries and has regional programs throughout Southeast Asia, Africa, Latin America, and the Caribbean.⁵⁶ The total expenditure in 2016 was \$12.4 billion.⁵⁷

DFID's blended finance covers operations in industries such as climate change mitigation, renewable energy, water supply management, infrastructure, healthcare, and economic development. They mobilize capital through blended finance to supplement other institutions' resources for these projects, like CDC, the Private Infrastructure Development Group (PIDG), and other private-sector actors. One example of DFID's blended finance initiatives was their support for the China Tuberculosis Control Project; the combination of a loan and grant meant the Chinese administration only had to cover one portion of the entire financing solution, resulting in a lessened financial burden.⁵⁸ Although DFID's blended finance mechanisms have produced positive results in China and other case studies, there are several in which DFID and its private-sector partners have faced scrutiny for poor management of programs and high transaction costs.⁵⁹ An assessment of DFID-PIDG operations in 2011 showed that donor partnerships require further collaboration and transparency across project investments and a stronger partnership with civil society.⁶⁰ DFID's blended finance operations are evolving to better fit the needs of local development objectives and their recent economic development strategy reflects their financing approaches.⁶¹

- Netherland's Development Finance Company (FMO)

The Dutch development bank (FMO) is structured as a public-private partnership with majority shares owned by the state, and minority interest held by commercial banks. FMO was established in 1970 with a sectoral focus on finance institutions, agribusiness (including food and water), infrastructure, and energy.⁶² Some of the financing challenges in the past led FMO to remove sectors like housing from their focus to target more specific areas to attract stronger partnerships

⁵⁶ See UK Department for International Development (DFID), "About Us: Where We Work," <https://www.gov.uk/government/organisations/department-for-international-development/about#where-we-work>.

⁵⁷ DFID, *Annual Report and Accounts 2016–17* (London: DFID, 2017), 17, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/625548/DFID-Annual-Report-and-Accounts-2016-17.pdf.

⁵⁸ World Bank Treasury, "Case Study: Blending Financing from Multiple Sources to Reduce Overall Cost of Financing in China," July 2013, http://treasury.worldbank.org/web/documents/China_BlendingJuly2013.pdf.

⁵⁹ See Maji Ni Maisha project in Kenya as described in Shakira Mustapha, Annalisa Prizzon, and Mikaela Gravas, *Topic Guide: Blended Finance for Infrastructure and Low-Carbon Development* (Surrey, UK: Evidence on Demand, January 2014), <http://www.evidenceondemand.info/topic-guide-blended-finance-for-infrastructure-and-low-carbon-development-full-report>; and Mark Anderson, "UK aid watchdog criticises DFID over partnerships with private sector," *The Guardian*, May 2015, <https://www.theguardian.com/global-development/2015/may/21/uk-aid-watchdog-dfid-public-private-partnerships-icai>.

⁶⁰ See Private Infrastructure Development Group (PIDG), "The Multilateral Aid Review: Assessment of the PIDG," February 2011, http://www.pidg.org/resource-library/progress-reviews?b_start:int=0.

⁶¹ DFID, *Economic Development Strategy: prosperity, poverty and meeting global challenges* (London: DFID, January 2017), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/587374/DFID-Economic-Development-Strategy-2017.pdf.

⁶² See FMO, "Who we are," <https://www.fmo.nl/profile>.

and remain agile. FMO has a total of 552 investments currently with a total portfolio of \$11.6 billion.⁶³

The bank has employed blended finance in Africa and South Asia for infrastructure, renewable energy, education, and water and sanitation projects. These projects show strong successes in comparison to other traditional financing methods because in markets like rural India, there are limited sources of capital to fund enterprises. FMO partnered with other development funders, CISCO and TIAA-CREF (Teachers Insurance and Annuity Association–College Retirement Equities Fund) in 2011 to help de-risk early-stage investments in India.⁶⁴ This fund produced nearly 20,000 jobs and has continued to build on these successes in recent years.⁶⁵ However, in other scenarios FMO has recognized the challenges of incentivizing commercial investors to meet their targets. During the global financial crisis, investors were less than eager to hear about potential risks, which meant that the investments for emerging markets came from public sources and were not mobilized from the private sector as FMO intended them to be.⁶⁶

- International Finance Corporation (IFC)

IFC is a member of the World Bank Group and is the largest global development institution focused exclusively on the private sector in developing countries. It helps developing countries achieve sustainable growth by financing investment, mobilizing capital in international financial markets, and providing advisory services to businesses and governments.⁶⁷

IFC was established in 1956 and is owned by 184 member countries. It has 104 offices in 98 countries.⁶⁸ In 2016, IFC invested nearly \$19 billion, including about \$8 billion mobilized from other investors.⁶⁹ The commitment of \$117 million in donor funds in 2016 catalyzed over \$1 billion in IFC and private-sector financing.⁷⁰ IFC has blended finance operations covering climate change, renewable energy, agriculture, food security, and SME finance for areas such as women entrepreneurs.⁷¹ Health and education are two new areas being explored.⁷² IFC blended finance

⁶³ See FMO, “572 Investments,” <https://www.fmo.nl/worldmap>; and FMO, *Annual Report 2016* (The Hague: FMO, March 2017), <https://www.fmo.nl/library/download/urn:uuid:638188d0-5def-49f4-bf5a-7db9c94ddb52/2016+fmo+annual+report.pdf>.

⁶⁴ OECD and WEF, *Blended Finance Vol. 1: A Primer for Development Finance and Philanthropic Funders* (Geneva: WEF, September 2015), 20, http://www3.weforum.org/docs/WEF_Blended_Finance_A_Primer_Development_Finance_Philanthropic_Funders.pdf.

⁶⁵ Ibid.

⁶⁶ FMO, “Fact Sheet FMO (Netherlands) and private finance for development,” Eurodad, <http://www.eurodad.org/files/pdf/53be75e54baeb.pdf>.

⁶⁷ IFC is a legally distinct part of the World Bank Group with its own articles of agreement, balance sheet, and staff.

⁶⁸ IFC, *IFC: The First Six Decades: Leading the Way in Private Sector Development: A History*, 2nd (Washington, DC: IFC, 2016), <http://www.ifc.org/wps/wcm/connect/6285ad53-0f92-48f1-ac6e-0e939952e1f3/IFC-History-Book-Second-Edition.pdf?MOD=AJPERES>.

⁶⁹ IFC, *Annual Report 2016*.

⁷⁰ IFC, “Blended Finance,” http://www.ifc.org/wps/wcm/connect/CORP_EXT_Content/IFC_External_Corporate_Site/Solutions/Products+and+Services/Blended-Finance.

⁷¹ IFC, *Blended Finance at IFC: Blending Donor Funds for Impact* (Washington, DC: IFC, October 2012), <https://www.ifc.org/wps/wcm/connect/02ad63804d920789b2dab748b49f4568/Blended+Finance+at+IFC.pdf?MOD=AJPERES>.

⁷² IFC, “IFC FY17 Budget Resources: Bridging Strategy and Delivery,” June 23, 2016, <http://documents.worldbank.org/curated/en/406461470773950157/pdf/IFC-FY17-Budget-Resources-Bridging-Strat-Dlvry-Redaction-FINAL-08022016.pdf>.

has yielded positive results depending on the area of support. Investment and advisory projects, among other things, supported the construction of solar plants, conversion of biomass to renewable energy, infrastructure, and improvement of forest management, generating power, and providing gas and water for millions of people.⁷³

- Investment Fund for Developing countries, Denmark (IFU)

IFU, the Danish DFI, is self-financed, and its revenues comprise income from interest, dividends, and capital gains.⁷⁴ IFU was established in 1967 and offers risk capital and advice to companies wanting to set up business in developing countries and emerging markets.⁷⁵ It aims to enhance Danish trade and investment while contributing to economic and social development in host countries through advisory services and commercial investments. IFU estimates its total investments generated until 2016 to be around \$27 billion, of which IFU has contributed about \$3 billion.⁷⁶ In cooperation with more than 800 Danish companies, IFU has invested in more than 1,200 projects covering more than 100 different countries in Africa, Asia, Latin America, and Europe. Annually IFU makes around 50 investments and has on average an active portfolio of 220 investments.⁷⁷

The IFU provides blended finance that covers areas such as renewable energy, energy efficiency, and climate.⁷⁸ But it took IFU over 55 years to build such a portfolio and investor trust. One important issue in blended finance is relating the lifecycle costs and investment time horizon to private donors as well as public funders. Eventually, IFU built trust based on portfolio performance, but for other institutions with newer blended finance operations, it could be years before larger projects are successful in terms of development goals or return. Lifecycle honesty and trust are two important aspects for partnering with the private sector.

Barriers to Blended Finance

Forms of blended finance have been leveraged in diverse industries for decades, but the conscious effort to align development goals with private capital in frontier markets is a relatively new phenomenon. Development institutions and private investors are both entering unknown territory when negotiating a blended finance deal. The lack of evidence of success, or of a model for a blended finance deal, restricts the growth and impact of this approach. So, while addressing the specific barriers below within a blended finance deal, just discussing the strategy to raise awareness could be one simple solution for growing the idea. Below are the specific issues within

⁷³ IFC, *Blended Finance at IFC*.

⁷⁴ Investment Fund for Developing Countries (IFU), *Annual Report 2016* (Copenhagen: IFU, 2016), <https://www.ifu.dk/wp-content/uploads/IFU-Annual-Report-2016.pdf>.

⁷⁵ Ibid.

⁷⁶ See IFU, "Background," <https://www.ifu.dk/en/about-ifu/background/>.

⁷⁷ Investment Fund for Developing Countries, "Annual Report 2017."

⁷⁸ OECD, "Blended Finance and Sustainable Development Partnership Initiative," February 2016, [http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC/AGID\(2016\)2&docLanguage=En](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC/AGID(2016)2&docLanguage=En).

IFU Case Study⁷⁹

IFU has been around for 50 years and, over time, has become one of the most successful institutions for crowding private investment into development impact goals. While there are cultural reasons for Danish industry to be interested in socioeconomic development aims, IFU has also made development impact into a commercially viable investment.

DFI's are usually capitalized with stake money with different risk-return profiles than commercial investment banks, that is why DFIs can focus on social utility interests that the private sector cannot. Private investors usually have a fiduciary duty that may inherently prevent them from investing in a high-risk deal in a developing country.

When IFU began, it was not infused with too much public money because of Treasury budget constraints, so they were naturally forced early on to focus on private engagement and become comfortable with private investors. This lack of capital resulted in a few private equity investments that gave IFU a trustworthy track record. Eventually, their performance caught the eye of pension funds.

The involvement with pension funds allowed IFU to focus on larger investments and larger-impact deals, diverging from normal development mode. In the past, IFU focused on connecting Danish SMEs to foreign SMEs, with the evidence of Danish domestic impact holding back investments.

Eventually, IFU formed an investment committee in partnership with the pension funds to steer impact but also evaluate the commercial viability of a deal early on. The healthcare pension is the primary actor because the development goals align with the industry, and for the industry, it is a good alternative to donating to philanthropy. These are relatively small investments for a large nurses' or teachers' pension fund, but the risk sharing gives protection in case of losses. Since then, two investment facilities—a climate fund and an agribusiness fund—have included about half pension money and half public money. The new SDG fund will include a similar split.

blended finance, but limited awareness of the tools and mechanisms for crowding in private-sector involvement is a key issue.⁸⁰

- **Scalability:** The biggest issue restricting scalability of blended finance is the bespoke nature of each transaction. The money to scale blended finance deals and existing programs proven to be successful is there, but it must be channeled in proper directions into "mass production."⁸¹ There is not a standardized, off-the-shelf model for a blended finance structured investment. There are popular methods for structuring, and all deals will

⁷⁹ Key informant interview.

⁸⁰ OECD and WEF, *A How-To Guide for Blended Finance* (Geneva: WEF, September 2015), http://www3.weforum.org/docs/WEF_Blended_Finance_How_To_Guide.pdf.

⁸¹ Key informant interview.

USAID-Cross Boundary First Loss Guarantee Case Study

CrossBoundary is an investment advisory firm focused on conflict zones and frontier markets.⁸² CrossBoundary Energy (CBE) emerged from CrossBoundary's advisory activities in sub-Saharan Africa as an investment fund to finance solar power for industrial and commercial businesses. Given the abundance, lack of grid infrastructure necessary, and decrease in solar energy costs, developing countries have been incentivized to adopt it as an alternative energy source in recent years. But one of the existing challenges to introducing solar power is the upfront cost, which will be alleviated by CBE's financing solutions in partnership with SolarAfrica and NVI Energy. The fund is a two-tier equity capital structure that mobilizes private investments by investing the equity into special-purpose vehicles (SPVs) that can leverage debt to increase the amount of capital and deploy it into solar projects.⁸³ CBE invests the capital to SolarAfrica, which offers a financed power purchase agreement (PPA) or finance lease to African enterprises, in combination with the technical expertise and asset management of NVI Energy, to install solar solutions that are then maintained by experts of CBE and SolarAfrica.⁸⁴ Then, African firms do not have to pay up front for the solar energy; rather, they pay for it over time as they would with other energy sources, alleviating one of the main concerns of solar energy adoption.

The financing platform promises good returns and environmentally friendly energy alternatives.⁸⁵ Given the nature of the investment, development agencies were compelled by the proposition for financing clean energy. Among its investors was USAID, which utilized a first-loss contribution for the first time. USAID's commitment to CBE prompted other investors to support the fund because it incorporated a "de-risking mechanism" and helped the company gain credibility.⁸⁶ CBE fundraising and investment security attracted investors, and its impact metrics for increasing access to finance and achieving sustainability in development pave the way for future investment. Innovative financing platforms like CBE demonstrate the possibility for successful blended financing deals in frontier markets with the proper legal structure and investment process to create mutually beneficial outcomes.

address risk and return profiles in some way, but each project must be adapted to the market, locale, sector, and investors. Independent of deal size, success must be replicated. To do so, some organizations are focused on improving current operations rather than growing new ones.

⁸² How We Made It in Africa, "Meet the Boss: Jake Cusack, managing partner, CrossBoundary," June 8, 2015, <https://www.howwemadeitinafrica.com/meet-the-boss-jake-cusack-managing-partner-crossboundary/49473/>.

⁸³ CrossBoundary Energy, "CrossBoundary Energy Formally Announces Raise of \$8M in Equity to Bring Solar Power to African Businesses."

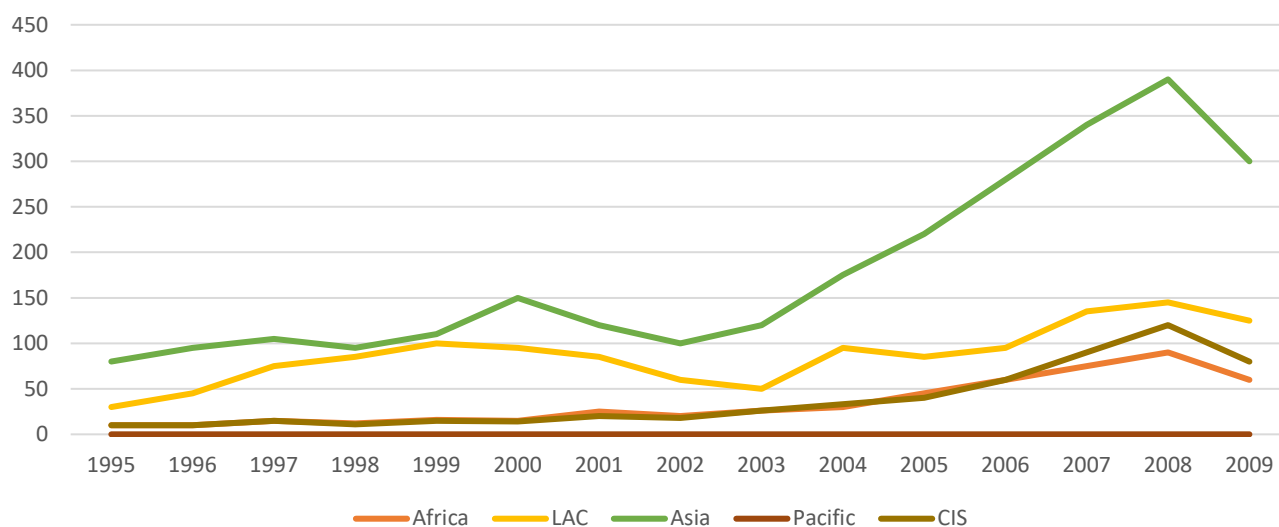
⁸⁴ Ibid.

⁸⁵ Ibid.

⁸⁶ Convergence, "Case Study—CrossBoundary Energy."

- **Deal Flow and Availability:** There is also a lack of blended finance deals in the market that prevent the tool from reaching its potential. The demand for blended finance deals exists among institutional investors like IFC or JP Morgan Chase, but sourcing these deals remains a challenge. One potential solution for deal flow is tools like Convergence Finance. Convergence offers a centralized database of available blended finance deals for donors, investors, and other industry players to learn about opportunities. But there is still a gap in the matchmaking process between merchant bankers as funders, who source the deals, the development banks, and who can market the deals. One barrier to building a process that connects these parties is getting the appropriate knowledgeable people in the right room together.
- **Focus on Fragile Markets:** Sub-Saharan Africa, for example, receives 40 percent of blended finance transactions, but the median size of those deals is smaller compared to other regions. The region only accounts for 16 percent of total capital mobilized via blended finance.⁸⁷ The bulk of work needs to be done in places like sub-Saharan Africa. Institutions need to demonstrate the viability of these markets to the private sector, which deemed them “unattractive.”⁸⁸ Proparco, refers to a “knock-on effect” for mobilizing capital this way.

Figure 2: FDI Inflows, by Region (US\$ billions)⁸⁹



⁸⁷ Convergence and the Business and Sustainable Development Commission, “The State of Blended Finance.”

⁸⁸ Proparco, “How Proparco Invests,” <http://www.proparco.fr/en/node/220>.

⁸⁹ UN Development Programme (UNDP), “Chapter 3: Private Capital Flows: Foreign Direct Investment and Portfolio Investment,” in *Towards Human Resilience: Sustaining MDG Progress in an Age of Economic Uncertainty* (New York: UNDP, October 2011), http://www.undp.org/content/dam/undp/library/Poverty%20Reduction/Inclusive%20development/Towards%20Human%20Resilience/Towards_SustainingMDGProgress_Ch3.pdf.

Conclusions and Recommendations

Donors have rightly focused on how they can use traditional ODA to catalyze greater levels of private investment into developing countries. Bilateral donors such as USAID and DFID have long relied on various risk-mitigation tools, including various types of guarantees and outright subsidies to encourage this investment. Blended finance is the latest approach and does offer some promise to mobilize the vast sums needed to achieve the SDGs. Right now, however, blended finance deals remain too tailored and inefficient vehicles for crowding in the private sector into global development. One step will be to structure blended finance deals in a standardized package and offering but with enough flexibility so that it can be applied to diverse regions, sectors, and investors. This will include a model for first loss guarantees, subordinate debt, technical assistance, and other tools. The objective is to achieve development goals and commercial self-interest. To scale blended finance on the “billions to trillions” agenda, there must be no more fine tailoring, rather mass production should be the focus. Two opportunities for opening room for large money flows are challenge funds—funds set up for specific causes to align many diverse parties—and business development services in the developing world.

- **Adapt Flexible Approaches:** To overcome the lack of skills in development agencies, donors should be prepared to adapt flexible approaches to deploy blended capital. This might include relying on outside funds to invest ODA on blended capital terms and who can properly assess private-sector deals. Some donors have also worked to deploy blended finance deals alongside DFIs own account investments, creating alignment of interest, ensuring high standards, similar application of policies and procedures to donor-funded investment, and to reduce transaction costs by minimizing replication of in-house expertise.
- **Identify Barriers to Investment:** If donors start from the perspective that “capital is a coward,” then beyond blended capital, donors should consider why private investors are unwilling to invest in certain contexts. This will mean a greater focus on addressing investment and business climate reforms and looking at how to deepen local capital markets.
- **Develop Local Capital Markets:** In many fragile and low-income countries, local capital markets are often shallow, meaning that local business cannot rely on local financial institutions to fund or scale up their operations.
- **Deploy in Appropriate Markets:** Blended finance will likely be most valuable in markets that struggle to attract needed private investment; this will mean focusing on fragile and lower-income countries. Risk is high in these countries and using instruments that can mitigate the various risks for private investors would achieve the greatest development impact. DFIs frequently are criticized for investing too much in middle-income countries

that can attract private investment or have well-developed capital markets. As blended finance deals become more commonplace, expansion into these other contexts should proliferate.

- **Create an association along the lines of EMPEA for blended finance:** OECD's recent meeting is a good start and could be the place to incubate this, or European Development Finance Institutions (EDFI) along with Canada and the United States might be another incubation home for such a community. IFC has a working group for concessional finance for the private sector, which features the Inter-American Development Bank (IDB), Islamic Corporation for the Development of the Private Sector (ICD), Islamic Development Bank Group (IDBG), European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), Asian Infrastructure Investment Bank (AIIB), African Development Bank (AfDB), Asian Development Bank (AsDB), and EDFI.

Blended finance remains a relatively new tool that still needs to prove it can play a role in mobilizing the amount of capital needed in developing countries. There are several questions that donors need to answer as they consider relying more heavily on blended finance. Is the role of blended finance to push the private sector into the poorest parts of the world, or tilt the balance in areas where the private sector is not quite ready to take off? Who will the future actors responsible for moving development finance from billions to trillions? It also raises questions about how catalytic ODA will truly be: Are development agencies prepared to essentially subsidize the profits of investment firms in developing countries? If development agencies deploy first loss guarantees as part of a blended finance approach, are they prepared to accept that some ODA might be lost as part of bad or failed deals?

This report notes that DFIs are in many ways the original form of "blended finance" as they explicitly deployed financial capital in developing countries with the full faith and backing of their sovereign governments. This explicitly allows them, should they choose to do so, to take greater risk than private-sector investors. The reality is, however, most DFIs do not take on risk or invest in countries that could benefit the most from accessing their financing. As several recent reports by the Center for Global Development make clear, DFIs such as IFC, OPIC, CDC, and others concentrate their investments in upper-middle-income countries that do not lack for access to finance.

Development institutions should focus on improving current operations and deal structure so that when blended finance does take off with exponential investment volume from new parties like pensions, existing issues are not magnified. This means standardizing a general model for private capital inclusion in a blended finance deal dependent of size, structure, sector, and geography. Addressing the issues described in this report could begin to make development a more hospitable environment for transformative private capital. But development actors need to remember why blended finance exists in the first place: To achieve sustainable growth in the developing world and transform wards of the international system into thriving and successful countries.

About the Project Director and Authors

Daniel F. Runde is director of the Project on Prosperity and Development and holds the William A. Schreyer Chair in Global Analysis at CSIS. His work centers on leveraging American soft power instruments and the central roles of the private sector and good governance in creating a more free and prosperous world. Previously, he led the Foundations Unit for the Department of Partnerships & Advisory Service Operations at the International Finance Corporation. His work facilitated and supported more than \$20 million in new funding through partnerships with the Bill and Melinda Gates Foundation, Rockefeller Foundation, Kauffman Foundation, and Visa International, among other global private and corporate foundations.

Earlier, Mr. Runde was director of the Office of Global Development Alliances at the U.S. Agency for International Development (USAID). He led the initiative by providing training, networks, staff, funds, and advice to establish and strengthen alliances, while personally consulting to 15 USAID missions in Latin America, the Middle East, and Africa. His efforts leveraged \$4.8 billion through 100 direct alliances and 300 others through training and technical assistance. Mr. Runde began his career in financial services at Alex. Brown & Sons, Inc., in Baltimore and worked for both CitiBank and BankBoston in Buenos Aires, Argentina. He received an M.P.P. from the Kennedy School of Government at Harvard University and holds a B.A., cum laude, from Dartmouth College.

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