BLENDED FINANCE IN FRAGILE CONTEXTS:
OPPORTUNITIES AND RISKS

Irene Basile and Carolyn Neunuebel
Working paper

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Abstract

The development community agrees on the need to address conflict and fragility for global security and sustainable development. In such complex situations, that are highly interconnected and often unpredictable, programming should strive to include multiple actors at various levels of society. Although the use of private investment in fragile contexts has so far been low, in fear of exploitation and further institutional weakening, the need to address the SDG funding gap makes innovative and more flexible financing methods worth considering. While the use of ODA will remain critical to development, particularly in fragile contexts, blended finance can help enlarge the total resources available for development.

In order to assess the linkages and potential for implementing blended finance in fragile and conflict-affected contexts, this paper analyses the OECD DAC statistics on amounts mobilised from the private sector by official development finance interventions, from 2012 to 2017, against the multidimensional lens presented in the OECD 2018 States of Fragility Framework. The data shows a positive relationship between blending opportunities and economic, political and environmental security. The amounts of private finance mobilised in 2012-2017 increase, as a country’s economic, political and environmental fragility decreases. The way blended finance interplays with societal fragility and security remains unclear, as these two dimensions exert more complex influence on the trade-off between perceived risks and anticipated returns, which typically guides private investors.
Executive summary

The development community agrees on the need to address conflict and fragility for global security and sustainable development. Peace is a global public good, the focus of the 16th Sustainable Development Goal and a cross cutting ambition of the 2030 Agenda.

Spurring virtuous, sustainable and peaceful growth in fragile contexts is even more crucial, considering that they represent almost a quarter of the global population. In such complex and unpredictable situations, development co-operation must consider the full range of tools available and strive to include multiple actors at various levels of society. Hence, the growing volume of cross-border private capital flows cannot be overlooked.

Despite growing recognition, blending is often omitted in development co-operation strategies to address fragility

The multilateral scene has broadly acknowledged the need to catalyse private capital, not only for development, but also for peacebuilding. Yet, national strategies for addressing fragility often bear no specific reference to the role of private investors. Those that do, often focus on capacity building and private sector development. Only a few strategies explicitly identify the private sector as a potential source of additional funding in fragile contexts.

Certain multilateral development banks have adopted an explicit focus on mobilising additional private finance, commensurate to the presence of fragile and conflict situations. Most bilateral development finance institutions limit their interventions to private sector development and only a minority has explicitly committed to mobilising private finance in fragile contexts.

In practice, blending in fragile contexts is led by multilaterals and few donors

Out of the USD 157 billion in private finance mobilised for development from 2012 to 2017, less than a fifth (i.e. USD 28.8 billion) went to contexts considered as fragile. As for all developing countries, most of the private finance was mobilised through a multilateral channel (over 60% of the USD value). In absolute terms, the World Bank Group is the largest multilateral player, accounting for over a third of all private finance mobilised in fragile settings.

Bilateral blending is driven by a few donors. The highest volume of private finance mobilised to fragile contexts was reported by the United States and France, respectively at USD 6.3 billion and USD 2.5 million from 2012 to 2017. They also figure among the top bilateral mobilisers across all developing countries, together with the United Kingdom.

Blending opportunities are influenced by risk perceptions and income levels

Less private investment in fragile contexts is to be expected, as risks are one of the main factors in investment allocations. On average, blended finance deals in more stable developing countries mobilised more than double the volume reported in fragile settings, with USD 42 million of private finance mobilised per operation compared to USD 15 million. This speaks to the more careful engineering required and the smaller ticket size that can be achieved in those contexts, along with development results. Those countries
where no mobilised private finance was reported scored significantly worse across all fragility dimensions.

In general, opportunities for blending increase with national income: 73% of all private finance mobilised in fragile settings was deployed in middle-income countries (MICs), such as Nigeria, Pakistan, Egypt and Kenya. The level of domestic income will also influence the average amount of private finance mobilised and its origin. When blending in fragile least developed countries (LDCs), more private money could be raised per deal from the domestic economy, rather than from the donor country. This might be attributable to risk misperceptions by private investors in cross-border transactions.

**Official development finance and private finance mobilised follow complementary patterns**

There does not appear to be a very strong relationship between how much official development assistance (ODA) is provided to a fragile country and the private finance it can mobilise. ODA is more prominent in LDCs and low-income countries, whereas private finance mobilised is more concentrated in MICs. This is true in fragile contexts as well as for all developing countries. Blending opportunities tend to materialise with other official development finance flows.

As for all developing countries, private capital tends to flow towards sectors with clearer revenue streams (Energy, Industry, Mining, Construction and Banking & Financial Services). While blended finance can potentially be deployed in all areas, country-programmable development assistance might be more appropriate in social sectors, whilst the most immediate opportunities for private investors lie on infrastructure development, rather than service provision.

**Opportunities for blending increase with economic, environmental and political stability**

To better understand the interplay between fragility and blending, authors compare the OECD statistics on private finance mobilised by official development finance from 2012 to 2017 with the OECD 2018 States of Fragility Framework. The data show that higher amounts of private capital were mobilised in countries described as more economically, environmentally and politically stable. Societal fragility and security, instead, did not bear a decisive influence on the amounts of private finance mobilised during those six years.

Significant economic growth is a key catalyst for investors, which explains the concentration of private capital mobilised in middle-income markets. Rule of law and fiscal regime are important constraints faced by investors when entering frontier markets. Access to human capital is another pressing issue for international investors and local entrepreneurs alike. Natural threats, famine, food insecurity and price volatility stifle the local agricultural industry.

Because each fragility dimension is a composite indicator, it is impossible to pinpoint a direct causal relationship between the two datasets. However, private finance mobilised in development co-operation is not equally sensitive to all dimensions of fragility. Contextual knowledge is critical to assess risks and select the most appropriate instruments and partners.
Ultimately, blending efforts must rest on continued support to the enabling environment

Despite its promising potential, blending remains a relatively selective aid modality, which cannot address all the SDG financing needs, particularly in fragile settings. Sustainable development in fragile contexts requires the presence of strong institutions, committed to improve the ease of doing business, attract foreign investment and spur domestic private sector growth. Ultimately, a strong local private sector is major component of a healthy civil society, and as such will contribute to public accountability in the peace and state-building process.

The investment, business and labour market framework are critical, not just for the concretisation of blended operations, but also for their sustainability in the long run. Poor regulation leaves way to predatory behaviour. Therefore, the use of private finance in development co-operation requires tighter safeguards and monitoring.

Donor support to policy reforms for private sector development, as a long term driver for sustained peace, should underpin all other catalytic aid approaches, especially in fragile contexts. Development finance providers have a crucial role to play in informing risk perceptions, building mutual trust, promoting the quality of investment and responsible supply chains.
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Abbreviations and acronyms

ADB  Asian Development Bank  
AFD  Agence Française de Développement  
AfDB  African Development Bank  
AIIB  Asian Infrastructure Investment Bank  
BMZ  Federal Ministry for Economic Cooperation and Development (Germany)  
CDC  Commonwealth Development Corporation  
CDD  Community Driven Development  
CIV  Collective Investment Vehicle  
CSPPS  Civil Society Platform for Peacebuilding and Statebuilding  
DAC  Development Assistance Committee  
DEG  German Investment Corporation  
DG DEVCO  European Commission's Directorate-General for International Cooperation and Development  
DFI  Development Finance Institution  
DFID  UK Department for International Development  
EBRD  European Bank for Reconstruction and Development  
EC  European Commission  
EDFI  Association of European Development Finance Institutions  
EIB  European Investment Bank  
ESG  Environment, Social and Governance  
EU  European Union  
FDI  Foreign Direct Investment  
FMO  Netherlands Development Finance Company  
GDP  Gross Domestic Product  
IDA  International Development Association  
IDB  Islamic Development Bank  
IDPS  International Dialogue on Peacebuilding and Statebuilding  
IFAD  International Fund for Agricultural Development  
IFC  International Finance Corporation  
IFF  Illicit Financial Flow  
IFU  Investeringsfonden for Udviklingslande  
IMF  International Monetary Fund  
IIX  Impact Investment Exchange  
KfW  German Development Bank
LDC Least Developed Country
LIBOR London Interbank Offered Rate
LIC Low Income Country
LFI Local Financial Institution
LMIC Lower Middle-Income Country
MDB Multilateral Development Bank
MFI Microfinance Institution
MIC Middle Income Country
MIGA Multilateral Investment Guarantee Agency
MNC Multi-National Corporation
MSME Micro, Small and Medium-Sized Enterprise
ODA Official Development Assistance
ODF Official Development Finance
OeEB Oesterreichische Entwicklungsbank
OECD Organisation for Economic Co-operation and Development
OOF Other Official Flows
OPIC Overseas Private Investment Corporation
PBF UN Peacebuilding Fund
PPP Public-Private Partnership
PSD Private Sector Development
SDG Sustainable Development Goal
SME Small and Medium-sized Enterprise
SPV Special Purpose Vehicle
TCX Currency Exchange Fund
UK United Kingdom
UMIC Upper Middle-income Country
UN United Nations
UNDP United Nations Development Programme
US United States
USAID United States Agency for International Development
USD United States Dollar
XCF Extreme Climate Facility
1. Introduction

1.1. The urgency to address fragility to leave no one behind

The development community agrees on the need to address conflict and fragility for global security and sustainable development. Peace is a global public good, the focus of SDG 16 and a cross cutting ambition of Agenda 2030. The effects of conflict and fragility transcend borders, violating the human rights of those directly affected as well as causing huge population displacement and refugee flows, putting pressure on their host communities.

The OECD characterises fragility as “the combination of exposure to risk and insufficient coping capacity of the state, system and/or communities to manage, absorb or mitigate those risks” (OECD, 2016[1]). Development cooperation in fragile contexts can thus be approached from a preventive perspective, identifying fragility and strengthening institutions preventively, or with a reactive response, where actors become involved after a conflict occurs. While the ensuing actions may differ, with a development approach being applied to the former and a humanitarian approach to the latter, they are both inherently a response to weak societal trust and institutional failure.

The OECD States of Fragility Framework saw an increase in the total number of fragile contexts from 56 in 2016 to 58 in 2018, with the same 15 contexts still considered as extremely fragile. Somalia, South Sudan and Central African Republic confirmed their place as the top-three most extremely fragile contexts. Moreover, the average score of aggregate fragility increased since 2016, mostly due to increases in the environmental, security and societal dimensions (OECD, 2018[2]).

Spurring virtuous, sustainable and peaceful growth in these contexts is even more crucial, considering that they represent about 24% of the global population. If no action is taken, more than 80% of the world’s poorest people could be living in fragile contexts by 2030. (OECD, 2018[2]). The urgency is even higher considering that many are already lagging behind on their path to achieve the Sustainable Development Goals (SDGs). Of the 157 countries for which data on SDG progress are available, fragile contexts consistently rank in the lower third. The extremely fragile countries of the Democratic Republic of the Congo, Chad and Central African Republic are at the bottom of the rankings (OECD, 2018[2]).
There is no one single solution to addressing fragility and conflict. In such complex situations, that are highly interconnected and often unpredictable, programming should strive to include multiple actors at various levels of society (OECD, 2016[1]). On the multilateral scene, there is a wide and shared recognition of the growing need for flexible instruments when it comes to preventing violent conflict and sustaining peace (World Bank, 2018[3]). Although the use of private investment in fragile contexts has so far been low, in fear of exploitation and further institutional weakening, the need to address the SDG funding gap makes innovative financing methods worth considering. In this context, it is necessary to understand the timing and conditions along the development pathway whereby private mobilisation may successfully contribute to sustainability and resilience.
1.2. Private finance can no longer be overlooked as an additional resource for the SDGs, even in fragile contexts

The Sustainable Development Goals, the Addis Ababa Action Agenda and the Paris Agreement on Climate Change require innovative solutions to finance development results. Private finance plays an increasingly important role in bringing innovation, expertise and additional resources to help developing countries achieve the SDGs.

In this context, the growing volume of cross-border private capital flows cannot be overlooked. Good development support in fragile, at-risk and crisis affected contexts must consider and use the full range of tools available (OECD, 2016[4]), including using blended finance to attract commercial investors.

**Figure 1.2. External finance to fragile contexts, 2000-17**

- **Note**: The figures shown are current prices. Figures for official development assistance (ODA), other official flows (OOF) and private grants are based on OECD statistics and are net disbursements. ODA and OOF include outflows from bilateral and multilateral institutions; capital subscriptions are included in private grants. OOF flows were negative in 2006-2008, 2011, and 2014, and are given a null value in the graph. Private grants cover gross outflows from NGOs and civil society minus support received from the official sector. Remittances are in gross disbursements. Private capital flows include net FDI and portfolio investments.

**Source**: Estimates based on the OECD 2018 States of Fragility Framework, on OECD-DAC statistics and World Bank data on remittances and private capital flows.

While financing towards development outcomes can be increased via certain leveraging mechanisms, this should not imply a decrease in concessional giving. ODA grew steeply from 2004 to 2005 before turning to a relatively stable trend, hovering around USD 50 billion per year to fragile contexts, in current prices, for the next decade. In an increasingly interconnected world, and with spiking migratory pressure, remittances have become the most significant external flow, in terms of volume, to fragile and developing countries in general (above USD 130 billion in 2017). Yet, remittances are not evenly spread and there are obstacles to mobilising them for development purposes (OECD, 2014[5]). While driven by a significant upward trend from 2000 to 2008, private capital flows appear to be fairly volatile overall. Without considering the mobilisation of domestic sources, Figure 1.2 displays the pivotal role that ODA can play in fragile areas and gives a general idea of the potential for blended finance to steer additional capital towards the SDGs.
Box 1.1. Financing for stability in the post-2015 era

One of the most significant challenges that the international community faces is how to provide the right financing mix in fragile contexts. The recent OECD study and associated guidance delivered the following key messages on how to define financing strategies for fragile contexts (OECD, 2018[6]):

- The aspirations of the Addis Ababa Action Agenda require an updated approach to bringing together financial flows from public and private, and domestic and international sources. Nowhere is this more so than in fragile contexts with the greatest potential risks, and the greatest potential returns.
- The use of development finance to leverage or mobilise private sector investment is an area of growing interest, but in high-risk and low capacity fragile environments, a dose of realism and a cautious approach are required.
- Increased diversity in financing sources and actors brings risk and complexity as well as opportunity: new and revised norms, standards and codes of behaviour and practice are needed to reduce the risk of doing harm.
- Shifting towards an “investment” culture and practice for public and private finance in fragile contexts requires a major conceptual shift as well as reforms, upgrades and investments in the capacities of international financing actors.

The use of grants will remain critical to development, particularly in fragile contexts. Blended finance should be regarded as a means to enlarge the development finance available as well as ensuring sufficient grant funding is allocated to fragile contexts.

1.3. Blending as an additional tool for development cooperation

Blended finance is defined as “the strategic use of development finance for the mobilisation of additional finance towards development in developing countries” (OECD, 2018[7]). This practice is rapidly gaining traction among development finance providers, as 17 of the 30 DAC members already carry out blended finance activities and more donors are looking to enter this field.

According to the OECD DAC Blended Finance Principles for unlocking commercial finance for the SDGs, endorsed at the DAC High Level Meeting on 31 October 2017, development finance providers should:

1. Anchor blended finance use to a development rationale
2. Design blended finance to increase the mobilisation of commercial finance
3. Tailor blended finance to local context
4. Focus on effective partnering for blended finance
5. Monitor blended finance for transparency and results

These principles are imperative when implementing blended finance in fragile and conflict affected contexts, as fragility by nature amplifies the risk of causing inadvertent harm.
Additionally, the principles frame blending as a tool first and foremost for development objectives, although applications already exist in the humanitarian field. Development finance being a scarce resource, particularly if concessional, blending should be regarded as an alternative tool available for donors to implement their development co-operation strategy, but also for developing countries to implement their own development strategies. In order to harness more evidence which will ultimately inform the policy guidance on these Principles, the OECD Development Co-operation has undertaken a series of sectoral and geographical deep-dives. This working paper is hence accompanied by other studies looking at the implications of blended finance, for instance in least developed countries, (in partnership with the UN Capital Development Fund), on water and sanitation (with the OECD Environment Directorate) and on agriculture (with the IFAD Smallholder and Agri-SME Finance and Investment Network).

1.4. Methodology and scope

This paper draws upon two main sources: (1) OECD 2018 States of Fragility Framework (OECD, 2018[2]) and (2) the DAC statistics on amounts mobilised from the private sector by official development finance interventions (Benn et al., 2016[8]), in order to assess the linkages and potential for implementing blended finance in fragile and conflict-affected contexts. It builds on and further expands the financing for stability work, presented in OECD Development Policy Papers No. 10 (OECD, 2018[6]) and 11 (OECD, 2018[9]), in light of the recently updated OECD States of Fragility Framework and by integrating more in-depth quantitative analysis on the private finance mobilised dataset.

For the purpose of this paper, the private sector is intended as composed by commercial private actors, residing in OECD members, other high income countries and/or developing ones. This diverse group can be further unpacked into:

- Institutional investors (e.g. pension funds, insurance companies, investment funds, endowments or sovereign wealth funds),
- Other private asset managers (e.g. private equity funds, venture capital and Infrastructure funds, hedge fund),
- Commercial banks, corporations and SMEs.

The lens through which this investigation is conducted is how blended finance can be used as a strategic catalyst for growing the development finance pie in fragile settings (OECD, 2018[7]). While the uptake of blended finance need not necessarily change the portfolio of development or humanitarian programming, the spreading of additional tools requires a strategic review of the development finance package as a whole. In order to better factor blending opportunities into their programmatic decisions, development finance providers must first understand how commercial investors may be drawn to certain sectors, and how that capital will inevitably affect the way projects are structured and implemented. The contextual factors influencing the behaviour of private investors are explored here through the five dimensions of fragility (economic, environmental, political, societal and security).
2. Understanding blended finance in fragile contexts

The following chapter tries to map which actors are committed to and actively engage in blending, in which contexts and what factors may influence blending operations. Unless otherwise stated, all data is drawn from the OECD statistics on private finance mobilised by official development finance from 2012 to 2017.

2.1. The role of private capital as part of the development-peace nexus

The complexity underlying the cause and effects of fragility and conflict makes these classifications highly contextual, while at the same time exacerbating the cost and gravity of mistakes within the space. The New Deal for Engagement in Fragile States was adopted in 2011 to change the way international and national actors operate in fragile and conflict affected situations, in line with a set of best practice principles for application in policies and programme (New Deal, 2014[10]).

The New Deal’s five Peacebuilding and Statebuilding Goals, adopted by members of the International Dialogue suggest a role, albeit implicit, for the private sector as key to building economic foundations and enabling countries to raise revenues and deliver services (IDPS, 2011[11]). These were complemented in 2015 by the compilation by the International Dialogue of International Standards for Responsible Business in Conflict Affected and Fragile environments and more recently by the ‘How to Scale up Responsible Investment and Promote Sustainable Peace in Fragile Environments’ paper (OECD, 2016[1]). According to the New Deal, national stakeholders, both state and non-state should be involved in regular country-led fragility assessments. These should inform the development of the government’s own national plan, which should in turn become the basis of a Compact established with international partners. It is country-led process drawing from a broad range of views from multiple stakeholders and the public, is also envisaged as a key mechanisms to find the country-led pathway out of fragility (g7+, 2018[13]).

Nonetheless, the New Deal approach primarily concerns aid delivery and does not consider the broader development finance spectrum. Hence, private actors are not mentioned as a potential source of finance. Still, g7+ Member States and members of the Civil Society Platform for Peacebuilding and Statebuilding (CSPPS) confirm their desire to work in concert with the private sector to contribute to building the economic foundations for peace (CSPPS, 2018[14]). Private organisations are acknowledged in the g7+ charter as a necessary partner to reform the way aid interventions in conflict and post-conflict affected states are managed, designed and delivered (g7+, 2014[15]), but also as a source of finance for much needed economic development, which may help address the problems of underemployment and unemployment in many fragile situations.

1 The International Dialogue is composed of members of the International Network on Conflict and Fragility (INCAF), the g7+ group of fragile and conflict-affected states, and member organisations of the Civil Society Platform for Peacebuilding and Statebuilding (CSPPS).

2 The Governments of Afghanistan, Burundi, Central African Republic, Chad, Comoros, Côte d’Ivoire, Democratic Republic of the Congo, Guinea, Guinea-Bissau, Haiti, Liberia, Papua New Guinea, Sierra Leone, Somalia, Solomon Islands, São Tomé & Príncipe, South Sudan, Timor-Leste, Togo and Yemen.
The necessity of catalysing private capital, not only for development, but also for peacebuilding, has clearly emerged in UN-led fora. The UN Security Council Resolution 2282 (2016) on the Review of United Nations Peacebuilding Architecture recognized the importance of strategic partnerships, pooled funding and blended finance with the private sector in order to share risks and maximize the impact of peacebuilding efforts (United Nations, 2016[16]). More recently, the joint UN-World Bank Pathways for Peace report emphasised the role of inclusive coalitions and public-private partnerships (PPPs) enabled by private actors, and the importance of mobilising capital from large domestic and multinational corporations. The study introduced the concept of arenas of contestation, the broad areas where conflict naturally arises among groups and between society and the state. The private sector is highly present in at least two (land and natural resources; service delivery) of these arenas, where “people or groups bargain for access to the basic means of livelihoods and well-being” and therefore where both the stakes and risks of violence are high (World Bank, 2018[3]).

The Peacebuilding and Sustaining Peace Report of the Secretary-General encouraged the United Nations system “to further develop partnerships with the private sector and the investment community to strengthen the peacebuilding impact of companies, set conflict-sensitive investment guidelines and explore potential contributions to United Nations peacebuilding activities”. The Peacebuilding Fund (PBF) will assume “a strategic resource mobilization role […] exploring opportunities for contributions from the private sector through traditional means, as well as considering partnerships and innovative financing methods” (UN, 2018[17]). In 2018, PBF has funded the first of its kind blended finance program in Colombia to support small to medium-sized business in conflict-affected areas. Another example is the Liberia Multi-Partner Trust Fund, established by the UN in 2017 as the principal financing mechanism to sustain peace in the country, which is designed to receive contributions from non-traditional sources such as the private sector and philanthropic organizations. The mobilization of timely, predictable, adequate and sustainable private funding is also recognised as a key component for the successful implementation of the Global Compact on Refugees (UNHCR, 2018[18]).

2.2. OECD DAC members increasingly recognise the private sector in their development cooperation strategies addressing fragility

Most OECD DAC members and other donors have developed specific development cooperation strategies to guide their intervention in fragile contexts. These national frameworks frequently reference both the World Bank and OECD definitions and the importance of a holistic and whole of government approach, though many do not reference the private sector.

Many central government strategies for addressing fragility still bear no specific reference to the role of the private sector (e.g. Canada, Austria, Ireland, Portugal, Spain, Switzerland, the United Kingdom and the United States). Those that do, often focus on capacity building for private actors and creating an enabling environment for private sector development. Finland’s Development Policy and Development Cooperation in Fragile States (MFA Finland, 2014[19]), mentions the importance of the international and domestic private sector for economic growth and job creation. The German Federal Government guidelines Preventing Crises, Resolving Conflicts, Building Peace 2017 (Federal Government of Germany, 2017[20]) focus on private sector development as a means of crisis prevention and commits to intensify cooperation work with private sector actors in the area of peacebuilding.
Other countries present more of a commitment to work in partnership with the private sector, including local and international businesses. Denmark’s “The World 2030” strategy for development cooperation and humanitarian action undertakes to cooperate on innovative solutions with private businesses in fragile countries, while recognizing that ODA’s potential to catalyse and mobilise private funding, knowledge and new technology remains strongest in middle-income countries (MFA Denmark, 2017[21]). The Australian Framework for working in fragile and conflict-affected states (DFAT, 2011[22]) aims to work closely with the private sector to rehabilitate infrastructure, noting the importance of vibrant and innovative private sector in delivering economic recovery and reinforcing peacebuilding. The document only briefly mentions that: “Large multinational companies can be instrumental in supporting growth and generating employment and domestic revenues. [...] Supporting political risk insurance mechanisms, [...] providing tax incentives and special economic zones can be important in stimulating outside investment.” USAID’s Office of U.S. Foreign Disaster Assistance plans to solidify its strategy for engaging with the private sector and with foundations in the future (USAID, 2015[23]).

Only a few strategies explicitly identify the private sector as a potential source of additional funding in fragile contexts. The Belgium government’s Guidance on Fragility calls for a “whole-of-society approach” in fragile areas working with government, civil society and the private sector (Acropolis, 2016[24]). There is a particular focus on the operating processes and due diligence of businesses operating in these settings. The Netherlands 2008-2011 Security and development in fragile states mentions the importance of mobilising investments and partnerships with the private sector in fragile contexts (Government of the Netherlands, 2008[25]). The European Commission’s Framework for engagement in fragility and building resilience (European Commission, 2016[26]) makes no reference to the private sector, but the 2016 European External Investment Plan aims to mobilise investment by private actors that would otherwise invest less or not at all in these difficult areas (EU, 2017[27]). In the Italian development agency’s framework, private sector investment is mentioned as being limited due to risks (AICS, 2018[28]).

2.2.1. This growing political commitment is progressively reflected in multilateral strategies

Certain MDBs have adopted an explicit focus on mobilising additional private finance, commensurate to the presence of fragile and conflict situations on their geographical perimeter. The IFC has established a target to increase its share of new commitments in low-income and fragile countries from about 7% in 2018 to 15 to 20% by 2030 (Sierra-Escalante, Karlin and Lauridsen, 2018[29]).

The African Development Bank (AfDB) Addressing Fragility and Building Resilience 2014-2019 strategy (African Development Bank, 2014[30]) acknowledges the need to use guarantees and other instruments to encourage private sector investments:

“The Bank will adopt a two-pronged and phased approach that initially focuses on strengthening the lead role of the government as enabler of these services, while promoting the engagement of capable non-state actors, such as the private sector or CSOs, as service providers.

[The Bank] will look to increased private sector involvement through public-private partnership (PPP) arrangements in providing and rebuilding infrastructure, as well as strengthening livelihoods through better management of shared resources, greater economic interdependence and trade.
To complement this framework, the AfDB launched the African Investment Forum in November 2018, which aims to catalyse private sector investments into Africa through guarantees, technical assistance, capacity building and investment promotion (AIF, 2018[31]).

The Asian Development Bank (ADB) has also adopted a specific framework for working in Fragile and Conflict-Affected Situations (Asian Development Bank, 2012[32]), which aims to channel public or concessional funds to mobilise private capital, with a particular focus on climate change. A variety of financing modalities are envisaged, including loans, grants, direct private sector investment, and credit enhancement tools.

The President’s Advisory Panel of the Islamic Development Bank (IDB) in March 2016 noted that Islamic Finance was a key solution for fragility of IDB’s member countries and beyond (Islamic Development Bank, 2016[33]). Whilst no explicit reference to fragility is made, the IDB in coordination with World Bank and the Public-Private Infrastructure Advisory Facility published *Mobilizing Islamic Finance for Infrastructure Public-Private Partnerships* in 2017, which details a strategy and recommendations for mobilising Islamic finance via PPPs.

### 2.2.2. Uptake by bilateral development finance institutions is still uneven

Surprisingly, the emphasis on mobilising private capital even in fragile contexts has not yet translated into the guiding documents of the main bilateral channel for blending, i.e. development finance institutions (DFIs).

Only a minority of DFI’s strategies contain explicit commitments to mobilising private finance in fragility. Finnfund’s 2018-2025 strategy (FINNFUND, 2018[34]) “places special emphasis on using our funding to lower the risk for companies that are looking to invest in fragile states and thus reduce the threshold of investment in such countries.” Similarly, IFU in their *Strategy Document for The Investment Fund for Developing Countries 2017-2021* acknowledged its key role in leveraging ODA to bring in private investment and help the poorest and most fragile countries mobilise domestic resources and attract private investments (IFU, 2017[35]). OPIC proposes seven approaches for investors operating in volatile governance environments (OPIC, 2014[36]). Indeed, their financing and political risk insurance instruments are intended to support American businesses in the most challenging frontier markets, but their understanding of what qualifies as fragile or conflict-affected remains unclear.

Most DFIs limit their interventions to private sector development in fragile contexts. The CDC Group in their *Investing to Transform Lives* strategy for 2017-2022, identifies fragile countries as having limited opportunities to mobilise private capital alongside investments (CDC, 2017[37]). A recent review found that CDC has successfully redirected new investments towards lower-income and fragile states, though these are largely concentrated in a few countries and in the infrastructure and financial services sectors (ICAI, 2019[38]). The AFD *Stratégie: Vulnérabilités aux crises et résilience 2017-2021* notes the important role the private sector can play in fragile contexts, but the focus is on recovery and development of the local private sector, rather than on the mobilisation of additional resources (AFD, 2017[39]).

Whilst there is increasing recognition of the need to mobilise private finance, even in fragile or conflict-ridden settings, most development finance providers have not yet developed a strategic approach on how to use blending instruments to address the SDG funding gap in these contexts.
2.3. In practice, blending in fragile contexts is led by multilaterals and few donors

Out of the USD 157 billion in private finance mobilised for development from 2012 to 2017, less than a fifth (i.e. USD 28.8 billion) went to contexts considered as fragile.

In fragile areas, as for all developing countries, most of the private finance was mobilised through a multilateral channel: over 60% of the USD value. In 2017, 33 donor agencies reported having mobilised private finance in fragile contexts, composed of 20 bilateral and 13 multilateral institutions. The upward trend in volumes of private finance mobilised over the six years examined is primarily driven by multilateral agencies.

![Figure 2.1. Private finance mobilised for fragile contexts by agency type, 2012-17](http://www.oecd.org/development/stats/mobilisation.htm)

The inflection in the private finance mobilised by multilateral sources during the last two years is primarily attributable to the lack of data from the International Finance Corporation (IFC), whose reporting was not broken down at activity level. Hence, the total amount reported by the IFC in 2016-2017 (USD 10.3 billion) cannot be allocated by country and cross-analysed with the OECD States of Fragility Framework. As a consequence, it is unclear whether the amount of private finance mobilised by multilateral agencies in fragile contexts is decreasing overall.

2.3.1. The multilateral system is the main channel for blending

In absolute terms, the Multilateral Investment Guarantee Agency (MIGA) has mobilised the largest volume of private finance to fragile contexts, reporting USD 5.8 billion mobilised in fragile contexts over the 2012-2017 period. Together with IDA (USD 1.8 billion), IFC (USD 1.6 billion) and International Bank for Reconstruction and Development (USD 0.6 billion), the World Bank Group is the largest multilateral player, accounting for over a third of all private finance mobilised in fragile settings.

The EIB is next, with USD 2.5 billion mobilised in fragile areas. The Private Infrastructure Development Group and the Africa Development Bank, where most fragile situations are located, also confirmed their place as important blending players.

Other multilateral institutions that reported mobilising private capital in fragile contexts include European Bank for Reconstruction and Development, the Asian Development Bank and its Credit Guarantee and Investment Facility, the Inter-American Development Bank, International Fund for Agricultural Development (IFAD) and the Nordic Development Fund.

The Global Fund to Fight AIDS, Tuberculosis and Malaria and the Global Alliance for Vaccines and Immunizations (GAVI) are also top concessional donors targeting fragility but they did not report any private finance mobilised to the OECD.

2.3.2. Bilateral blending is driven by a few donors

The two donors reporting the highest volume of private finance mobilised to fragile contexts are the United States and France, at USD 6.3 billion and USD 2.5 million respectively from 2012 to 2017. They also figure among the top bilateral mobilisers across all developing countries, together with the United Kingdom.

The two countries alone claimed almost 30% of all private finance mobilised in fragile areas over the 6 year period. Therein, OPIC reported mobilised finance of USD 4.2 billion and AFD, USD 2 billion. The prominence of the United States is corroborated by the fact that USAID is most generous ODA to fragile areas, whereas OPIC is the largest bilateral agency for private finance mobilised across all developing counties.

Taking a closer look at the US blending activities in fragile contexts, the mobilisation reported by OPIC is mostly concentrated in Pakistan, Egypt and Nigeria, whereas USAID focused largely on Iraq. While OPIC has mobilised more private capital in absolute volumes, almost 40% of the mobilisation reported by USAID occurred in fragile areas (compared to 21% for OPIC). The Millennium Challenge Corporation, despite being an important donor, did not report any private finance mobilised in these settings.

As for France, almost 70% of the private finance mobilised went to Cameroon, Nigeria, Côte d'Ivoire, Madagascar and Egypt, countries historically tied to France by language, trade and colonial history. For instance, Egypt is France's first export market in the Middle East, whereas Nigeria is the largest trading partner in sub-Saharan Africa (with over 4 billion volume in 2018). AFD reported over half of its private finance mobilised in fragile areas, whilst Proparco brings a relatively small contribution at approximately USD 235 million.

The above data confirms that, **where development agency and DFI coexist, both actors are equally important blended finance players**, despite the latter having a specific mandate to work with the private sector in developing countries. Looking at the United States and France, the OECD data further seems to imply that national development agencies are more prone to extend their reach into fragile settings, whereas bilateral DFIs remain, paradoxically, more risk averse.

Runner ups in the OECD statistics are the United Kingdom, Sweden and Denmark, which claimed over USD 500 million each in private finance mobilised in fragile contexts, followed by the Netherlands, Norway and Germany each being above USD 100 million.
2.4. Blending is a small but non-negligible part of the development finance pie

Official development finance by DAC members and other donors succeeded in mobilising **USD 28.8 billion from the private sector to fragile contexts from 2012 to 2017**, i.e. 18% of the total across all developing countries. Less private investment in fragile contexts is to be expected, as risks are by definition significantly higher in such settings. The volume of private finance mobilised has increased over the six year period, suggesting an increased recourse by donors to market oriented tools (loan, equity, guarantees). Still, the amount remains quite moderate, peaking at over USD 6 billion in 2015, mostly driven by standard loans and guarantee/insurance disbursements.

2.4.1. Volume and ticket size decrease with fragility

Much like fragility, the private finance going to fragile situations is geographically concentrated around Africa and, to a lesser extent, Asia. More precisely, 57% of private finance mobilised went to the South Saharan Africa, 22% to Asia (mostly the South and Central sub-regions), 10% to the North Saharan Africa region (primarily Egypt, but also Libya) 6% to North and Central American (about half of this was to Honduras, followed by Guatemala then Haiti) and 4% to the Middle East (Iraq, Iran, Yemen, West Bank and Gaza Strip). In Oceania, Papua New Guinea and Solomon Islands were also mentioned but for negligible amounts.

Over the course of six years, development finance providers have unlocked private finance in 51 of the 58 countries classified as fragile under the OECD 2018 States of Fragility Framework. Those contexts where no mobilised private finance was reported scored significantly worse across all fragility dimensions, on average. Additionally, 7 have economic sanctions being enforced by both the EU and US, often in combination with a resolution passed by the United Nations Security Council for an arms embargo. By contrast, more than USD 1 billion was mobilised in Nigeria, Pakistan, Kenya, Egypt and Angola, followed by Honduras, Cameroon and Zambia with over USD 500 million each cumulated over the 4 years.

Over a third of all blending operations declared to the OECD over 2012-17 occurred in fragile contexts. On average, however, blended finance deals in more stable developing countries mobilised more than double the amounts reported in fragile settings, with USD 42 million of private finance mobilised per operation compared to USD 15 million. This speaks to the more careful engineering required by each blended finance deal and the smaller ticket size that can be achieved in those contexts, along with development results.

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3 Amounts mobilised from the private sector between 2012 and 2017 were reported by (in alphabetical order) African Development Bank, Asian Development Bank, Australia, Austria, Belgium, Canada, Credit Guarantee and Investment Facility, Czech Republic, Denmark, EU Institutions, European Bank for Reconstruction and Development, Finland, France, Germany, IFAD, Inter-American Development Bank, International Bank for Reconstruction and Development, International Development Association, International Finance Corporation, Ireland, Korea, Luxembourg, Multilateral Investment Guarantee Agency, Netherlands, Nordic Development Fund, Norway, Portugal, Private Infrastructure Development Group, Slovak Republic, Sweden, Switzerland, United Kingdom, United States.
2.4.2. Blended finance in fragile contexts is even more concentrated in a few sectors

Blended finance tends to converge towards those sectors where the business case is clearer and the potential for revenue streams stronger. The SDGs most targeted by blended finance funds and facilities concern economic growth and jobs, infrastructure and climate change (OECD, 2018[7]). In fragile contexts as in other developing countries, the top sectors for the mobilisation of private finance are Industry, Mining, Construction and Banking & Financial Services.

**Figure 2.2. Private finance mobilised by sector, 2012-17**

![Sectoral Distribution of Private Finance](http://www.oecd.org/development/stats/mobilisation.htm)

This is particularly true in fragile contexts, where the top five sectors represent 84% of the total reported private finance mobilised. Therein, Energy, Industry, Mining, Construction and Banking & Financial Services captured over 70% of the private finance mobilised. Other notable sectors are Communications and Water Supply & Sanitation, which all support foundational infrastructure needs for economic growth. This can be partially explained by the importance of natural resources for many fragile economies, especially oil rents in Angola, Nigeria and Egypt and mining in Cote d’Ivoire. Other developing countries share similar proportions and categories, but Transport & Storage and Agriculture, Forestry, Fishing are relatively more represented there.

This finding is partially counterbalanced by another important actor in the blending space, i.e. foundations working for development, whose giving is strongly skewed towards health and education. However, foundations are as risk averse as other private actors, as their resources are mainly destined to stable middle income countries – fragile contexts received only 18% of the 23.9 USD billion disbursed over 2013-15 (OECD, 2018[40]).
2.4.3. The origin of private finance varies with income more than fragility

Almost 36% of the private finance mobilised in fragile contexts originated from the country of the development finance provider or from another high income country. Still, over 8 billion USD were mobilised from domestic private investors residing in the beneficiary country.

The origin of private finance mobilised does not vary significantly between fragile and non-fragile contexts. Looking at the average amount per deal, blended finance operations in fragile contexts are slightly more likely to attract private investors from a third developing country. This concerns operations taking place in lower middle income countries (MICs), such as Côte d'Ivoire, Honduras, Nigeria, as well as LDCs (Democratic Republic of the Congo, Mozambique). Further evidence would be needed to understand from what country the private investment originated and if, for instance, the partnership was facilitated by a triangular cooperation agreement.

Figure 2.3. Private finance mobilised by origin of funds, 2012-17

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Even in extremely fragile contexts, over USD 1.4 billion in private financing could be unlocked locally. This is mostly attributable to the recent use of guarantees in Iraq. In Yemen, just like in Iran and Libya, only external resources were mobilised, certainly due to the distressed status of local markets. In a few countries (Eritrea, Central African Republic, Syrian Arab Republic) no blending was reported.

In general, the opportunities for blending increase in line with national income: 73% of all private finance mobilised in fragile settings was deployed in MICs, mostly lower MICs such as Nigeria, Pakistan, Egypt and Kenya. Despite being upper MICs, Iraq and Libya offer more limited opportunities for blending due to their ongoing conflict and sanctions. One reason why development finance providers may focus on private sector

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4 This relates to the following extremely fragile contexts: Afghanistan, Burundi, Chad, Democratic Republic of the Congo, Ethiopia, Haiti, Iraq, Mali, Somalia, South Sudan, and Sudan. In a few extremely fragile contexts (Eritrea, Central African Republic, Syrian Arab Republic) no blending was reported,
engagement in fragile MICs is because they house higher numbers of active conflicts and refugees in comparison to low-income ones (The World Bank, 2018).  

**Figure 2.4. Private finance mobilised by origin of funds and income group, 2012-17**

The average amount of private finance mobilised per deal will be influenced by the country income group, especially when it stems from the beneficiary country itself. Between 2012 and 2017, USD 5.8 million were mobilised on average from local co-investors by each transaction occurring in fragile LDCs, against USD 25.8 million in LMICs and USD 1 billion in UMICs. This also applies to private finance coming from the same country as the development finance provider. In fragile LDCs, the average amount mobilised from the provider country was USD 1.6 million as opposed to USD 15 million in fragile LMICs. In other words, when blending in fragile LDCs, more private money could be raised per deal from the domestic economy rather than from the donor country. This might be the consequence of risk misperceptions by private investors in cross-border transactions.

*Note:* The diameter of each pie chart indicates the volume of private finance mobilised in fragile contexts by income group category; percentages are calculated as a proportion of total private finance mobilised for amounts allocated to an income group.  

2.5. Development assistance and blending are complementary approaches

2.5.1. Recent trends of official development finance in fragile contexts

ODA to fragile contexts has been on the rise since the end of the global financial crisis, growing by 26% in real terms from 2009 to 2017, mostly driven by humanitarian assistance. From 2015 to 2016 alone, humanitarian assistance for all fragile contexts increased by 38%, reaching a historical peak of USD 18.3 billion (OECD, 2018[2]). This steep rise in humanitarian assistance has radically changed the financing landscape, prompting calls for greater development investment in fragile contexts, following the principle of “development wherever possible and humanitarian aid only where necessary” (OECD, 2016[3]).

Moreover, development assistance is not equally distributed among fragile contexts. In 2016, 74% of ODA spent in fragile contexts was concentrated on 20 of the 58 fragile contexts and 50% of it went to 10 “aid darlings”. Average ODA per capita is higher in fragile lower middle-income contexts than in fragile low-income contexts, although aid dependency remains higher in the latter group. Current OECD analysis on ODA channelled towards the five Peacebuilding and Statebuilding Goals raised important questions regarding how much donors are tailoring their development approaches for the special needs of fragile contexts (OECD, 2018[2]).

Finally, the portion of ODA channelled through private sector institutions and public-private partnerships in fragile contexts remains very small in 2016, which demonstrates that the private sector is not yet a preferred delivery option in fragile contexts (OECD, 2018[2]).

2.5.2. ODF and private finance mobilisation follow different patterns

There does not appear to be a very strong relationship between how much ODA is provided to a fragile country and the private finance it can mobilise. Though countries such as Egypt, Pakistan and Kenya rank high on both ODA received and private capital mobilised, many countries appear at opposite extremes of each category. The top ODA recipients (Afghanistan and the Syrian Arab Republic, at USD 28.8 billion each) are extremely fragile contexts which mobilised little to no private capital. Bangladesh, Tanzania and Ethiopia each received over USD 15 billion in ODA during the 6 years examined, but mobilised less than USD 1 billion in private finance each. Nigeria stands out as the country that mobilised the most (over USD 5.5 billion cumulatively) while also receiving almost USD 16 billion in ODA.

Blending opportunities tend to materialise with other official flows. Nigeria, Pakistan, Egypt, Kenya and Côte d'Ivoire (in descending order) are the top 5 countries for private finance mobilised from 2012 to 2017. They also received over USD 1.5 billion each in other official flows, mostly related to the Energy sector, Banking & Financial Services, Industry, Mining, Construction, but also Transport & Storage and Action Relating to Debt. Another notable example is Angola which ranked highly (with over USD 1 billion) on both categories.

ODA is more prominent in LDCs and other LICs, whereas private finance mobilised is more concentrated in MICs. This is true in fragile contexts as well as for all developing countries. Looking at the financing mix by income group, throughout the six years examined, ODA represented 98% of all development finance tracked by the OECD in
fragile LDCs and 68% in fragile UMICs. Private finance mobilised represented merely 3% of the total development financing available for fragile LDCs and 6% for fragile UMICs.

**Figure 2.5. Development finance to fragile contexts by income group, 2012-17**

Note: The figures are shown in net current prices. Figures for official development assistance (ODA), Other Official Flows (OOF) are based on OECD statistics and are net deflated disbursements. Numbers indicated on the horizontal axis labels represent the total count of fragile contexts as identified in (OECD, 2018[43]) included in each income group.


At a regional level, Africa ranks first as both ODA and private finance receiver, due to the high number of fragile areas therein. The Middle East instead received a significantly higher proportion of ODA than private finance mobilised, primarily due to humanitarian spending. This is largely driven by the Syrian Arab Republic and Afghanistan, which received over USD 28.8 billion each in ODA, but received zero to 127 million in private finance mobilised within the same time period.

Non humanitarian ODA is by far the largest source of finance in fragile developing areas, concentrating on public goods and social services.\(^5\) Despite being concentrated on three sub-regions (South and North of Sahara, Central & South Asia), private capital mobilised remains a relatively small but significant part of the development finance pie.

While blended finance can potentially be deployed in all areas, country-programmable development assistance might be more appropriate in social sectors, whilst the most immediate opportunities for private investors lie on infrastructure development, rather than service provision. Of the USD 760 thousand mobilised for the humanitarian sector, most private investment went for Reconstruction Relief & Rehabilitation.
Figure 2.7. Development finance to fragile contexts by sector, 2012-17


Although development aid has a catalyst role to play for blending and FDI, even in fragile areas, this is not (and should not be) its primordial aim. Indeed, investments in human capital may be the most promising, yet urgent, drive to stability and prosperity for conflict ridden or displaced populations, particularly in Africa. The diffusion of blending for revenue generating sectors and in stable, middle-income countries might progressively free up concessional resources for the humanitarian sector in fragile contexts.

2.5.3. The lack of coping capacity can solely be addressed by public resources

Each dimension outlined in the OECD 2018 States of Fragility Framework reflects both the existence of contextual risks and a lack of sufficient coping capacity of the state, system and/or communities to manage, absorb or mitigate those risks. Indeed, the lack of coping capacity across the spectrum, not one area alone, results in the classification of especially fragile contexts. Development assistance thus remains crucial to promote policy reforms tackling structural disincentives by improving the ease of doing business and attracting foreign investment, which in turn will spur domestic private sector growth and thus potentially blended finance.
Support to private sector development (PSD) is necessary but contextual in the same way as all other international development interventions. It is difficult to determine the exact mechanisms affecting how PSD may unfold in fragile contexts.

A review of job creation projects by the World Bank between 2001 and 2013 found that fragile contexts do not differ significantly in terms of design or objectives from those carried out in more stable areas. These projects in fragile and conflict-affected states did however attract less than half the average net commitments by the World Bank. Nonetheless, fragility did not introduce any statistical difference in whether projects obtain at least a moderately satisfactory outcome rating (Ralston, 2014).

Another review of over 300 PSD interventions in fragile contexts implemented by the World Bank between 2005 and 2014 found that those involving direct investments were significantly more effective as compared to those employing technical assistance alone or mixed with grants (Liu and Harwit, 2016). Recurring factors for failure included lack of investment and insufficient private sector engagement, whereas the use of sector-appropriate instruments improved the chances of success.

While fragile settings are more difficult to operate overall, it is important to look deeper into the mechanisms that cause such a difference. Assuming that this adversity will necessarily apply to all potential deals might falsely reinforce the status quo. An improved investment framework and vibrant local private market will generate higher domestic resources mobilisation, which is a more sustainable source of public revenue than any form of external financing. Indeed, two-thirds of fragile contexts would have difficulty financing basic services from their own revenue, yet only 0.2% of aid to places affected by fragility or conflict in 2015 and 2016 was dedicated to technical assistance for domestic resource mobilisation (OECD, 2018).
3. Each fragility dimension brings along specific challenges for private investment

The different dimensions of fragility are strongly interconnected (OECD, 2016[11]). For example, the economic system of a country determines its wealthy elite, while the political system determines its political elite (Acemoglu and Robinson, 2006[46]). Those with political power, however, are able to influence the economic system in a way that determines who has economic power. Alternatively, those with economic power are capable of influencing who has political power. This relationship reinforces political and economic institutions, resulting in the tendency to maintain a status quo. This interplay illustrates the difficulty of enacting institutional stabilisation and progression for systems that are fragile or have experienced conflict.

This circular relationship underlies many of the issues in fragile and conflict-affected contexts, from corruption to domestic resource mobilisation. Financing that works across multiple actors and strengthens more than one facet of society has the potential to address the circularity between these dimensions by simultaneously incentivising and intertwining stakeholders that face trust issues (OECD, 2016[1]). For example, governments that lack tax revenue may be able to fund necessary development outcomes for infrastructure by engaging the private sector. Yet, external financing (of any sort) will likely strengthen one group's interests over another, which is particularly dangerous in such settings.

Private investment, be it cross-border or domestic, can increase access to capital, jobs, skills, technology, and links to global value chains. A flourishing financial market may also support reconstruction financing, boost public revenue, and improve foreign exchange. However, private investors in fragile and low income countries must face particularly high risks and costs related to poor market information and uninformed buyers, a limited supply base, inadequate hard and soft infrastructure (such as credit registries), weak financial institutions with limited long term financing available, inexperienced local sponsors or contractors, weak regulatory environment, unreliable or unproven off-takers or buyers, and reputational risks. Moreover, the public image of foreign direct investors is often associated with extractive projects and major infrastructure concessions. Low-capacity institutions may result in poorly negotiated contracts and weak oversight, while companies engage in activities with potential environmental and social risks.

Each dimension of fragility will thus influence the behaviour of private investors in a different manner, as different types of underlying risks may affect the investment decisions, of both international corporations and local entrepreneurs. Moreover, investment choices are often blurred between real and perceived risks (IDPS, 2018[47]). Risk narratives can change and be determined by factors unrelated to the business environment. Ultimately, profit-oriented actors will be guided by their risk/return calculation rather than risk per se. To better understand the interplay between fragility and blending, this chapter compares the OECD statistics on private finance mobilised by official development finance from 2012 to 2017 with the OECD 2018 States of Fragility Framework (OECD, 2018[2]).
3.1. Economic fragility

The economic dimension aims to capture the vulnerability to risks stemming from the weaknesses in economic foundations and human capital including macroeconomic shocks, unequal growth, high youth unemployment, etc.

Figure 3.1 confirms that **there is a positive relationship between a more secure economic environment and increased opportunities for blending**. The heat map below shows how, from 2012 to 2017, higher amounts of private capital (above USD 1 billion) were mobilised in countries described as less economically fragile (noted 4 or 5 in the OECD 2018 States of Fragility Framework), whereas the opposite also holds true: the most extremely fragile economies (ranked 1) captured less than USD 50 million each.

![Figure 3.1. Private finance mobilised by economic fragility level, 2012-17](http://www.oecd.org/development/stats/mobilisation.htm)

While countries with more resilient economic infrastructure are able to attract and mobilise greater volumes of private finance, the variation in the data indicates that other factors play significant roles as well. The economic composition of countries classified as ‘extremely fragile’ or ‘fragile’ under the OECD Framework can vary widely, especially considering that the Gross National Income (GNI) per capita in 2015 ranged from 226 USD in Burundi to 10 892 USD in Equatorial Guinea. Significant economic growth is a catalyst for investors, which explains the concentration of blended private capital in middle-income markets.

According to a survey led by the IFC, the macroeconomic environment is one of the top constraints faced by investors when considering the expansion of debt and (even more) equity financing in emerging or frontier markets (Narayanan, 2018[48]). Another study on the securities markets in the EBRD region revealed how macroeconomic risks, interdependence of markets and illiquidity generate negative sentiment among global institutional investors. Many fragile contexts face these exact challenges, which may dissuade commercial actors from investment opportunities. Conversely, evidence of reforms on a company-specific or market-wide basis is a strong catalyst for investors to increase their allocation of capital to a market (EBRD, 2018[49]). Indeed, OECD data show that the private finance mobilised (as a proportion of GNI) shows a small but positive
correlation to both the World Bank’s Country Policy and Institutional Assessment and to the Ease of Doing Business index.

The relationship between a high prevalence of poverty and the coping capacity for risks feeds largely into the economic dimension of fragility (OECD, 2016[1]). Poverty translates into a lack of the human and economic capital needed to attract FDI. Addressing poverty relates back to the circular nature of dimensions in fragility, as multiple factors feed into and reinforce poverty. For example, a lack of private sector development (PSD) and jobs reinforces poor living standards and low access to basic necessities. In fragile contexts, a lack of capital and sufficient engagement with private sector actors by DFIs often hinders PSD projects (Liu and Harwit, 2016[43]). Additionally, local entrepreneurs must overcome a fundamentally different set of risks when operating in fragile markets largely due to challenges in governance and corruption (World Bank, 2011[51]).

Access to human capital is a pressing issue for international investors and local entrepreneurs alike. The quality of the workforce (e.g. high unemployment rate, low technical skills and formal qualifications) all discourage productive investment. Local managerial expertise was cited by almost all investors surveyed by the IFC as a major constraint for debt and equity financing (Narayanan, 2018[48]). Fragility jeopardises the private actor’s social capital network, which in turn dramatically reduces their ability to attract talent, especially for early stage ventures (Clemmons, Lapointe and Georgen, 2017[52]). Another deterring factor may be the dominance of the shadow economy: informal employment represents over 80% of total employment in 30 of the 58 fragile contexts (OECD, 2018[2]).

Finally, many fragile economies are dependent on revenue for natural resources and therefore highly exposed to changes in the global market, as foreign direct investment (FDI) is subject to slumps in global commodity prices (Sy, 2017[53]). This is particularly true in fragile contexts, where FDI is often perceived by investors to flow almost exclusively to extractive sources, or to require significant concessional financing in order to receive acceptable returns (Whyte et al., 2014[54]). The extractive sector creates relatively few local jobs and has a chequered record on human rights and environmental protection (OECD, 2018[2]). The Kimberley Process was heralded as a remarkable pact between the international community and the private sector to regulate the control of illicit diamonds along the supply chain. However, since open conflicts have been resolved and illicit activity has morphed into hybrid arrangements, it has been recently estimated that 50-90% of the diamond trade in Sierra Leone continues to be lost through smuggling (OECD, 2018[55]).

Rent-seeking is another major issue within fragile contexts, largely due to natural resource wealth (Speakman and Rysova, 2015[56]). Investments into resource wealth are particularly likely to fuel civil war and conflict due to the prevalence of rent-seeking and corruption (Collier and Hoeffler, 2008[57]). The absence of anti-corruption regulation, or enforcement thereof, and of the necessary checks in the political system, can exacerbate the positive correlation between natural resources and rent-seeking.

Volatile macroeconomic conditions are especially challenging for states with weak political institutions. When commodity prices are high, states that are significantly dependent on natural resources receive a windfall in tax revenue. A lack of mechanisms, such as sovereign wealth funds, that govern the use of such windfalls stably over time can hamper economic growth in the long-run (Ploeg and Poelhekke, 2009[58]). The LSE-Oxford Commission on State Fragility, Growth and Development also proposed that DFIs could link their debt service to observable risks, thereby reducing fragility and exposure to default (Commission on State Fragility, 2018[59]).
The OECD Investment Policy Reviews clearly show how weak **institutional capacities** hinder successful investment promotion and that policies towards inward FDI are not always well-aligned with national development objectives. Nigeria has one of the most sound and liberal investment legal frameworks in Africa, but its effectiveness is hampered by bottlenecks and delays in the enactment of announced legal reforms. Insecurity and supply-side constraints, which are especially binding for SMEs affect the country’s investment attractiveness (OECD, 2015[60]). In Mozambique, the cumbersome land registration process and insecurity tenure rights pose an especially complex barrier for all investors. In addition, land tenure rights can be revoked at any point if investors are deemed to contravene agreed land exploitation plans (OECD, 2013[61]). Besides the regulatory capacity, the depth and fluidity of the local financial sector also matters, as weak local banks can make capital infusions by development partners risky.

**Box 3.1. Business as a driver for peaceful development**

Chevron, the third-largest oil producer in Nigeria with operations based in the Niger Delta, became a force for greater stability in that region. Noting that its approach to community relations was utterly failing to manage operational disruptions, theft, extortion and increasingly high levels of violence against the company, Chevron took a new approach that established local governance over community development where it had not existed before. Chevron has since explicitly linked its business success to peaceful co-existence in regions where they operate.

Since 2005, Chevron has been implementing a community-led, multi-stakeholder participatory partnership model for community engagement and sustainable development. Through this innovative community engagement model, Chevron used its influence to moderate the government’s militarised response to conflict. Chevron’s approach – mitigating corrupt and even hostile government – has had a demonstrable effect on development outcomes and the reduction of violence for communities in the Niger Delta (Ganson and Wennmann, 2015[62]).

Launched in 2010, with a cumulated USD 90 million endowment from Chevron, Foundation for Partnership Initiatives in the Niger Delta (PIND) has attracted additional support from key partners such as USAID and DFID (Chevron, 2016[63]). PIND is committed to use Chevron funding to leverage other sources as private sector investment, cost sharing, co-funding, and co-investment.

Although this example pertains more to corporate social responsibility, it illustrates how a foreign investor can play a driving role for peace in the national ecosystem, because of its political weight and social-economic footprint within a conflict map, that it may in the past have contributed to fuel.

Yet, many developing countries are pushing for large-scale investments at a much faster rate than their institutional capacity to manage them. Building the capacity of governments to capture and manage revenues from extractive industries and natural resources should be a priority for the use of ODA. For example, Eritrea, Guinea, and Liberia added community development regulations to their mining codes (World Bank IEG, 2018[64]).
While blended finance actors must accurately consider the strong evidence of negative effects associated with the extractive industries, especially when coupled with poor institutional quality, liberalisation is already occurring in the mining sector for many African countries (Perks, 2012[65]). Utilising forms of public-private partnerships could thus be beneficial in the endeavour to promote environmental, governance and social safeguards in such sectors.

### 3.2. Environmental fragility

The environmental dimension aims to capture the vulnerability to environmental climactic and health risks to citizens’ lives and livelihoods. This includes exposure to natural hazard, pollution and disease epidemics (OECD, 2018[2]).

Figure 3.2 suggests that the relationship between environmental fragility and blending is positive, with generally more private finance being mobilised the more resilient a country is towards environmental risks.

#### Figure 3.2. Private finance mobilised by environmental fragility level, 2012-15

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By definition, the risk of natural disasters is much higher in fragile contexts. This applies not only to the inability to fund disaster relief efforts, but also the sheer prevalence of natural disaster events (IMF, 2017[66]). Climate change can be considered as the ultimate threat multiplier, affecting the human security of vulnerable communities in terms of political instability, food insecurity, a weakening of the economy and large-scale movements of people displacement.

As climate change worsens, the risk of climate-related shocks is projected to increase globally. The consequences of climate change are particularly severe in Africa, where 80% of people depend on agriculture for their livelihood. Cities are unprepared for extreme weather events and disasters. A lack of structural and individual coping mechanisms, such as social safety nets, insurance mechanisms and social networks to support migration, can fuel grievances.

The private sector expertise and strengths in advancing disaster risk reduction and mitigation, including enhanced resilience and effective response, are widely recognised
(Watson et al., 2015[67]). However, climate financing remains extremely difficult to obtain in fragile contexts, in part because these instruments require tangible results in short timeframes, which are difficult to track in a complicated environment (OECD, 2018[2]).

An African-led initiative, the Extreme Climate Facility (XCF) aims to facilitate direct access to private capital for those African countries most vulnerable to climate change. Still at the conceptual stage, XCF is intended to track extreme climate shocks in Africa and provide additional financing for members of the African Risk Capacity (ARC), a specialized agency of the African Union. This data-driven, multi-year financial vehicle will issue bonds on the international capital markets through insurance policies, derivative contracts or catastrophe bonds (Stéphanie Besson, 2016[68]). At the beginning of each financing window, the financial risk of XCF triggering pay-outs would thus be transferred to private investors, with donors supporting the annual bond coupon payments.

**Box 3.2. Private funding for post-disaster reconstruction in Haiti**

Haiti is extremely vulnerable to natural hazards with more than 90% of the population at risk. Hurricane Matthew caused damage equivalent to 32% of GDP in 2016. The disaster exacerbated three of Haiti’s significant pre-existing challenges: food insecurity; cholera and other waterborne diseases; and deforestation.

The United States is Haiti's largest trading partner. The Investment Incentive Agreement signed with OPIC in 2013 aimed to support U.S. private sector investment in the nation, by doubling OPIC’s portfolio in Haiti to USD 150 million. OPIC offers a mix of loans, guarantees and political risk insurance to a growing and diverse number of U.S. firms (commercial banks, airlines, oil and agribusiness companies, and U.S.-owned assembly plants). Through the Haiti Housing Finance Facility, OPIC provided USD 17 million in long-term loans to Development Innovations Group, in conjunction with a USD 6 million grant by USAID, and USD 3 million from the Clinton Bush Haiti Fund. The project also provides micro-lending to low-income borrowers to build or repair their homes and businesses (OPIC, 2013[69]).

The Clinton Foundation has also played a crucial role in facilitating the emergence of creative solutions and, working alongside the Government of Haiti. Through a partnership with the Timberland Company and the Smallholder Farmers Alliance, an estimated 6 million trees have been planted over six years in deforested rural areas, while supporting sustainable agriculture, environmental restoration, and the socio-economic development of local farmers (Milne, 2016[70]).

Local enterprises are particularly exposed to volatile agrifood prices and provision. Some of the highest proportions of food-insecure and malnourished children in the world are now concentrated in conflict zones (FAO, IFAD, UNICEF, WFP and WHO, 2017[71]). Many of these areas also are adversely affected by climate change, such as northeast Nigeria, Somalia and Yemen. Climate threats, famine, food insecurity and food price volatility stifle the onset of a local agricultural industry. A notable example in this field is the Somali
AgriFood Fund, a partnership between IFAD, Shuraako, and BiD Network, which offered access to finance for agriculture and rural businesses, with the ultimate objective of enhancing food security, supporting job creation and economic development. The initial seed capital provided by the Fund, now closed, managed to raise over three times in match funding from the client entrepreneurs, from the Somali diaspora and from local institutional investors.

3.3. Societal fragility

The societal dimension aims to capture the vulnerability to risks affecting societal cohesion that stem from both vertical and horizontal inequalities, social cleavages, access to justice (OECD, 2018[2]).

Based on Figure 3.2, the societal dimension of fragility did not bear a clear influence on the amounts of private finance reported mobilised between 2012 and 2017. The data is extremely varied and showcases a lack of driving factors behind societal fragility and blending. While measures of societal fragility inherently overlap and feed into many other risk factors, societal dimensions themselves also may not be a key concern for most investors. This lends to the argument that blending occurs in industries and countries where it is easier to mobilise private capital and that private investors are not driven by societal objectives.

Figure 3.3. Private finance mobilised by societal fragility level, 2012-15

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Poor regulation and corruption fuel a lack of trust between society and government in fragile contexts, especially in post-conflict and resource-rich countries. This makes regulation that does exist difficult to implement, resulting in the rise of informal economic activity and escalating the likelihood of predatory private sector activity (Sweeney and Tanburn, 2009[72]). Responsible business conduct entails above all compliance with laws, such as those on respecting human rights, environmental protection, labour relations and financial accountability, even where these are poorly enforced (OECD, 2011[73]).

6 http://somaliagrifood.org/
Otherwise, there is a risk that the private sector will increase inequality, by responding to rent-seeking incentives, and undermine sustainable peace or exacerbate current fragilities.

Box 3.3. Telecoms operator steps up to prevent electoral violence

Kenya’s largest telecoms operator Safaricom (part of the Vodafone Group) has been supported by the IFC and DFID to establish in 2007 one of the most successful mobile money transfer services, M-PESA. With support from major donors, including USAID and the Bill and Melinda Gates Foundation, the Kenyan M-Pesa mobile banking solution went on to expand to Tanzania, Mozambique and Afghanistan, where households, farmers and merchants in remote areas use this system to pay salaries, utility bills and health services, reducing the risk of corruption.

On the run-up to the 2013 elections in Kenya, the mobile phone company, whose services had been used to spread hate speech in 2008, stepped up to prevent the instigation of violence through incitement. When threatened with a shutdown of the SMS system, Safaricom convinced the government to instead allow providers to disseminate messages of peace and calm, which the company sent to 9 million customers. In addition, Safaricom blocked inciting text messages, and donated 50 million text messages to the NGO ‘Sisi Ni Amani’ (‘We are peace’), which in turn used these to specifically target groups in conflict-prone.

This operation was accompanied by a more widespread recognition that the private sector could take on a pro-active, peacebuilding role. The Kenya Private Sector Alliance (KEPSA) conducted a public communication campaign on the importance of peaceful elections, trained representatives from partner groups as peace ambassadors, and organised presidential debates for the 2013 elections, fostering democratic legitimacy and transparency areas (Austin and Wennmann, 2017[74]).

Community driven development (CDD) programs strive to address inequities and increase social cohesion by requiring representation for marginalised groups in the decision-making process for service delivery of public and private goods. As such, they have been used to mobilise private financing in the form of community contributions, credit financing and commercial investment (Alkire and Polski, 2003[75]). However, recent evidence shows that most CDD programs actually amplify and reinforce inequities within local societies (White, Menon and Waddington, 2018[76]).

The urban-rural divide affects enabling environment for, and hence the likelihood of, private investment. In turn, the pace and characteristics of the urbanisation process may strongly influence the quality of the business environment. Many cities in poorer countries are urbanising before they industrialise, reducing their ability to provide services or integrate expanding peripheries. Private investment can play a significant role in accompanying urban transition and tackling many risk factors such as the availability and quality of infrastructure, levels of unemployment, income inequality, and access to basic services. For example, Colombia’s rising economic performance has been driven by city development Bogotá, Cali and Medellín, where integrated and inclusive solutions have proven that the private local sector can offer much support in combating economic
inequality and poor service delivery. On the other hand, rapid, unregulated urbanisation appears to be a key driver of fragility, rising social tensions, violence and organised crime in Kinshasa and San Salvador (OECD, 2018[2]).

Box 3.4. Blending for peace in Colombia

Although not a fragile context as such, Colombia still ranks pretty high on the security dimension, mainly due to criminal activity and violence in the most vulnerable rural communities. To answer the financing needs of post-conflict areas, blended finance is being tested as an additional channel to support sustainable development and SDG 16.

Colombia has widely been heralded as a positive example of the contribution that domestic private actors in brokering and consolidating peace agreement. Since 3 years, a coalition lead by Impact2030, the Blending Capitals Lab and Concordia Americas has been promoting a strategy to blend ODA, philanthropic and private capitals in support of the peace consolidation process in Colombia’s rural areas (Clemmons, Lapointe and Georgen, 2017[52]).

Besides the social & human capital shortfalls, the biggest obstacle identified in this process is the absence of coordination between financial service providers. The Concordia Innovative Financing Coalition (CIFC) has been established with companies, multilateral institutions, NGOs, and public sector representatives to promote policy frameworks for blending, in Colombia and the Latin American region.

The government of Colombia is progressively incorporating innovative and results-based finance into its development plans. In 2018, the UN Peace Building Fund (PBF) has responded to the growing need and opportunity for working with the private sector in support of sustaining peace, by allocating USD 3 million for the design and set up of a blended finance mechanism that will focus on areas affected by the conflict, particularly rural ones.

While there is no clear evidence on whether gender equality per se matters as a decision factor, the international community has recently raised concerns around the gender impact of blending on women empowerment. As a consequence, some donors are actively pursuing a gender agenda to palliate any potential negative effects. For instance, aligned with Canada’s feminist vision for its international development agenda, the newly-born FinDev Canada has made gender a critical part of its core business strategy (Export Development Canada, 2018[77]). Moreover, the DFIs of the G7 countries (Canada, the UK, U.S., Italy, France, Japan and Germany) pledged to mobilize USD 3 billion by 2020 to support women’s access to leadership opportunities, quality employment, finance and enterprise support in developing countries.

3.4. Political fragility

The political dimension aims to capture the vulnerability to risks inherent in political processes, events or decisions, to its political inclusiveness and transparency (corruption) and to its ability to accommodate change and avoid oppression (OECD, 2018[2]). Political
risk is highest in countries recently afflicted by civil conflict or government crises, such as Somalia, South Sudan, Syrian Arab Republic, Yemen, Sudan, Burundi, Chad, Democratic Republic of the Congo, Eritrea and Ethiopia.

Figure 3.4 shows a generally positive relationship between the political dimension of fragility and blended finance: as political fragility decreases, the volumes of private finance mobilised increase.

![Figure 3.4](image)

**Figure 3.4. Private finance mobilised by political fragility level, 2012-15**

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Rule of law, government capacity and the local regulatory regime are important constraints faced by investors surveyed by the IFC when considering the expansion of equity instruments in emerging or frontier markets (Narayanan, 2018[48]). Global institutional investors on the securities markets in the EBRD region are also deterred by unpredictable regulation and political volatility (EBRD, 2018[49]).

The typical assumption is that the quality of governance, the business enabling environment and financial market flows share a positive relationship. However, different types of flows respond to varying degrees: while ODA effectiveness is positively correlated to good governance and better governance increases tax revenue for domestic resource mobilisation, foreign direct investment does not typically respond to improvements in governance (Sy and Sow, 2016[78]). The private finance mobilised by blended operations is not statistically influenced by the Corruption Perceptions Index, but it is positively correlated to the Economist Intelligence Unit's Democracy Index.  

The possibility of corruption and abuse poses serious reputational risks to brand-conscious companies (OECD, 2018[23]). In 2017, Credit Suisse barred transactions with ties to certain Venezuelan bonds and Standard Life Investments avoided exposure to the country’s debt sales due to “reputation risk” and a failure to meet socially responsible investment principles, respectively (Milhench, 2018[79]). Although BlueBay Asset Management reduced the company’s exposure to Venezuelan bonds for financial reasons, viewing

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7 The total volume of private finance mobilised in fragile contexts, as reported to the OECD from 2012 to 2015, show a correlation of 0.198601224 with the Economist Intelligence Unit's Democracy Index and of 0.065710825 Corruption Perceptions Index in 2018.
Maduro’s increasing power as a country risk, the head of investment risk also stated that “ethical issues [are] increasingly becoming an investment issue.”

When institutions responsible for the rule of law are manipulated by the ruling elites, public confidence in security services and justice system is heavily undermined. In Sierra Leone, a court judgment brought by a host community ruled in favour of a tax exemption to a particular mining company, whereas complaints of abuses against foreign companies in opposition areas often go unheeded (Ganson and M’cleod, 2017[80]). In Myanmar, multinationals must establish mandatory joint ventures with local firms for operational functions. While this builds local capacity, it also increases military elites’ hold on power and profits, furthering the inequalities that form the root causes of conflict (Miklian et al., 2018[81]).

Further exacerbating the challenge of financing entrepreneurial efforts in these regions are investors’ concerns regarding illicit financial flows (IFFs), which are a major impediment to the financial enabling environment, and intensify the uncertainty that impedes investment flows (Clemons, Lapointe and Georgen, 2017[52]). More precisely, IFFs may affect the private sector in two ways: (1) through mispricing or invoice manipulation by multinational and private companies, with a view to channelling money abroad or laundering money by bribing regulators or inspectors and (2) by stifling business and entrepreneurship and significantly reducing structural transformation and economic diversification (UN, 2012[82]). Indeed, in fragile contexts, IFFs are largely estimated to exceed inflows of aid and net FDI combined (OECD, 2018[2]).

Still, businesses, fundamentally driven by profit motives, are not necessarily deterred by the inherent conflict risk. The potential for significant financial returns over a short payback period is likely to convince some investors to operate in a high risk environment. Based on research by the Multilateral Investment Guarantee Agency (MIGA), political risk does not deter investment in conflict-affected and fragile economies when business opportunities outweigh risks and potential losses are limited. This finding applies across sector, company size and geographical origin (World Bank Group, 2010[83]).

In the changing landscape of business and conflict in fragile contexts, their presence and operations may create and exacerbate social and political unrest. A sober analysis must admit that, at least today, the international policy regime of incentives and disincentives for business will do little to change this dynamic (Ganson and Wennmann, 2015[62]). Since fragile contexts are typically paired with poor regulation for worker’s right and lack governmental accountability, there is a high risk for the private sector to exploit such contexts. This is especially problematic from the perspective of bilateral and multilateral development institutions that have a responsibility to ensure the ethical use of the funding they provide. The challenge is therefore not to attract business, but the right business with the right motivations.

3.5. Security

The security dimension aims to capture the vulnerability of citizen safety emanating from social and political violence. As such it includes indicators of citizen exposure to direct political and social violence (OECD, 2018[2]). The most insecure countries are those subject to ongoing conflicts and civil unrest: Somalia, South Sudan, Afghanistan, Iraq, Syrian Arab Republic, Yemen, Sudan, but also Libya.

In Figure 3.5, the relationship between the security dimension of fragility and amount of private finance reported mobilised remains unclear. This is surprising, as much of
the rhetoric regarding the challenges of mobilising the private sector points to the uncertainty triggered by conflict and violence, and seems to defy the traditional logic whereby security is necessary before economic development can occur.

**Figure 3.5. Private finance mobilised by security level, 2012-15**

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*Note: The heat map tallies the number of fragile contexts by degree of fragility and amount of private finance mobilised in 2012-2017. Dimensions of fragility range on a scale between 1 and 5 from more fragile to less. Source: (OECD, 2018[84]) and OECD-DAC Statistics on amounts mobilised from the private sector by official development finance interventions, [http://www.oecd.org/development/stats/mobilisation.htm](http://www.oecd.org/development/stats/mobilisation.htm). Database accessed on 10 July 2019.*

Conflict can be viewed as the culmination of every other dimensional aspect of fragility taken to the extreme. Private investors, much like ODA providers, become reticent to invest monies that may be deterred to support illicit activities like money-laundering, corruption, organized crime, drug production, and terrorism. Recent literature confirms that countries performing well on the Global Peace Index, which measures the absence of violence or fear of violence, show easier access to financing, higher rates of FDI and, ultimately, stronger GDP growth (Institute for Economics & Peace, 2019[84]).

In extremely violent situations, such as Somalia and South Sudan, which received the highest ranking on all fragility dimensions, FDI will be very scarce. In Somaliland, for instance, the few foreign multi-national corporations (MNCs) are present under special arrangements that may involve either the state or private arrangements involving Somaliland entrepreneurs (Ahmed M. Musa and Cindy Horst, 2017[85]). Because it often targets wealthy private individuals, kidnapping discourages entrepreneurship and foreign investment, damaging the region’s potential for economic growth. Terrorist groups as Boko Haram in Nigeria and Al-Qaeda in the Islamic Maghreb rely on kidnapping for ransom as their dominant source of funding (OECD, 2018[55]).

The conclusion of armed conflict may however generate new and attractive investment opportunities, due to depleted physical and human capital stock. Notable examples include the growth of the telecommunications sector (specifically mobile phones) in Afghanistan after 2001, the development of cocoa farming in Sierra Leone after 2003 (Mckechnie, Lightner and Willem Te Velde, 2018[86]) or urban reconstruction in Haiti since 2010. The needs of post-ISIS reconstruction in Iraq are estimated at USD 88 billion (World Bank, 2018[87]). Damage in Libya, Syria, and Yemen are thus far assessed on the order of USD 300 billion (IMF, 2017[88]).
4. Several blending instruments are available for donors, but their relevance to address fragility remains extremely context-specific

4.1. Leveraging mechanisms available to donors

Guarantees are, by far, the mechanisms that has allowed donors to mobilise most private finance, according to the OECD statistics. While this finding applies for all developing countries in general, it is even truer in fragile settings. Direct investment in companies played an important role in fragile contexts, while credit lines seemed more effective in more stable countries, possibly due to deeper financial markets. Syndicated loans also stand out for their leveraging potential.

![Figure 4.1. Private finance mobilised by instrument, 2012-17](image)

Note: Concerning project finance SPVs, amounts refer to private finance beyond syndicated loans and guarantees.


Guarantees mobilised the most private financing to fragile contexts, at USD 17.8 billion between 2012 and 2017. Direct investments in companies and SPVs mobilised USD 4.1 billion in private capital, closely followed by credit lines at USD 3.5 and syndicated loans at USD 2.3 billion.

Guarantees have an important leveraging potential, considering that they make up for 62% of the total volume mobilised, while representing 28% of the total number of operations. In fragile settings, donor agencies were more likely to utilise co-guarantors than in other developing contexts. This is to be expected, as fragile markets present a more important and more diversified array of risks to ensure against.

Still, credit lines showcase the highest mobilisation per deal, at USD 43.6 million in fragile contexts. This is also true for developing countries at large. Yet, credit lines and shares in
CIVs were much less popular in fragile than in stable areas (by transaction count), possibly owing to the lack of local financial intermediaries.

Syndicated loans are another prominent tool, where donor agencies often act as a participant with another official institution as the arranger, but private institutions were also used at times. Simple co-financing were the most frequently reported leveraging mechanisms (by count), both in fragile and more stable contexts, although they represent smaller transactions (by average volume).

4.1.1. Guarantees are the most prominent instrument for the mobilisation of private finance in fragile contexts and beyond

Guarantees can address failures in the local financial market, from the lack of collaterals to misperception on the default risk of MSMEs. They allow local financial institutions to grow their portfolio, by expanding into new areas or clients that were not bankable before. They can become a vector to disseminate good practices, for instance in terms of environmental, social and governance (ESG) standards. Counterparts may also benefit from reputational transfer, raising their credibility in the eyes of other financial institutions and local authorities. For instance, the Principles for Public Credit Guarantee Schemes introduced by World Bank Group provide a set of good practices for governments to improve the legal and regulatory environment in the SME credit market.

Guarantees are not appropriate for all needs, for instance they cannot solve a lack of liquidity, but they can be deployed very well even in fragile contexts. Technical assistance remains however a key success factor to accompany and reinforce capacity of local actors. Local banks are not just wary of extending loans, they also often lack the technical preparation. In particularly challenging environments, guarantee funds need to be publicly subsidised in order to mobilise the commercial investors.

These tools can be started with little development finance, as the financial market in conflict areas are virtually non-existent. For instance, the Afghan Credit Guarantee Foundation (cf. Box 4.1) was started by DEG with EUR 350 thousand in 2005. Since then, the fund has received EUR 7 million from BMZ, USD 5 million from USAID, and was recently capitalized with USD 6 million equity and a USD 5 million grant by the World Bank, as part of Afghanistan Access to finance project (Afghan Credit Guarantee Foundation, 2016[89]).

The blended finance players interviewed for this study recognised however that guarantee funds operating on a purely commercial model are very difficult to implement in fragile contexts, as they do not provide enough cushion for negative contextual developments. In order to reach the development goals, investors must be willing to lower return expectations when entering such markets. Structured guarantee funds, where donors and development finance institutions with higher risk tolerance, are thus indispensable for the mobilisation of commercial capital in adverse environments.
Box 4.1. Tailoring guarantees to fragility

LANDT is an international group born in Germany, dedicated to improving SME finance through credit guarantee funds and technical assistance in challenging environments. Since 2014, they have been operating two credit guarantee funds:

- Afghan Credit Guarantee Foundation (ACGF), which follows a donor-funded concessional model, started by the German development cooperation with USAID and now also supported by the World Bank. The donors here don’t expect any financial return other than development impact. ACGF has achieved remarkable results in a very challenging environment. By June 2018, ACGF had facilitated disbursement of approx. USD 205m guaranteed loans to some 4,850 SMEs. ACGF helped retain more than 50,000 jobs and created in access of 9,000 new jobs. The historical net loss rate of an average of 1.2% p.a. is also considered a very good result in light of the challenging business environment.

- Credit Guarantee Fund Tajikistan GmbH (CGFT) is designed on a market-based model, with investment from DEG, OeEB and FMO of EUR 12.5 m coupled with a technical assistance facility of EUR 1m. By June 2018, approx. USD 33m amount of loans guaranteed by CGFT were disbursed by Tajik partner institutions, 950 SMEs were supported and more than 4,000 jobs retained. CGFT is facing challenges, due to the slow growth in business volume, which is explained by the dearth of local intermediaries (commercial banks and micro-finance institutions) and the consequences of the Russian crisis that weighed heavily on Tajikistan, as remittances represent more than 40% of its GDP.

The success of their business model relies on finding the right legal and fiscal set-up: ACGF was incorporated as a charitable foundation, which under German law cannot disseminate dividends or returns. For CGFT, a limited partnership (GmbH & Co KG) was preferred, so that profits can accrue directly to each DFI, who benefit from preferential tax treatment.

The extremely low loss rates can largely be attributed to a corporate culture that values portfolio quality more than efficiency. LANDT relies on two local consulting firms (both subsidiaries), SME Client Support Afghanistan LLC and Tajik Credit Support Partner LLC, to accompany partner financial institutions in their SME credit operations – in many cases performing the due diligence on new loans together with the partner institutions. This ongoing assistance implies higher operating expenses, but better portfolio performance. Both subsidiaries are well-established in the local markets and are currently expanding into provision of consulting services beyond the advisory support to the CGFs.

This is reinforced by a strong commitment to local capacity building. ACGF and CGFT systematically support their partner institutions in developing their SME lending operations – often from scratch – by creating SME departments, formulating their lending strategy, training their staff, developing lending products and improving the partners’ risk management.

Source: Bernd Leidner, Managing Partner, LandT
4.1.2. Public-private partnerships

Public-Private Partnerships remain the most traditional and widespread form of blended finance. Brookings Institution found that one-third of the 1,600 public-private partnership USAID has engaged in from 2001 to 2015 were implemented in fragile states, as identified by the World Bank and the Fund for Peace (Ingram, Johnson and Moser, 2016[90]). In practice, they can entail the use of several leveraging mechanisms, ranging from simple co-financing, to direct investment in SPVs and syndicated loans.

Such agreements have raised concerns in the development community about the higher cost of capital, the lack of savings and benefits, complex and costly procurement procedures, particularly in the health sector (Green, 2015[91]). Despite the additional flow of resources, they may place an unforeseen burden on domestic public resources. The World Bank’s response is that PPPs in fragile and conflict situations generally rely on lease, management contracts, or hybrid schemes, which limit the level of risk sharing and usually do not involve ownership of assets (World Bank Group, 2013[92]).

Indeed, partnerships can often make it more difficult to maintain country ownership and increase transaction costs for partner countries. The success of PPPs depends on the capacity of local government to manage and deliver the defined outcomes, which is particularly lacking in fragile contexts (Rensch, 2018[93]).

Effective partnerships are characterized by mutual agreement on goals, clear governance arrangements, and clarity in relation to respective responsibilities (World Bank Group, 2014[94]). Partnership arrangements backed by multi-donor trust funds facilitate donor coordination and joint dialogue in countries recovering from conflict and disaster. Multi-donor trust funds have provided clear value-added in fragile and conflict-affected states where they have been used to pool donor resources and contributed to donor coordination, policy dialogue, and institution building (World Bank Group, 2013[92]).

4.1.3. Debt instruments attract rising criticism

Blended concessional financing is particularly needed in fragile contexts to provide below market interest rates. Care is required before making new loans to fragile contexts, due to their rising levels of indebtedness and concerns on their debt sustainability. Since blending mostly concerns financing to private actors, its consequences on public deficit should be limited. Local currency lending to SMEs is recognised by DFIs as bringing high levels of expected development impact in fragile and conflict-affected situations (AfDB et al., 2017[95]). Still, in a crisis, public authorities may be called to pick up the debts of the private sector.

Evidence shows that the effects of this debt remain a potential burden in the event of economic downturns (IMF, 2017[66]). The increased appetite of sovereign borrowers has been facilitated by the willingness of commercial lenders looking for yield in a market awash with liquidity, and by credit from China and other bilateral lenders who are not part of the Paris Club (Masood Ahmed, 2018[96]). The press has repeatedly exposed the perils of non-concessional lending to low-income countries, especially if at “high” risk of debt distress according to the IMF.
Box 4.2. The risks of non-concessional lending

In 2017, the Tajikistan Nurek Hydropower Rehabilitation Project loan has been launched with financing by the Asian Infrastructure Investment Bank’s (AIIB), the World Bank and the Eurasian Development Bank. Because of Tajikistan’s high risk rating, the World Bank’s financing is required to be on extremely concessional terms (IDA Credits and Grants). The AIIB will instead provide a USD 60 million loan and charge a lending spread of 1.4% over LIBOR.

While electricity sales are expected to increase, the higher lending rate charged by AIIB will make it more difficult for Tajikistan to generate the revenues needed to cover the cost of the repaying the loan. Moreover, there is little financial incentive for AIIB to pressure Tajikistan to meet its rate hike commitment (John Hurley, 2017[97]).

Higher levels of indebtedness intensify the borrowers’ exposure to market risks and create challenges for debt resolution, especially when debt is secured on commercial terms from non-commercial sources (International Monetary Fund, 2018[98]). The international community lending strategies must strive to limit the associated risk of debt distress, by considering the existing debt burden, but also the likelihood of conflict and other shocks.

4.1.4. Equity investments and the missing middle

Relatively underdeveloped private equity markets, especially in Africa, compounded by high interest rates on bank lending and limited availability of longer-term loans are perceived as barriers to the growth of MSMEs. Patient capital is direly needed for long term investments, without the expectation of early returns. The majority of European DFIs portfolios are placed through the use of equity (EDFI, 2016[99]), but privately managed funds and corporations may also contribute direct investment in local companies.

Equity investors have an ability to influence and direct the management of the company, depending on the ownership interest, with their returns on investment based on the company’s success in growing or enhancing profitability. Because ownership constitutes a claim on the residual value of the company after all creditors are reimbursed, equity investors will be more exposed to loss in the event of bankruptcy. Market risk, particularly in the form of equity risk, will thus strongly influence decisions regarding investment in equity.

In least developed and fragile contexts, SMEs are often reliant on straight debt to fulfil their start-up, working capital and investment needs. The need for a wider range of terms and conditions (e.g. tenor and security coverage) make mezzanine capital, equity and quasi-equity important types of alternative financing for SMEs there. By investing risk capital, private equity investors can become partners in a firm’s growth, providing technical expertise and networks, driving operational advances and improving ESG standards (UNCDF, 2018[100]).

While equity is a relevant tool to promote micro, small-and medium-sized enterprises (SMEs), DFIs and mainstream investors usually concentrate on larger operations. As a result, businesses find it hard to raise the required smaller amounts (ranging from EUR 100 000 to EUR 300 000). The so-called “missing middle” is targeted for instance by IPDEV 2, an investment company managed by Investisseurs & Partenaires (I&P) through locally-
incorporated and locally-managed funds based in Burkina Faso, Côte d’Ivoire, Madagascar and Niger (amongst others).

Another example is the Central Africa SME Fund launched by the fund manager XSML in 2010 which provides private equity, long-term debt and technical assistance to SMEs in Democratic Republic of Congo and Central African Republic, two of the most difficult markets for private investors in sub-Saharan Africa. The USD 19 million fund leverages technical assistance grants to support SMEs pre- and post-investment. Building on this successful experience, XSML closed the African Rivers Fund in 2016 at USD 50 million, adding Uganda, the Republic of Congo and Burundi to the geographic scope (UNCDF, 2018[100]).

**Box 4.3. Blending for resilience business**

Cordaid Foundation, a Dutch faith-based organisation, is a frontrunner in opening markets to impact investments in fragile and post-conflict contexts since 1997. The Stability Impact Fund Africa (SIFA), managed by Cordaid Investment Management, targets MSMEs and MFIs, paying special attention to women and youth employment. The targeted fund size is 40 million euros. The anchor investor of the fund is Cordaid Foundation that has taken a first loss position in order to attract like-minded investors. Its portfolio is distributed across on the Democratic Republic Congo, Mali, Sierra Leone and South Sudan. The fund will also focus on Ethiopia, Guinea, Liberia and Uganda.

SIFA provides investment capital (senior/subordinated debt and/or equity) to MSMEs in order to catalyse business growth. For instance, Cordaid Investments provided, together with a private investor, equity and debt investment in Hekima, a microfinance institution serving vulnerable and low income women in DRC. This supported the diversification and increment of Hekima’s equity value as well as its transformation into a public limited liability corporation.

SIFA also focuses on job creation. For example, in Sierra Leone, it supported WARC Africa with loans in local currency for the expansion of rice production and the launch of maize production. Cordaid Investments also worked with WARC Africa to develop some Environmental, Social and Governance plans. The investee has created more than 160 jobs since 2016. Cordaid’s loans catalysed additional funding from other investors that supported the expansion of the company.

In order to steer the growth process, SIFA executes regular monitoring of the investees on the financial performance and social impact targets, allocating special attention to the smaller SMEs. Technical assistance is provided to selected investees to strengthen their performance by building specific capacities (CORDAID, 2018[101]).

While both equity funds managed to attract significant volumes of additional finance, their experience proves the challenge of drawing purely commercial investors into fragile
Like for guarantees, these cases also reiterate the importance of a concessional element to support knowledge transfer and capacity building in favor of local private actors.

### 4.1.5. Impact investing is increasingly tested, even in humanitarian settings

Increasing innovation, even in the context of humanitarian crises, has given rise to new financial instruments which, by their structure, mandate and funding sources, may qualify as both blended finance and social impact investment.

**Box 4.4. Humanitarian Impact Bond**

The Humanitarian Impact Bond, a pooled vehicle of USD 27 million, issued by the International Committee of the Red Cross (ICRC) is funding physical rehabilitation centres in the Democratic Republic of Congo, Mali and Nigeria.

Initial payments by social investors (New Re, part of Munich Re Group, and others identified by co-sponsor Bank Lombard Odier) will be refunded, after 5 years, by the outcome funders (governments of Belgium, Switzerland, Italy, the UK and La Caixa Foundation) depending on the effectiveness and efficiency achieved by ICRC.

The bond operates on a results-based framework that provides a return based on the benchmark of how many patients receive mobility devices per physical rehabilitation professional in existing centres. Anything above the benchmark receives a return, while operating below the benchmarks results in an investment loss (Hanger, 2017[102]).

Development impact bonds are not per se debt securities, but rather pay for success mechanism. Although the costs of design and measurement remains for now very high, these tools can stimulate innovation and impact-oriented behaviour by service providers, while at the same time producing knowledge around development results.

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8 Following a first closing at EUR 9.5 million in October 2015, IPDEV 2 realized its final closing at EUR 11.5 million, bringing its equity to EUR 21 million. Investors include: African Development Bank, Ceniarth, BNP Paribas, Soros Economic Development Fund, the Adolf H Lundin Charitable Foundation and FISEA, the Investment and Support Fund for Businesses in Africa managed by Proparco. The two funds managed by XSML count as investors several DFIs (IFC, FMO, CDC Group, BIO, and Proparco) plus the Lundin Foundation and the Dutch Good Growth Fund.
Box 4.5. Cameroon Cataract Bond

The Cameroon Cataract Bond is a collective investment vehicle that strives to address blindness across sub-Saharan Africa by targeting a shortage in cataract surgeries (Oroxom, Glassman and Mcdonald, 2018[101]). Start-up capital comes from OPIC and the Netri Foundation, financing the total investor ask 87.5% and 12.5% respectively. OPIC will provide USD 2 million for operational costs, covering aspects such infrastructure, IT, outreach, overhead and training, and aim to assist the hospital to reach self-sufficiency.

The five year loan shall allow the service provider, the Magrabi ICO Cameroon Eye Institute, to keep operating costs low while expanding the number of cataract surgeries performed. The bond is paid across the following targets:

- A volume within 10% of 18 000 cataract surgeries across the five years;
- A quality check measured by 50% of all surgeries within a year achieving a “good outcome” where visual acuity in 6/18 of the operated eye is achieved a day after the surgery;
- The achievement of a net profit before interest, taxes, depreciation and amortisation within five years to showcase long-term financial sustainability;
- Providing 40% of surgeries within the bottom half of Cameroon’s income distribution in order to receive bonus equity.

The criteria listed above will be paid by three outcome funders: the Conrad N. Hilton Foundation, the Fred Hollows Foundation and Sightsavers, who also contributed approximately USD 800 000 towards bond development costs, including legal and transaction manager fees. The bond was officially launched in January 2018 and, if successful in achieving its outcomes, will serve as a model for social enterprises in fragile contexts and elsewhere on the African continent.

Avenues for long-term recovery and resilience should be considered from the outset of humanitarian crises, including in terms of private sector engagement (OECD, 2016[104]). Some private actors are interested mainly in procurement opportunities for the delivery of goods and services, whereas others are looking to contribute to projects and programmes as a partner. The development of memoranda of understanding with businesses on how cooperation will occur a priori is important for ensuring efficient and effective responses in times of crises (USAID, 2015[23]).

The idea of social impact bonds in fragile contexts explicitly targeted towards peace and development outcomes (so-called peace or yellow bonds) has already been raised but not yet materialised (IDPS, 2018[47]). Despite long gestation periods, performance-based mechanisms can be one means for clear expectation setting with private partners, even in humanitarian crises.
4.2. Pooled vehicles are a primary channel for blending, but their mobilisation potential in fragile contexts remains to be proven

The popularity of pooling funds from multiple donors into a single instrument, a multi-partner trust or pooled fund has peaked over the last decade, including in fragile contexts. Pooled vehicles emerged as a primary channel to attract commercial investors and as an important driver of financial innovation. While many of the countries targeted by pooled mechanisms, like the Global Concessional Financing Facility, such as Jordan and Lebanon, are not classified as fragile under the OECD 2018 States of Fragility Framework, they do host high proportions of refugees that come from such fragile areas.

As of April 2018, there were 66 pooled funds operating in 37 fragile contexts, with total approved budgets of USD 247.7 million, representing 71.6% of the total approved budgets for all United Nations pooled funds (UNDP, 2018[105]). The UN Peacebuilding Fund (PBF) was established in 2006 to provide timely, risk-tolerant and catalytic funding to meet the particular needs of countries and situations at risk of or affected by violent conflict. Since its inception, the PBF has grown in size and scope. However, amounts mobilised by the private sector remain negligible9. The UN Mutual Trust Fund Office reported contributions of barely USD 42 419 by the private sector from 2007 to 2017.10

The World Bank’s State and Peacebuilding Fund is directed at addressing fragility, conflict and violence at the source, with a focus upon flexibility and a wide range of applicability. Since its establishment in 2008, the current total envelope amounts to USD 322.7 million. Eligibility is examined using tools, such as Risk and Resilience Assessments, Recovery and Peacebuilding Assessments and Security and Justice Public Expenditure Reviews, to understand the nature of fragility within any given context and how to best engage the private sector to achieve sequenced development outcomes (The World Bank, 2018[41]). The Conflict-Affected and Fragile Economies Facility supports provision of political risk insurance products in fragile and conflict-affected states. With funding from Canada, Sida, and DFID, the facility has so far exceeded the output expectations of the original business plan. In 2017, the International Development Association established a Private Sector Window (PSW) of USD 2.5 billion, aiming to catalyse foreign and domestic private investment in eligible fragile and conflict afflicted states, by de-risking at country and transaction levels (IDA, 2018[106]). IDA issues AAA-rated bonds and part of the funds raised on capital markets is then channelled to a separate window dedicated to fragile contexts and a separate sub-window for blending.

The Africa Enterprise Challenge Fund (AECF) is a pooled mechanism that specifically targets private sector engagement in post-conflict states (OECD, 2016[104]). So far, the Post-Conflict Window has provided capital for 20 projects to establish innovative agribusiness in the DRC, Liberia, Sierra Leone, Somalia or Somaliland (AECF, 2018[108]). Additionally, the Transition Support Facility set up by the African Development Bank strives to address how resources are allocated in fragile contexts. While historically the bulk of resources came from the African Development Fund (ADF), the Facility is increasingly attracting

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9 UN PBF total commitments from 2006 to 2019 amount to USD 862 705 397, including USD 19 333 from the private sector. Source: http://mptf.undp.org/factsheet/fund/PB000 (accessed on 30/07/2018).

additional resources and voluntary contributions from donors or third parties. Since 2008, it has mobilized more than USD 4 billion additional development finance for a set of low-income countries where fragility is the main development challenge (OECD, 2018[2]).

Collective vehicles targeted to fragility are also being established at the bilateral level. France recently doubled allocations to the Minka Fund, which is poised to reach up to EUR 200 million by 2019 (AFD, 2018[109]). Similarly, Canada (Peace and Stabilization Operations Program), Denmark (Peace and Stabilisation Fund), the UK (Conflict, Stability and Security Fund) and others have facilities specifically earmarked for fragile contexts.

Box 4.6. Addressing the transparency challenge raised by blended finance funds and facilities

While transparency is a key aspect to the OECD DAC Blended Finance Principles, ensuring that the funding provided ultimately supports its intended development outcomes is complicated. This can be illustrated in the use of collective investment vehicles (CIVs), which share risk through joint investment in a company portfolio, posing a challenge in monitoring what that investment ultimately supports.

DFIs have already faced challenges in this regard; for example, France’s Proparco, the FMO Entrepreneurial Development Bank, Norfund and the European Investment Bank all channelled funds through a venture firm that invested in the private education firm Bridge International Academy (Aubry and Zondani, 2017[110]). Later, the Academy was found to provide “ineffective and unsustainable” development outcomes due to low quality education, high fees and low wages (Ratecliffe and Hirsch, 2017[111]). While the Academy received other forms of funding, such as direct ODA funding from DFID, the use of a venture firm makes financial flows more difficult to track.

Accountability is especially important in fragile contexts, where illicit financial flows and corruption are more easily exploited. To gain visibility into the functioning of blended finance funds and facilities, the OECD has started a survey in 2017 which will be repeated and refined in the future.

Pooled funds can help improve risk management for individual development partners, particularly in fragile and conflict-affected contexts (UNDG, 2016[112]). But a deeper understanding on the functioning and objectives of each vehicle is needed in order to ensure coordination and efficiency. In Sudan, for example, there is significant potential to harmonise and align the work of the four pooled instruments, with many benefits in terms of information sharing on partner performance and results, aligning goals, and clarifying division of labour (Scott and Topping, 2017[113]).
5. Conclusion

5.1. Private finance mobilised in development co-operation is not equally sensitive to all dimensions of fragility

The OECD data analysis shows a positive relationship between blending opportunities and economic, political and environmental security. The amounts of private finance mobilised in 2012-2017 by official development finance increase, as the country’s ranking on economic, political and environmental fragility decreases.

The way blended finance interplays with societal fragility and security remains unclear, as these two dimensions exert more complex influence on the perceived risks versus anticipated returns trade off, which guides private investors. The societal dimension is more difficult to capture and quantify in the investment decision making process, whereas security can be prevented by deploying reinforced protection services, albeit at higher costs.

Local factors are decisive for the success of blended operations, hence contextual knowledge by financing and implementing partners is critical. In practice, private firms may engage in a wide variety of coping strategies to reduce risk, e.g. hiring local staff, issuing local shares and sometimes going so far as building public infrastructure themselves (McKechnie, Lightner and Willem Te Velde, 2018[114]). While some dimensions of fragility may be more prominent in the investor’s strategy, what ultimately will determine their investment decision is not the inherent existence of risk, but rather its assessment and their appetite for it.

The grounding principles of development effectiveness require context specificity. Blending partners, in concertation with local stakeholders, must understand what investment choices are more conducive to revenue and jobs creation, in a way that sustains peace and resilience. A company’s social license to operate, intended as the informal assent of affected communities (Miller et al., 2019[115]), must be secured before investment and maintained over time.

More fine-grained data would help pinpoint more precisely the geographical gaps in (and opportunities for) the mobilisation of private finance. But the international community is still struggling to identify the most appropriate “frontiers” to understand and support fragile contexts, within and beyond administrative borders. Future research could investigate if and how the blending mechanisms activated by multilateral and bilateral development finance providers are linked to the five dimensions of fragility, and in particular to what extent they might prompt investors to revisit their strategy along certain industry verticals, by rebalancing their portfolios away from the traditional rent-seeking sectors.

5.2. The use of private finance in development co-operation requires tighter safeguards and monitoring

If governments, agencies and DFIs are increasingly adopting development co-operation strategies specific to fragile contexts, these rarely mention the possibility of leveraging private capital, despite it representing almost 40% of all external flows in 2016 (as per Figure 1.2). Other blending actors, such as private asset managers and other intermediaries, rarely define strategies tailored to fragility. This implies that, when private mobilisation occurs, the specificities linked to the different dimensions of fragility may be overlooked,
or that the blended operation may not be fully embedded in the broader development co-
operation policy.

When mobilising commercial capital, development finance providers must recognise that it will abide to a different intervention logic. The business case guiding private investors is not necessarily aligned with the peace and stability agenda. Hence, blended finance instruments should be designed to steer implementation towards measurable social, environment and governance outcomes. Result-based mechanisms allow to incentivise beneficiaries and implementing actors, therefore improving development results and ownership of policies.

Fragile contexts require a finer understanding and a more granular assessment of development results. Since the introduction of new resources will inevitably affect the precarious balances in the social and economic structure, public authorities should carefully understand the possible consequences for the different stakeholder groups. It is important that projects, especially large infrastructure ones, do not widen existing disparities (gender, income or regional) within the country. Transparency on the use of subsidies becomes even more critical, to avert the crowding out of local market players and manage public expectations.

In practice, the need to adapt to the local context is too often reduced to ensure harm avoidance. None of the investors or intermediaries interviewed for this study had defined more stringent ex-ante safeguards to apply in case of fragility. Ideally, development finance providers should foresee specific checks when mobilising commercial partners, taking into consideration all fragility dimensions and their intensity (e.g. through ex-ante conflict sensitivity analysis). Indeed, companies that positively contribute to the peacebuilding process usually demonstrate exceptional abilities and willingness, well beyond ordinary business activities or corporate social responsibility initiatives (Miller et al., 2019[115]).

The monitoring and evaluation approach should also better integrate the ‘do no harm’ principle. For instance, the objective of financial inclusion would require a more detailed tracking than just the number of client SMEs, to understand if the pricing and coverage is adapted to the characteristics of final beneficiaries. Development finance providers should thus pay particular attention during the design phase, by conducting ex ante risk assessments, but also by requesting more careful monitoring from their implementing partners.

5.3. Fragility should matter in the choice of investment instruments

Public-private partnership is a broad term for long term agreements between the government and a private partner, whereby the latter delivers and funds public services using a capital asset and sharing the associated risks. Such project financing arrangements may encompass the use of a broad range of instruments. While the literature does not concur on their cost-effectiveness, the public and private interests will generally be better served when such partnerships are based upon a collaborative approach and assist in establishing principles of good governance, especially in conflict areas. This in turn can help build trust and regain the credibility of both sectors among local communities. (Abramov, 2010[116])

In fragile settings, especially if recovering from conflict, development partners should expect higher operating expenses and demand for support. Blended operations often take longer to prepare and require significant upfront technical assistance. Smaller deal tickets (cf. page 24) also imply it will take more time to reach enough volume and to produce
revenues. In conditions of low human capital and formalisation, investors must often step up to reinforce the business management and risk assessment capabilities of local counterparts. Long investment horizons and some degree of concessionality may at times be prerequisites for the materialisation of blending opportunities.

5.3.1. Caution is advised when using debt

Debt levels are at historic peak both in developed and developing countries, which could in the long run constrain the capacity of both beneficiaries (through reduced absorption capacity) and providers (through reduced budgetary flexibility) to marshal financial resources for sustainable development (OECD, 2018[117]).

Debt financing is a widely used instrument, publicly and privately. Since debt needs to be repaid, it can create positive incentives for borrowers to exercise fiscal discipline. At the same time, it may place a fiscal burden on the borrower and unsustainable debt levels can lead to currency and banking crises, especially with low government capacity and weak regulatory regimes (OECD, 2018[117]). Where blended finance projects are funded by public authorities, they might indeed bear fiscal implications and hence weigh on national debt. If the blending operation is fully underwritten by the private sector, it should not impact fiscal constraints as the capital should ultimately be repaid through consumer fees.

Development finance institutions are the main providers of non-concessional lending to country governments, but also to private companies (OECD, 2018[117]). For low-income countries, the choice between grants and loans is often guided by the World Bank/International Monetary Fund Debt Sustainability Framework, which is followed by several multilateral and bilateral providers. Grants tend to be prioritised in countries that do not have alternative financing options or cannot afford external borrowing.

Most privately extended debt in developing countries takes the form of non-tradable loans. However, the increasing use of tradable securities (e.g. bonds) can have negative consequences for any required debt restructuring, because on capital markets it is more difficult to ensure the co-ordination needed to produce agreements acceptable to all major creditors.

Development finance providers may thus caution before backing the use of debt instruments, particularly in countries with high economic and political fragility.

5.3.2. Mezzanine finance and guarantees are powerful tools to unlock additional capital

Mezzanine finance and guarantees both involve sharing risk between provider and recipient. Mezzanine finance is a hybrid instrument situated between debt and equity and used mostly by private sector actors and institutional investors. Development finance institutions are increasingly applying it in the form of structured blended funds.

Guarantees provide protection against political and/or commercial risk, typically in return for a premium. Although only half of the guarantees used in development finance are structured to maximize the mobilization of private capital (Lee, Betru and Horrocks, 2018[118]), they can provide immediate leverage on financing by private investors, thereby accelerating and increasing development outputs.

Guarantees can be a low-cost means for public authorities to meet development objectives. In fact, such schemes often exhibit very low default rates and even lower pay-out claims, as for instance in (Carnegie Consult, 2016[119]) and (SEGURA Partners LLC, 2013[120]),
raising doubts on whether public intervention was warranted in the first place, and questioning its additionality. It further indicates that the perceived risk is usually greater than the real one. Ratings for country and project risk remain confidential, whether the issuer was a public or a private entity. As a consequence, the overall pricing system lacks consistency and transparency.

Few institutions offer comprehensive risk insurance, one notable exception being the Multilateral Investment Guarantee Agency (MIGA) through its sovereign non-honouring cover. In most cases, political insurance instruments do not cover default caused by economic difficulties, local currency devaluation, or borrower insolvency. Guarantees that support commercial borrowing by enhancing credit terms are hence increasingly preferred to partial political risk mitigation.

Particularly in fragile situations, credit guarantees can substitute, or complement, the collateral that a borrower cannot supply. Lending by local banks may be restrained by the lack of credit history for new clients, or due to the absence of a credit bureau data on the market. Guarantees can thus expand the frontier of finance to previously unbanked businesses. Finally, because they are not associated to interest payments, they can be used even when financial institutions adhere to principals of Islamic finance.

Local currency depreciation remains one of the main burdens for international lenders. Hedging against foreign currency exchange fluctuations is another efficient and widespread means to lower transaction risk. The minimum transaction size for currency risk facilities remain quite high (USD 250 thousand for TCX and USD 100 thousand for MFX), although more retail solutions are emerging, such as Aidhedge supported by Sida. For instance, a partnership between TCX and the Livelihoods and Food Security Trust (LIFT) allowed Cordaid Investments to continue its operations in Myanmar despite pressing concerns over the expected devaluation of the Kyat, and to disburse EUR 10 million in loans to four MFIs in 2016.

Insurance instruments on other risk factors, notably environmental, for private investors are still at very early stages. Indeed, insurance remains one source of disaster risk management that remains under-exploited, even for sovereign clients (Giugale, 2017). The OECD data analysis shows that environmental fragility clearly plays a role in the capacity to mobilise private capital. Development finance providers could thus further explore such leverage mechanisms, if they want to attract long-term institutional investors in countries vulnerable to climate shocks. The Global Risk Financing Facility, established by Germany and the United Kingdom, with support from the World Bank, endeavours to work in strong collaboration with the private sector (World Bank, 2018).

Beyond natural disasters, similar solutions can be tailored to tackle more specific sources of risk, by mutualising potential financial losses among different stakeholders. The International Rescue Committee is currently piloting a displacement risk insurance to address potential delays in ODA disbursements during crisis situations. In the future, the same principle could be applied to early-warning and conflict prevention (Kantowitz, 2018), although their capacity to crowd in private investors remains to be tested.

5.3.3. Equity can bring more than just finance

While direct investment in companies remains relatively underrepresented in the mobilisation of private finance, both in fragile and in other developing countries (cf. 11 https://www.aidhedge.org
Figure 4.1, it can bring much value added to the ultimate beneficiaries, beyond the mere transfer of resources.

Equity or quasi-equity investments are a powerful tool to address the needs of SMEs and local financial institutions that go well beyond access to long-term financing. Investors can accompany the formalisation process, support the recruitment of skilled labour or training of the existing workforce, improve the governance and management practices, including on ESG concerns.

With the rising number of blended finance funds and facilities (Basile and Dutra, 2019[124]), intermediated venture capital and equity approaches have become more readily accessible. Striving to increase its presence in more challenging markets, the CDC Group has been piloting the use of permanent capital vehicles that offer a longer-term horizon beyond the standard ten-year private equity model. In 2017, CDC’s invested USD 20 million in Solon Capital Holdings, which operates in priority sectors like education and construction in Sierra Leone (ICAI, 2019[38]).

The experience of IPDEV proves that positive private equity exits are possible even in the fragile sub-Saharan region (e.g. in Mali). During its 15 years lifespan, the fund has achieved 20 exits (out of 33 positions), with good gross investment return rates. The minority shares were sold to the entrepreneur themselves or to a third party, who would keep supporting the business and bring additional skills (Investisseurs & Partenaires, 2018[125]).

5.4. Blending efforts must rest on continued support to policy reform

Any external investments can shake uncertain resource equilibrium in societies at risk of conflict. For blended finance operations, especially those involving foreign private investors, to bear peace-supporting and development-friendly results, an appropriate legal framework must be in place in the host country protecting workers’ rights and securing benefits are retained in the local economy (local content rules, sharing know-how with local actors, etc.) Dialogue prior to launching blended investments is crucial to secure space for the expression of diverging interests, to avoid an excessive weight of private commercial interests, and to ultimately foster ownership by local actors.

Despite its promising potential, blending remains a relatively selective aid modality, which cannot address all the SDG financing needs, particularly in fragile settings. In particular, the private finance mobilised in development co-operation, but also blended funds and facilities, do not yet address pressing deficiencies in social infrastructure and services. The financing gap on shock-responsive social protection and resilience-building measures remains marginal when compared to the potential costs of rising fragility (OECD, 2018[2]). Future efforts should thus be devoted to better understand how private investment can be better targeted to answer social needs in developing and fragile contexts.

The business environment and the investment policy framework are critical, not just for the concretisation of blended operations, but also for their sustainability in the long run. While the role of the public sector is often minimal in fragile contexts, owing to a lack of capacity, all investors eventually look for a credible commitment from government (McKechnie, Lightner and Willem Te Velde, 2018[114]). Development finance providers must thus accompany their leveraging efforts with continued support to policy reform, in order to enable effective management of resources and sustainable economic development.

A virtuous, cyclical relationship between economic activity and positive peace hinges on a number of highly interconnected factors (e.g. sound business environment, low corruption,
accumulation of human capital, free flow of information), where private investment can play a pivotal role (Institute for Economics & Peace, 2019[84]). If realism and cautiousness are required when devoting scarce public, concessional resources towards blending (Box 1.1), opportunities for mobilisation may arise in areas such as institution building and fighting against corruption, where private actors can bring their skills and technology to bear, alongside their financial assets. One concrete example of rewarding businesses’ contribution to peace building is the IIX-N-Peace Innovation Challenge promoted by UNDP, N-Peace Network and Impact Investment Exchange Asia (IIX) in 2015 whose laureates included impact enterprises operating in Afghanistan, Myanmar, Nepal and Pakistan.

Economic development in fragile contexts requires the presence of a willing government intent on change, backed by forward-thinking political leadership, and alongside technical support from international partners. Private sector development and anti-corruption policies must curtail the perpetuation of rents, foster competition and the ability of new entrants to penetrate existing markets. Development finance providers must also play their part in promoting the quality of investment and responsible supply chains. Fundamentally, donor support to the enabling environment for private sector development should underpin all other catalytic aid approaches, especially in fragile contexts.

More space is needed to encourage innovation, test different solutions and promote dialogue with the private sector to help solve challenges alongside humanitarian, development and peacebuilding actors. Especially for those countries in chronically fragile situation and/or affected by protracted conflicts, development aid has a significant catalytic role to play in creating an enabling environment for private sector development, as a long term driver for sustained peace. Therein, development finance providers are in a crucial position to foster participation, address risk perceptions and ensure a framework of trust with private investors.
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