

PART I
Chapter 3

Blending public and private funds for sustainable development

by

Richard Samans, Head of the Centre for the Global Agenda and Member of the Managing Board,
World Economic Forum

Blended finance offers huge, largely untapped potential for public, philanthropic and private actors to work together to dramatically improve the scale of investment in developing countries. Its potential lies in its ability to remove many bottlenecks that prevent private investors from targeting the sectors and countries that urgently need additional investment. To accelerate social and economic progress towards the Sustainable Development Goals, blended finance needs to be scaled up, but in a systematic way that avoids certain risks. This chapter outlines how to underpin international development efforts using blended finance solutions that have the potential to transform economies, societies and lives, concluding with a set of key recommendations.

Challenge piece by Gavin E.R. Wilson, International Finance Corporation Asset Management Company. Opinion pieces by Jay Collins, Citigroup; LI Yong, United Nations Industrial Development Organization.

The challenge: Can blended finance increase the scale and sustainability of finance for development?

Gavin E.R. Wilson,

CEO of the IFC Asset Management Company

Policy makers and experts from all sectors are discussing ways to finance the 17 Sustainable Development Goals (see Chapter 1) (Sachs, Schmidt-Traub and Shah, 2015). This dialogue is testament to an ongoing paradigm shift in the thinking about development finance: today, there is a clear focus on how to remove constraints, mitigate risks and unlock the resources needed to move from billions to the trillions required to achieve the new development agenda (see Figure 3.1) (ADB et al., 2015).

Providers of official development assistance (ODA), working in partnership with the private sector, can play a key role in underpinning commercially viable, sustainable and scalable solutions. They can use public funds strategically to provide, for instance, de-risking instruments; these instruments can incentivise private finance for investments with strong social and development benefits that would otherwise not materialise due to higher actual or perceived risk (OECD, 2014). Operating at the intersection of fully commercial and subsidised/grant-dependent projects, they can move the needle towards self-reliance, viability and scalability.

This is the concept behind what is referred to as “blended finance”. Where development challenges or perceptions of risk prevent investment on purely commercial terms, these models can enable the private sector to balance certain risks with appropriate rewards. This, in turn, can connect target groups to the market and eventually enable solutions to become financially sustainable. For multi-stakeholder partnerships to have the desired development impact, both public institutional expertise and emerging market knowledge are essential; together they permit the identification and structuring of projects that can be sustainable and replicable in the long run.

Blended finance investment solutions capitalise on partnerships among diverse actors, including international organisations, development co-operation agencies and private enterprise. An example of such a partnership is the Women Entrepreneurs Opportunity Facility, launched in March 2014 by the International Finance Corporation and Goldman Sachs’ 10,000 Women. This is the first of its kind of global facility dedicated to expanding access to capital for women-owned small and medium enterprises. Through the facility, the International Finance Corporation aims to invest up to USD 600 million in financial institutions that are committed to expanding their financial services to small and medium enterprises owned by women in emerging markets. It also aims to signal the relevance of this asset class to the broader investor market. The funding for the facility includes USD 50 million of blended finance from Goldman Sachs’ 10,000 Women to create performance incentives for financial institutions to boost their lending to this segment, and to support capacity building among financial institutions and women borrowers.

Nonetheless, it is important that the growing focus on blended instruments within the post-2015 development agenda does not lead partners to overlook other financial vehicles that can deliver commercially viable outcomes without a concessional element. The range of tools available to catalyse private finance for development includes instruments such as market-priced co-financing, seed capital for collective investment vehicles, partial risk guarantees, advisory services and support for sound project structuring. Some of these tools depend simply on an alignment of interests rather than the provision of an explicit subsidy. Blended finance solutions are best used when partial market failures undermine economic efficiency, including pioneering investments in high-risk environments or those that use new technologies; or when equity or distributional goals prevail, such as promoting affordable access to basic services for underserved groups.

The use of concessional subsidies could, however, encourage investors to compete against each other, leading to a race to the bottom in terms of pricing. The challenge for development partners providing blended finance instruments is to implement them strategically and selectively. This requires, to begin with, a shared understanding of exactly which forms of capital constitute a blended finance instrument. In addition, organisational capacity and vision are needed to:

1. Identify and structure projects where blending is needed to make projects viable and ensure that the concessional element can be phased out in a reasonable time period, leading to commercially sustainable projects.
2. Target projects that address critical gaps in development and can be scaled up and/or replicated to yield significant benefits beyond the original undertaking. This is particularly important for projects in fragile and conflict-affected states.

In essence, blended finance implies that certain policy-driven investors take on a higher level of risk, without commensurate commercial rewards. These partners are compensated by the prospect of strong development impact, of demonstrating the viability of new sectors and of attracting additional commercially-driven private finance to fund development challenges.

Despite the challenges of investing in emerging markets,¹ where development needs are the greatest, developing countries offer investment opportunities that are increasingly attractive to private investors and corporations, including rising financial returns, portfolio diversification, and access to young and growing markets. By helping to mitigate the perceived and real risks, and the inefficiencies that characterise these markets, new financial approaches can enable investors to realise commercial benefits while allowing developing countries to tap into significant capital resources.

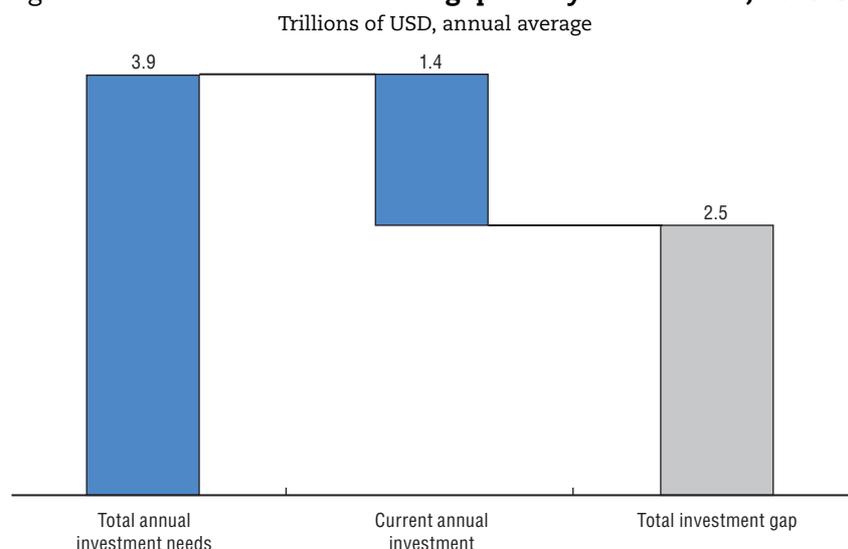
Blended finance² – development finance and philanthropic resources used to mobilise private capital to promote development outcomes across a range of sectors and countries – is one such innovative approach (see the challenge piece by Gavin E.R. Wilson at the beginning of this chapter). By mitigating risks and enhancing returns for investors, this financing model can accelerate financial flows to emerging markets, thereby dramatically improving the scale of investment in development.

This chapter outlines how blended finance can promote public-private co-operation to underpin international development efforts, offering huge, largely untapped potential for public, philanthropic and private actors to work together towards win-win solutions. Private investors can make attractive returns on their capital. Public and philanthropic providers can make their limited dollars go further, yet ensure scale of implementation. Most importantly, people in developing countries can benefit from more funds – and knowledge – being channelled to emerging and frontier markets,³ and being used strategically to transform economies, societies and lives – and ultimately to achieve the Sustainable Development Goals (SDGs).

New sources of capital are available to close the sustainable development financing gap

The development challenges of the 21st century remain vast, requiring the transformation of developing economies to ensure long-term development. The annual SDG financing gap in developing countries is estimated at approximately USD 2.5 trillion (Figure 3.1). Although this seems a huge amount, it constitutes only 3% of global gross domestic product (GDP), 14% of global annual savings,⁴ or 1.1% of the value of global capital markets, estimated at USD 218 trillion (Sachs, 2014).

The good news is that there is enough money to close the SDG financing gap.

Figure 3.1. **Estimated investment gap in key SDG sectors, 2015-30**

Source: UNCTAD (2014), *World Investment Report 2014: Investing in the SDGs: An Action Plan*, United Nations Conference on Trade and Investment, Geneva, http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf.

The good news is that there is enough money to close this gap (OECD, 2014). Today only a small fraction of the worldwide investment assets of banks, pension funds, insurers, foundations and endowments, and multinational corporations is targeted at sectors and regions that advance sustainable development in developing countries. Translating these assets into SDG-compatible investments is fundamental.

Among the prospective sources of new capital to help finance SDG outcomes, pension funds from developed and developing countries already have at least USD 1.4 trillion of assets invested in developing markets, and the value is growing. Flows of cross-border bank lending to developing countries were roughly USD 325 billion in 2013 (UNCTAD, 2014), making international bank lending the third most important source of foreign capital after foreign direct investment and remittances. Of the total USD 31 trillion in international cross-border bank claims by the end of 2014, 28% came from developing countries (Bank for International Settlements, 2014).

The potential – and the need – to do more is enormous, particularly in sectors such as infrastructure (e.g. power, renewable energy, transport), telecommunications, and water and sanitation, which together have an estimated shortfall in public sector funding of up to USD 1.6 trillion a year (UNCTAD, 2014; Sachs, Schmidt-Traub and Shah, 2014; see the “In my view” box by Jay Collins later in this chapter). Thanks to a likely reversal of the factors contributing to the recent decline in real estate interest rates,⁵ global capital markets appear to be entering a protracted period of high liquidity and low cost that could last a decade or more (Kharas, Prizzon and Rogerson, 2014). At the same time, owing to downward pressures on returns in developed markets, investors and financial institutions are seeking to invest in emerging and frontier markets. These markets are attractive because they offer above-average returns and are relatively less affected by prevailing developed world challenges. High GDP growth in emerging economies also signals that there are opportunities for investors to “buy into” a country’s overall prospects, or seek out opportunities by identifying undervaluation in specific sectors.

Emerging and developing economies already contribute to more than 60% of global GDP.

In my view: “Doing good while doing well” is the mantra for SDG success

Jay Collins,

Vice Chairman, Corporate and Investment Banking, Citigroup

Global and local capital markets have powerful potential as development funding tools and offer the world the ability to move beyond traditional development assistance and philanthropy to structures and solutions that leverage public funding and crowd-in the private sector (OECD/WEF, 2015a). With myriad structures, themes and formats, capital markets have the scale, depth and potential to reach far beyond the current multi-billion dollar development funding level. Largely because of their size, they can drive the move called for by World Bank’s President Jim Yong Kim (2015), “from billions to trillions”.

Perhaps the most important example of the underutilised potential of capital markets lies in the infrastructure funding gap, which exists in both emerging and developing economies. The world spends approximately USD 3.3 trillion per year on infrastructure (Dobbs et al., 2013: 10), with the bulk of this funded directly by governments on their balance sheets, despite debt and deficit limitations; only some USD 400 billion is contributed annually through project finance markets, in the form of non-recourse loans and/or bonds that are paid from cash flows from the project rather than the balance sheets of its sponsors (Dealogic, 2015). With Basel III and Solvency II constraints, which impose more stringent capital requirements on financial institutions and insurance companies, this predominantly bank-funded market will not grow meaningfully unless solutions are found to push more infrastructure financing into global and local capital markets. Currently, only USD 30-50 billion of project bonds are completed annually, which makes global bond markets only a small fraction of the infrastructure funding pie (ibid.).

This has to change. To achieve rapid growth in the infrastructure project bond market, governments and development institutions must innovate and develop new structures involving the private sector – structures that distribute risk differently. As the private sector embraces instruments that combine social returns with risk-adjusted financial returns, the development community will need to focus on blending more of its public resources into risk-adjusted return structures. This includes using development capital to create guarantees and other financial solutions that make infrastructure projects “bankable” – or viable for the private sector.

The concept of blended financial solutions is not new. For years, Citi has been partnering globally with institutions such as the World Bank Group’s Multilateral Investment Guarantee Agency and the US Overseas Private Investment Corporation through a variety of risk-sharing arrangements. The challenge – and the imperative – going forward is for development finance to better incorporate grants and concessional financing, including official development assistance (ODA) and philanthropic capital, to catalyse and crowd-in more private sector capital. Global ODA stands at roughly USD 135 billion per year and philanthropic giving is holding relatively constant at about USD 30 billion (OECD, 2014). By better leveraging these funds, much more can be mobilised (OECD/WEF, 2015a). For example, an injection of ODA as first-loss equity in a project with positive development impact could go a long way in making a previously un-bankable deal bankable.

To promote innovative solutions and put theory into practice, Citi is participating in public-private partnerships that are developing new blended finance solutions, such as the Sustainable Development Investment Partnership (see Box 3.4). With partners that include USAID, the OECD, the World Economic Forum and the Swedish International Development Co-operation Agency, this partnership aims to mobilise USD 100 billion in private financing over five years for infrastructure projects in developing countries in support of the SDGs. It will do so by using official funding to better mitigate risk and attract private sector capital (OECD/WEF, 2015a).

Yet unless development institutions measure their performance based upon amounts leveraged or “mobilised”, rather than public funds committed, the behavioural change necessary to create capital market and blended finance solutions will simply not happen. At the same time, global for-profit institutions – banks, corporations and institutional investors – must embrace a paradigm that measures social and financial returns and builds those metrics directly into core businesses. As capital markets will likely be the dominant tool to fund the SDG gap, “doing good while doing well” must be the mantra for SDG success.

© Citigroup Global Markets Inc. 2016.

In emerging markets, expansion of the middle class, fuelled by increased accumulation of wealth and attractive demographics (e.g. a young and growing workforce), is also driving tremendous growth. This middle class is poised to expand by around 3 billion people (more than 40% of today's population) over the next 20 years and assets under management are expected to double by 2020, to roughly USD 13 trillion (Pelosky, 2014). Emerging and developing economies already contribute to more than 60% of global GDP and this percentage is expected to grow if growth rates increase as projected – from 4.3% in 2015 to 4.7% in 2016, compared to the 2.4% growth projection for advanced economies (euro area and the United States) over the same period (IMF, 2015; Lagarde, 2016). Attracted by these positive metrics, combined with the rapidly growing workforce and consumer base of these economies, corporations and investors are increasingly seeing emerging and developing economies as their future source of growth and differentiation, offering important opportunities to meet their business and financial objectives.

Since the 2008 global financial crisis, over USD 1.1 trillion in private capital flows has been channelled into the developing world every year, and global investments there are expected to triple by 2030 (IIF, 2014; World Bank, 2012; UNCTAD, 2012). Moreover, for the past 15 years long-term investments in emerging markets have outperformed those in advanced economies.⁶ Private equity investment has seen significant growth in emerging markets, reaching 11% of global private equity investments in 2014; this represents USD 33.8 billion, the highest total in the Emerging Markets Private Equity Association's records. More than 50% of total private equity investment in 2014 was allocated to sectors targeting the growing middle class, including consumer services, consumer goods, technology, healthcare and financial services (Canada, 2015).

Finally, philanthropic foundations are recognised as important providers of additional funding for development.⁷ Available data suggest that philanthropic contributions to development have multiplied by nearly ten in less than a decade, from around USD 3 billion in 2003 to USD 30 billion in 2012 (OECD, 2014).

Numerous barriers limit private sector investment in emerging markets

Despite this potential, however, only a fraction of global capital market investment flows to emerging markets annually. To realise the potential – and to achieve the SDGs – it is fundamental to address the bottlenecks that prevent private investors from targeting the sectors and countries that urgently need additional investment. The following are five fundamental barriers that prevent the private sector from deploying capital into emerging and frontier markets, of which the first is the most significant (OECD/WEF, 2015a):

1. **Returns are seen as too low for the level of real or perceived risk.** Private capital providers have a fiduciary duty to maximise returns while ensuring capital is preserved. While a wide range of investment opportunities in emerging and frontier markets have the potential to deliver strong development impact, transactions often do not meet investor return requirements in terms of risk-appropriateness. Specific risks faced by investors in emerging markets include business model risk (nascent markets, new projects), technical feasibility, macroeconomic and corporate governance risks, and funding shortfalls. In addition, the transaction costs and time associated with learning about new markets, capital-intensive projects and relatively small deals can be high, dampening return expectations. The challenge is therefore to either reduce the level of perceived and real risk or to increase the returns.
2. **Markets not functioning efficiently.** Local financial markets in emerging and frontier economies are often at a much earlier stage of development than in developed countries. They often lack the infrastructure, expertise, deep pools of capital and seamless connection of supply to demand required for efficient functioning. For example, bond and equity markets are often under-developed and illiquid, introducing high uncertainty about whether investors will be able to exit the investment

and receive their money back. Also, while institutional investors usually require that investment managers have a verifiable history of positive returns, many local fund managers are new and do not have sufficient experience to demonstrate results. Finally, only a limited number of financial institutions have the structuring expertise needed to package the financial and non-financial solutions appropriate for countries and sectors of high potential development impact. The resulting shortage of scalable, standardised, investable products limits the ability to effectively connect supply of capital to demand, and to efficiently access capital markets.

3. **Knowledge and capability gaps of private investors.** In many cases, private capital providers lack in-depth understanding of emerging and frontier markets; they may also lack the sector-specific expertise (particularly related to development) needed to accurately assess risk and make informed investment decisions. This increases the cost of investment and reduces the likelihood of success. Limited understanding of local business practices when structuring and executing investments, as well as limited market data (including historical financial returns) on which to base investment decisions, further widen the knowledge gap. Finally, private investors and fund managers may be unfamiliar with the challenges involved in assessing the development impact of investments.
4. **Limited mandates and incentives to invest in sectors or markets with high development impact.** Private sector investors often do not have the explicit mandate – or the flexibility – to invest in emerging and frontier economies and/or in sectors that have potential for social, environmental and economic impact. With the high competition for capital in global markets across geographies and sectors, the lack of a clear directive can block such investments.
5. **Difficult local and global investment climates.** The lack of strong, transparent local regulatory and legal systems in emerging and frontier markets is a significant deterrent to private capital flows (see Chapter 2). Capital controls, tax barriers, labour policies, inconsistent tariffs and visa challenges reduce the attractiveness of investment by adding to the complexity of transactions and the difficulty of realising returns. These limiting factors are amplified by risks associated with fluctuating exchange rates and local currencies, lack of liquidity in local capital markets and political instability. Certain regulatory policies in developed markets have also affected the ability of their private capital providers to transact in emerging and frontier economies. For example, since 2008 many global banks have reduced their presence in emerging and frontier markets because a tightening of policies (e.g. Basel III⁸) has raised the cost of long-term and risky lending. While not an intended consequence, these policies have created a capital shortfall in critical sectors, including infrastructure, clean energy and local currency lending.

Blended finance can help diversify skills and resources for development

Blended finance can help to overcome many of these obstacles. It offers new and exciting opportunities for providers of development finance and philanthropic funders to work with private investors on identifying and supporting key investment opportunities in the developing world (Box 3.1). It can enhance the impact of limited philanthropic and development resources, using those funds to tap into the trillions of dollars of private capital available in global markets through three key functions:

1. **Leveraging capital** by reducing risks and guaranteeing investments, or by supplementing private investment with grant financing to create incentives for the private sector.
2. **Enhancing impact** by bringing into play skillsets, knowledge and resources dedicated to development.
3. **Increasing returns in line with expectations** by helping to improve the investment climate in key markets.

Box 3.1. Innovative private financing in Sudan

Irrigation is critical to the Sudanese economy. The country has one of the largest irrigated areas in Africa – close to 2 million hectares, with the potential to reach 2.78 million hectares – and the agriculture sector employs 80% of the country's workforce, contributing 30% of its GDP.

Yet in spite of this potential, irrigation intensity figures in Sudan have been consistently low over the past three decades and have resulted in crop yields far below the potential. A myriad of institutional, policy and legislative factors have contributed to this situation. To begin with, liberalisation/privatisation policies, applied in haste and without due consideration of the conditions required to make such policies successful, have contributed to a decline in performance. An unbalanced shift to hydro-generation projects has resulted in lack of funding for the operation and maintenance of the existing irrigation infrastructure. And finally, these problems have been exacerbated by limited government capacity in co-ordination, strategic planning, and water and land legislation and governance, as well as by limited transparency regarding the problems that have plagued the sector.

Historically, financing for irrigation operation and maintenance in Sudan was underwritten by a combination of irrigation fees collected from farmers and government subsidies. During the 1980s and into the mid-1990s, however, the collection of irrigation fees declined; this, together with a reduction in funding resulting from liberalisation/privatisation policies adopted in 1995, led to the deterioration of storage (dams) and irrigation infrastructure. As tariffs and subsidies failed to cover the costs of maintaining and operating the irrigation infrastructure, cropping intensity and yields dropped.

In 2005, the government began to open up to the private sector the rehabilitation of existing small-scale pump irrigation schemes in the River Nile and northern states, aiming to turn their management over to corporate entities (a private sector delegation approach). The first such entity – Al-Shamil – was formed in 2006 with 21% minority participation by the federal and state governments and 79% participation by private sector funds. The company took on a total of 11 projects with responsibilities that included providing irrigation water to farmers, collecting water fees and operating the irrigation infrastructure, including its routine maintenance. The state retained responsibility for major maintenance and overhaul work.

The Al-Shamil project has proved to be acceptable, affordable and in line with the government's privatisation policy. Accountability is built into the project through production councils that monitor its activity. With fees being collected by a private entity rather than the government, there has been a change in the perception of water as a free resource, which has improved farmers' willingness to pay; this in turn has reduced levels of farmer migration and contributed to the development of stable farmer communities. Collection levels increased from 50% in 2006 (the maximum achieved in other areas of the country to date) to an average of 70% in 2011/12. These improved collection rates indicate that the fees are affordable, and have also helped to resolve previous operation and maintenance issues.

Source: ADB (2012), "Strategic financing framework and innovative financing mechanisms in the water sector in African countries: Sudan irrigation sub-sector", African Development Bank, pp. 4-38.

Investors express a range of benefits from partnering with public institutions. They note that blended finance mechanisms help to effectively overcome many of the barriers referred to in the previous section by:

- reducing costs
- adding liquidity and exit opportunities
- demonstrating or enhancing commercial viability of new products, projects or markets
- creating credit-quality and institutional-grade investments
- sharing local market knowledge
- providing access to local networks and partners

- improving the overall regulatory environment, investment climate and ease of doing business
- improving the terms for borrowers in emerging and frontier markets.

By offering these benefits, development finance institutions and foundations can mobilise additional sources of finance for development, increase the impact of their own investments and accelerate progress towards the SDGs (Box 3.2).

Box 3.2. A fund that has proved its efficacy in providing development impact

The European Fund for Southeast Europe was initiated by the KfW Development Bank in 2005 with the financial support of the German Federal Ministry for Economic Cooperation and Development (BMZ) and the European Commission. It fosters economic development in Southeast Europe and the European Eastern Neighbourhood through the sustainable provision of development finance, notably to micro and small enterprises and to private households, via qualified financial institutions. Since its inception, investments by the fund in 16 countries have enabled more than 660 000 micro and small enterprises to access much-needed credit. As the global economic crisis has not yet come to an end, the fund's mission, and its role as an example of a successful public-private partnership, are more important than ever.

With EUR 358 million in public resources, the fund has leveraged twice that amount in private funding by tailoring capital investment opportunities to the needs of diverse investors. Depending on the desired risk-return profile, options range from first loss capital (junior shares) for public investors to more senior capital tranches (notes) for private investors. The junior shares serve as a risk cushion, in the sense that these are the first funds to be depleted in case of investee default; public investors are also the last to benefit from income distribution. Note holders, on the other hand, are the first in line to receive returns and they have the highest risk protection.

The fund's approach to corporate governance also contributes to its success. It integrates professional service providers – such as fund managers and advisors or fund administrators – for day-to-day management, in addition to a Board of Directors and an Investment Committee constituted by seasoned professionals from the international finance institutions that invest in the fund.

Last but not least, the fund pairs investment with technical assistance offered to partner financial institutions by its Development Facility. This strategy has consistently proved its efficacy in maximising development impact and outreach.

Contributed by Sylvia Wisniwski, Managing Director, Finance in Motion GmbH, Investment Adviser of the European Fund for Southeast Europe.

Blended finance is not intended to replace ODA.

It is important to note that blended finance is not intended to replace ODA, provide excessive subsidies to private capital, crowd out the financial sector or completely eliminate risk in a transaction. Rather, blended finance helps facilitate risk-taking at acceptable levels to encourage investment without distorting functioning markets. Some of the particular advantages development funders have in making blended finance work include:

- **Flexible capital.** Development funders can assume exposure to greater potential risk and forego commercial returns in exchange for development impact. Similarly, they can improve project financial viability by offsetting high up-front transaction costs.
- **Local market knowledge and experience.** Development funders can use their local expertise and presence to help bridge investor knowledge gaps, leveraging their local partners and networks to support successful transactions (Box 3.3).

Box 3.3. Financing local needs in sub-Saharan Africa

Since its inception in 1999, the Islamic Corporation for the Development of the Private Sector (ICD) – a member of the Islamic Development Bank Group – has promoted the development of the private sector in its member countries as a means of contributing to inclusive growth and poverty reduction. The ICD establishes local subsidiaries to act as its “financial channels” so as to gain proximity to target communities and yield deeper customer insights.

In June 2009, in Senegal, it created Tamweel Africa Holding, of which 60% is owned by the ICD. Tamweel Africa Holding currently comprises four local banks – in Guinea, Mauritania, Niger and Senegal – which mainly serve small and medium enterprises. One of these four banks – the Islamic Bank of Mauritania (BIM), with paid-up capital of USD 25 million – is a fully owned Tamweel subsidiary. After three years of operations, it has provided financing to more than 100 small and medium enterprises in Mauritania for a total of USD 34.5 million. The bank’s investment strategy addresses the economic, social and environmental needs of the local community, covering key sectors in the Mauritanian economy, including fishing, construction, telecommunications, education and industry. The BIM directly employs 61 full-time workers, of which 29 are women, and has contributed to the creation of more than 1 500 jobs. Twelve of the enterprises financed by the bank contribute to the country’s foreign currency inflows through exports of their products.

Another one of the BIM’s clients, the Burj El Ilm private school established in 2005, provides quality primary and secondary education for the inhabitants of Nouakchott, Mauritania’s capital. With a total student body of 1 750 spread across five different locations, the school’s students include some of the top performers nationwide. In 2014, the school’s success rates in exams were 96% (elementary), 100% (middle school) and 68% (high school baccalaureate) compared to 50%, 30% and 30% respectively on the national level. Its high school graduates continue their tertiary education in universities worldwide, including in Canada, France, Morocco, Tunisia, Turkey and the United States. The school offers merit and need-based scholarships to orphans and other qualifying students as part of its social contribution to the local community. It employs 232 teachers, 75% of whom are locals.

Source: Islamic Corporation for the Development of the Private Sector (ICD), Member of the Islamic Development Bank Group.

- **Local capacity development.** Development funders can finance specialised strategic, financial and technical advisory services that may be required in local markets; for example, training for small and medium enterprises in preparing and managing balance sheets.
- **Policy and regulatory reform.** Development and philanthropic actors undertake many activities that directly support improvements to the local investment climate in emerging and frontier markets, including in procurement processes and the preparation of strategic investment plans.

Development funding provided to a project or enterprise through blended finance instruments (Table 3.1) helps to overcome barriers in emerging and frontier markets at the following stages of the investment life cycle:

- **preparing** – reducing uncertainty and high initial costs before commissioning a project
- **pioneering** – helping to reduce failure rates and transaction costs associated with high-risk enterprises or projects that are experimenting with, testing and piloting new business approaches
- **facilitating** – deferring or improving returns to encourage investments with high expected development impact but limited commercial returns
- **anchoring** – crowding in private capital
- **transitioning** – providing a cultivated pipeline that meets the needs of private investors to source mature transactions and deploy capital at scale.

Table 3.1. **Blended finance instruments**

Instrument	Description
Grants	A financial award with no expected repayment or compensation over a fixed period of time.
Guarantees	Protection from various forms of risk intended against capital losses for investors.
Debt	Money lent for repayment at a later date, usually with interest: <ul style="list-style-type: none"> • <i>Market rate debt</i>, when rates and terms are determined based on capital market prices and tenors, but can be subordinate to senior debt (i.e. mezzanine). • <i>Flexible (concessional) debt</i>, with favourable terms or rates for the borrower relative to market pricing.
Equity	Ownership in a company – value determined at time of investment: <ul style="list-style-type: none"> • <i>Junior equity</i>, accepts higher risk for lower financial returns in exchange for social, environmental and economic impact, typically in a position to take the first losses.

Source: OECD/WEF (2015a), “Blended finance Vol. 1: A primer for development finance and philanthropic funders”, September, OECD, Paris and World Economic Forum, Geneva, www3.weforum.org/docs/WEF_Blended_Finance_A_Primer_Development_Finance_Philanthropic_Funders.pdf.

What is needed to achieve the potential of blended finance?

If it is to accelerate social and economic progress towards the SDGs, blended finance needs to be scaled up. To achieve its potential, development funders must actively commit to mainstreaming the blended finance approach in a systematic way (see the “In my view” box by LI Yong). This requires embracing some fundamental changes:

- **Awareness and common language:** Using a common blended finance lexicon is essential to facilitate relationship building with the private sector, speed up investment processes, improve transaction times and lower costs.
- **Analytics and education:** Analysing the effectiveness of various blended finance models and documenting good practices can inform approaches to future financing deals. Communicating these insights to a wide audience can increase the number of actors using blended finance.
- **Institutional readiness:** Defining clear mandates and strategies for engaging private sector investors to achieve development goals, and ensuring appropriate resources and capabilities are in place, are essential for scaling up blended finance.
- **Partnerships:** Developing relationships with funders and investors that possess similar development goals, as well as complementary investment goals, can help to identify investment structures and products that will work for all partners.
- **Alignment of impact expectations:** Standardising metrics can enable measurement of outcomes and impact from blended finance across different sectors. Impact targets must be reasonable: if targets are too onerous and costly in terms of time and funding, private capital may not invest.
- **Consolidation of the market:** Developing unified platforms to bring together public funders and private investors can reduce fragmentation and duplication of effort while lowering costs and building transparency.
- **Recognition of private sector incentives and needs:** Addressing the objectives of private capital is fundamental, as these partners will not invest if asked to compromise between risk-adjusted returns and development impact.

Although blended finance instruments are enjoying increasing popularity, they can involve some potential risks. To mitigate these, a number of actions need to be taken:

- **Financial incentives need to be balanced with development objectives.** Using development finance and philanthropic funds to leverage private sector investment in support of projects with limited development outcomes can be a poor use of funds.

In my view: Well-structured public finance can align profit and sustainability aspirations

LI Yong,

Director-General, United Nations Industrial Development Organization

The ambitious global commitment to pursue inclusive and sustainable paths of development – outlined in the 2030 Agenda for Sustainable Development – comes at a moment that does not admit any further delay. The economic, environmental and social challenges we face are enormous and must be addressed today, before climate change, demographic pressures, fragile security situations and other unsustainable global trends take their unbearable toll on all of us.

At the same time, this agenda unveils a new set of opportunities for investments to yield unprecedented levels of economic and social dividends, provided that the appropriate co-ordination mechanisms and instruments are put in place.

This means rethinking the role of official development assistance (ODA) to increase its efficiency and impact as an international public investment tool. It means making it more co-ordinated, catalytic and targeted as an instrument for attracting additional public and private investments for the transformation we all strive to achieve. Public finance will need to focus on initiatives that can drive progress on the SDGs, bringing into play the necessary industries – with their investments and their knowledge – thus generating a virtuous circle of further investment, innovation, structural transformation and technological upgrades.

Driving the structural transformation required to increase the domestic tax base and achieve the SDGs also means targeting public finance to strengthen the institutional infrastructure and capacities of developing countries and regions to implement their own industrial policies and activities.

Environmental sustainability offers important opportunities for investment and technological exchange among “green industries” worldwide. The development of cleaner production technologies and the adoption of healthier and more equitable production-system practices will provide significant returns in terms of both private and social benefits.

Mitigating food insecurities or health risks offers similar opportunities, for example by attracting responsible agro-industrial investments or promoting partnerships with medical industries.

International public investment in inclusive and sustainable industrialisation should aim at supporting small and medium enterprises – including building their trade capacities, which tend to be the backbone of developing and industrialised economies alike. It should contribute to localising or integrating value chains to provide equitable distribution of added value, boost income generation, increase purchasing power and strengthen the domestic tax base.

Finally, public investment should provide incentives for the formalisation of jobs and the development of entrepreneurial skills, particularly for women.

In my view, the objective of ODA-based international public investment should be to strengthen institutional infrastructure at all levels so as to enable economies to flourish, acting as a catalyst for further responsible, sustainable investment into key industrial sectors.

Such a structured approach to international public investment can ultimately raise the trillions we require for implementing the SDGs and for shaping the next era of globalisation.

There are already some success stories to be shared. For example, in 2014 the government of Ethiopia and the United Nations Industrial Development Organization (UNIDO) launched an initiative aimed at achieving higher levels of inclusive and sustainable industrial development by attracting public and private investment around a government-owned industrial strategy. The Programme for Country Partnership (PCP), as this successful model is called, is founded on several essential elements: policy alignment, focused investment, technical co-operation and an inclusive approach to ensure ownership. After only two years, the programme is yielding impressive results, including the set-up of national structures for PCP governance and monitoring, completed feasibility studies for integrated agro-industrial parks, and mobilisation of several investors for infrastructure development. Major private investments have been made in industries that are key to Ethiopian competitiveness, such as agro-food processing, textiles and apparel, and leather and leather products. Examples include the establishment of an environmentally friendly leather industrial zone in the country and the mobilisation of soft loan programmes for agro-food industrial and rural infrastructure.

A similar programme between UNIDO and Senegal, launched at the same time, also offers a promising outlook. Among other successes, the PCP Senegal has developed an incentive package and business plan for the country's first integrated industrial platform. The first garment factory is expected to start operations in March 2016. Also in 2016, the PCP model is being expanded to Peru, demonstrating its applicability and effectiveness in middle-income countries as well.

Examples like these show that we are taking steps in the right direction. Legitimate profit interests are aligning with sustainability aspirations at many levels. But innovative approaches are required to systematise and scale up these initiatives.

- **Care needs to be taken not to crowd out private financing and cause market distortion.** Crowding out occurs when development funders invest in a project that would have been commercially viable, or that could have attracted full private sector financing without any public support. In these cases, not only is scarce donor funding perceived as being misspent; markets may also be distorted, undermining the development of a healthy private sector.
- **Transparency needs to be ensured while protecting commercial confidentiality.** Transparency is important in all areas of development finance and, many would argue, particularly so where development finance and/or philanthropic funds are used to subsidise and leverage private investment. Blended finance processes create a unique set of challenges to full transparency – in particular because of private sector needs for commercial confidentiality. Development funders need to strike the balance between accountability for their resources and the impact they have, and the confidentiality needs of private investment partners.
- **Demonstration effects need to be managed.** When projects and companies do not succeed because of factors such as lack of political support, or the application of the wrong model or funding mechanism, the demonstration effect can be negative, discouraging private investors from further involvement in the sector or even the country.

The way forward for blended finance

Development co-operation agencies, development finance institutions and foundations are clearly looking for opportunities for more catalytic ways to engage with the private sector. Blended finance has the potential to become a transformative tool for future development efforts and to serve as a major pillar of the sustainable development financing framework. There is growing momentum in support of blended finance as a systematic, ecosystem approach, with a range of development funders already showing strong political will and allocating funds to innovative financing mechanisms.

To contribute to realising this potential, the World Economic Forum and the OECD have established the ReDesigning Development Finance Initiative (OECD/WEF, 2013). This initiative creates strategic links among development, investor and philanthropic resources to promote the use of blended finance to deliver social impact through sustainable, investable, scalable enterprises and projects (Box 3.4). One outcome of this initiative – the Blended Finance Toolkit (comprising the reports “Blended finance Vol. 1: A primer for development finance and philanthropic funders” and “A how-to guide for blended finance”; OECD/WEF, 2015a; 2015b) – outlines practical steps development funders can take to make good use of blended finance.

Blended finance is currently at a pivotal juncture. It has evolved from a niche activity to a mainstream focus of development finance, offering the potential for development funders to address some of the world’s most pressing challenges. A recent survey of blended finance funds and facilities identifies 74 pooled public and private funds, accounting for a total of USD 25.4 billion in committed assets (OECD/WEF, 2016). These funds are already having an impact in sectors such as climate resilience and clean energy, financial services, food and agriculture, healthcare and infrastructure.

Nonetheless, as Gavin E.R. Wilson points out in his challenge piece at the beginning of this chapter, it is important not to let the enthusiasm for blended finance lead development partners to overlook other financial approaches that may be more appropriate in a given circumstance – and may not require public funding. He also flags the need to avoid encouraging competition with each other for risk-mitigation instruments, encouraging a “race to the bottom”. For blended finance to fulfil its potential in helping to accelerate sustainable and social economic progress towards the SDGs, however, it needs to be scaled up. The approaches outlined in this chapter provide a framework for how institutions can address risks and create incentives to accommodate the investment goals of private sector capital while achieving development objectives.

Box 3.4. The Sustainable Development Investment Partnership

Hydropower projects in Nepal or solar power plants in Mali should be good for business, people and the planet. But all too often, the market fails to match supply with demand. At the Third International Conference on Financing for Development in Addis Ababa (2015), the World Economic Forum and the OECD launched the Sustainable Development Investment Partnership (SDIP).*

The partnership promotes co-operation among commercial investors, governments, development agencies and development banks from both developing and developed countries, combining its members' assets and capabilities. The partners work together to mobilise private sector investment, share existing tools, and develop new tools and financing models. By expanding the use of blended finance to support sustainable infrastructure in developing countries, the SDIP aims to mobilise USD 100 billion in private financing over the next five years. Using a sustained, co-ordinated approach, it aims to deliver the scale, speed, transaction efficiency and risk mitigation necessary to close existing viability gaps. The ultimate goal is to support inclusive growth and poverty alleviation through commercially feasible projects in areas such as water and sanitation, transportation, clean energy, agriculture, health and climate adaptation.

* See: www.sdiponline.org.

The time is right for development funders to take bold action.

The time is right for development funders to take bold action and actively commit to embracing the blended finance approach in a mainstream and systematic way.

Key recommendations for scaling up blended finance

- Recognise private sector incentives and needs and balance financial incentives with development objectives.
- Use a common blended finance lexicon to facilitate relationship building with the private sector.
- Develop relationships among funders and investors with complementary development and investment goals.
- Develop unified platforms to bring together development funders and private investors.
- Ensure clarity on the roles of development funders and private actors.
- Identify standardised, scalable investment structures and products.
- Make sure appropriate resources are in place.
- Take care not to crowd out private financing and promote market distortion.
- Set reasonable impact targets; standardise metrics and measures of impact across sectors.
- Analyse the effectiveness of different blended finance models and aggregate best practices; communicate these insights to a wide audience.
- Take a structured approach to public investment using innovative approaches to systematise and scale up successful initiatives.
- Manage demonstration effects so as not to discourage private investors from further involvement in a given sector or country.

Notes

1. This chapter uses the term “emerging markets” to refer to developing country markets in general.
2. Blended finance is the use of development finance and philanthropic resources to mobilise private capital at scale so as to deliver risk-adjusted returns and economic progress across a range of sectors and countries while ensuring significant development outcomes.
3. For the purposes of this chapter, emerging and frontier markets refer to countries included in the OECD “DAC List of ODA Recipients (2014-16)” at: www.oecd.org/dac/stats/documentupload/DAC%20List%20of%20ODA%20Recipients%202014%20final.pdf.
4. Calculation based on IMF (2014), at purchasing power parity exchange rates.
5. Emerging market economies’ saving rate increased significantly between 2000 and 2007, driving down interest rates; this increase is expected to be only partly reversed. At the same time, there is a rising demand for risk-free assets as a result of increased accumulation of foreign exchange reserves in the emerging market economies and an apparent rise in the perceived riskiness of equities relative to bonds. Finally, the decline in investment rates in advanced economies as a result of the global financial crisis is likely to persist.
6. MSCI data.
7. See the 2011 Busan Partnership agreement, at: www.oecd.org/development/effectiveness/busanpartnership.htm.
8. “Basel III” is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to: improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; strengthen banks’ transparency and disclosures. See: www.bis.org/bcbs/basel3.htm?m=3%7C14%7C572.

References

- ADB (2012), “Strategic financing framework and innovative financing mechanisms in the water sector in African countries: Sudan irrigation sub-sector”, African Development Bank, pp. 4-38.
- ADB et al. (2015), “From billions to trillions: Transforming development finance post-2015 financing for development: Multilateral development finance”, *Development Committee Discussion Note*, 2 April, prepared jointly by the African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the Inter-American Development Bank, the International Monetary Fund and the World Bank Group, [http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23659446/DC2015-0002\(E\)FinancingforDevelopment.pdf](http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23659446/DC2015-0002(E)FinancingforDevelopment.pdf).
- Bank for International Settlements (2014), *BIS Quarterly Review: December 2014*, Bank for International Settlements, www.bis.org/publ/qtrpdf/r_qt1412.pdf.
- Canada, H. (2015), “5 things happening in emerging markets private equity”, online article, *The Wall Street Journal*, 10 February, <http://blogs.wsj.com/briefly/2015/02/10/5-things-happening-in-emerging-markets-private-equity>.
- Dealogic (2015), *M&A Analytics* (database), www.dealogic.com/investment-banking/ma-analytics.
- Dobbs, R. et al. (2013), “Infrastructure productivity: How to save \$1 trillion a year”, McKinsey Global Institute, www.mckinsey.com/insights/engineering_construction/infrastructure_productivity.
- IIF (2014), “Capital flows to emerging market economies (October 2014)”, Institute of International Finance, Washington, DC, www.iif.com/publication/capital-flows/october-2014-capital-flows-emerging-market-economies.
- IMF (2015), “World economic outlook update”, January, International Monetary Fund, Washington, DC, www.imf.org/external/pubs/ft/weo/2015/update/01/index.htm.
- IMF (2014), *World Economic Outlook: Recovery Strengthens, Remains Uneven*, International Monetary Fund, Washington, DC, www.imf.org/external/Pubs/ft/weo/2014/01.
- Kharas, H., A. Prizzon and A. Rogerson (2014), “Financing the post-2015 Sustainable Development Goals: A rough roadmap”, Overseas Development Institute, London, www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9374.pdf.
- Kim, Jim Yong (2015), “Ending extreme poverty by 2030: The final push”, speech by World Bank Group President Jim Yong Kim, 7 April, Center for Strategic and International Studies, Washington, DC, www.worldbank.org/en/news/speech/2015/04/07/speech-by-world-bank-group-president-jim-yong-kim-ending-extreme-poverty-final-push.
- Lagarde, C. (2016), “The role of emerging markets in a new global partnership for growth”, speech by Christine Lagarde at the University of Maryland, 4 February, International Monetary Fund, www.imf.org/external/np/speeches/2016/020416.htm.

- OECD (2014), *Development Co-operation Report 2014: Mobilising Resources for Sustainable Development*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/dcr-2014-en>.
- OECD/WEF (2016), “Insights from blended finance investment vehicles and facilities”, OECD, Paris and World Economic Forum, Geneva, www3.weforum.org/docs/WEF_Blended_Finance_Insights_Investments_Vehicles_Facilities_report_2016.pdf.
- OECD/WEF (2015a), “Blended finance Vol. 1: A primer for development finance and philanthropic funders”, September, OECD, Paris and World Economic Forum, Geneva, www3.weforum.org/docs/WEF_Blended_Finance_A_Primer_Development_Finance_Philanthropic_Funders.pdf.
- OECD/WEF (2015b), “A how-to guide for blended finance”, OECD, Paris and World Economic Forum, Geneva, www3.weforum.org/docs/WEF_Blended_Finance_How_To_Guide.pdf.
- OECD/WEF (2013), “ReDesigning development finance”, OECD, Paris and World Economic Forum, Geneva, www3.weforum.org/docs/WEF_ReDesigningDevelopmentFinance_Overview.pdf.
- Pelosky, J. (2014), “Emerging markets portfolio globalization: The next big thing”, online article, *Pensions & Investments*, 17 July, www.pionline.com/article/20140717/ONLINE/140719890/emerging-markets-portfolio-globalization-the-next-big-thing.
- Sachs, J. (2014), *Financing Sustainable Development: Implementing the SDGs through Effective Investment Strategies and Partnerships*, United Nations Sustainable Development Solutions Network (UNSDSN), http://unsdsn.org/wp-content/uploads/2014/11/Full-FSD-draft-for-public-consultation_clean.pdf.
- Sachs, J., G. Schmidt-Traub and A. Shah (2015), “Six financing priorities for Addis”, online article, United Nations Department of Economic and Social Affairs, New York, www.un.org/esa/ffd/ffd3/blog/six-financing-priorities-for-addis.html.
- UN (2015), *Transforming our World: The 2030 Agenda for Sustainable Development*, United Nations, New York, <https://sustainabledevelopment.un.org/post2015/transformingourworld/publication>.
- UNCTAD (2014), *World Investment Report 2014: Investing in the SDGs: An Action Plan*, United Nations Conference on Trade and Investment, Geneva, http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf.
- UNCTAD (2012), “Development and globalization: Facts and figures (2012)”, United Nations Conference on Trade and Investment, Geneva, http://unctad.org/en/PublicationsLibrary/webgdsdsi2012d2_en.pdf.
- World Bank (2012), *Global Development Finance: External Debt of Developing Countries*, The World Bank, Washington, DC, <http://data.worldbank.org/data-catalog/global-development-finance/gdf-2012>.



From:

Development Co-operation Report 2016

The Sustainable Development Goals as Business Opportunities

Access the complete publication at:

<http://dx.doi.org/10.1787/dcr-2016-en>

Please cite this chapter as:

Samans, Richard (2016), "Blending public and private funds for sustainable development", in OECD, *Development Co-operation Report 2016: The Sustainable Development Goals as Business Opportunities*, OECD Publishing, Paris.

DOI: <http://dx.doi.org/10.1787/dcr-2016-9-en>

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.