AFRICAN FORUM AND NETWORK
ON DEBT AND DEVELOPMENT

Conceptual Paper

Blended Finance and Impacts on Development Effectiveness

Introspection on Increasing Financing for Development in Africa

I. Introduction

In order to achieve the Sustainable Development Goals (SDGs), developing countries require the mobilisation of significant additional financial, human and material resources. The current state of development funding shows a big gap between the required funding to eliminate poverty, meet the SDGs and Agenda 2063 Aspirations and the actual available resources. According to UNCTAD, developing countries alone face an estimated US$2.5 trillion annual investment gap in key sustainable development sectors.[1] A fundamental cause of this gap is that developing countries lose hundreds of billions of dollars every year to ill-advised investment agreements and investor state dispute settlements, corruption , illicit financial flows (IFFs)and debt servicing. This has led OECD as well as developing countries to start considering engagement with the private sector for the delivery of development and public goods such as infrastructure in sectros such as health, education, transport and water and sanitation. This has largely been done through blending of public and private finance popularly known as blended finance.

Whilst there is no unanimously accepted definition for blended finance, OECD (2018) notes that blended finance is the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries[2], whilst EURODAD (2017) points out that blending can be broadly defined as the combination of public concessional Official Development Assistance (ODA) with private or public resources, generally with the aim of 'mobilizing' or 'leveraging' development finance from other actors[3]. With a slightly different angle, the World Economic Forum posits that blended finance is the planned use of development finance and philanthropic funds to mobilise private capital flows to emerging and frontier markets resulting in positive results for both investors and communities (2016).

The importance of blended finance emanates from the fact that it contributes to development objectives by increasing capital leverage, enhancing impact and managing risk

[1] UNCTAD (2014) World Investment Report, http://unctad.org/en/PublicationChapters/wir2014ch4_en.pdf#page=11
[2] http://www.oecd.org/development/financing-sustainable-development/blended-finance-principles/
[3] EURODAD, 2017, https://www.eurodad.org/Entries/view/1546703/2017/02/13/Blended-Finance-What-it-is-how-it-works-and-how-it-is-used

of projects under implementation. Capital leverage extends the reach of limited development finance and philanthropic funds as they are used strategically to facilitate larger volumes of private capital that are channelled to investments with high development impact. Blended finance also enhances the impact of projects due to the fact that skill sets, knowledge and resources of public and private investors increase the scope, range, and effectiveness of development-related investments. Risk-adjusted returns can be delivered to realise returns in line with market expectations (WEF, OECD 2015). In as much as the importance of blended finance looks progressive, there has not been much evidence to authoritatively suppose that there will be positive outcomes if development aid is merged with commercial finance for developmental projects.

It is worth noting that debates over the importance and rationale of developing countries' up-take of blended finance have been increasing over the past decade mainly due to the fact that official development assistance has been dwindling with limited alternatives to turn towards to finance development. These debates have also been taking centre stage because domestic resources mobilisation has been moving at a slow pace and also being inadequate to meet the development needs of developing countries in the Africa region. In observance of the debates, this conceptual paper does not try to offer a position on whether blending is good or bad in financing development projects as there is a rationale for blending that can be ideal from both a development and business (economic) sense. Due to the fact that developing countries need private finance to promote development of their economies which in turn create opportunities for entrepreneurial growth, employment and markets expansion, this paper seeks to conceptualize the importance of blended finance, its approaches and weaknesses, to inform government policy when engaging with blended finance instruments.

II. Blended Finance Structures and Challenges

Given the fact that the SDGs and A2063 are transformational agendas in which partnerships and innovation are key to the continents development, ensuring the acquisition of the right model of financing has become more important and progress on new tools and instruments for resource mobilisation has been underway albeit the slow pace. Too little private finance has found its way being invested in least developed countries (LDCs) as only 6% of private finance mobilised by official development finance benefits LDCs[4]. With the dwindling trend in official development assistance to LDCs, fewer disbursements of international public finance are being invested and if the current trend is to persist, development finance will embed exclusions and exacerbate inequalities between and within countries, rather than lift countries out of poverty and inequality.

This calls for the need for new ways of channelling additional and better quality public and private, domestic and international financial flows to the world's most vulnerable countries, underserved communities, and financing for projects from small to medium enterprises

[4]https://www.uncdf.org/bfldcs/home#:~:text=LDCs%20also%20often%20find%20it,investment%2C%20including%20foreign%20direct%20investment.&text=In%20these%20settings%2C%20blended%20finance,LDCs%20and%20the%20missing%20middle.

often termed the "missing middle".[5] In these settings, blended finance offers potential opportunities to increase the resources available to African LDCs and the missing middle[6]. But such approaches are not without limitations or risks, and need to be deployed carefully. To improve how blended finance strategies can best work for African countries, it is essential to understand not only the quantities of finance they mobilise and the regions and sectors they are benefitting, but also how these strategies are being applied, and, more broadly, how the financing for development architecture is evolving and supporting LDCs to meet the SDGs and ensure no one is left behind.

III. Blended Finance Structures: Opportunities and Concerns

The fact that the blended financing approach is not a blanket approach but rather a mechanism with differing financing instruments or structures, gives impetus to the need to assess the common four structures used in blending in development projects. These are (i) Public or philanthropic investors' provision of funds on below-market terms within the capital structure to lower the overall cost of capital or to provide an additional layer of protection to private investors (ii) Public or philanthropic investors' provision of credit enhancement through guarantees or insurance on below-market terms (iii) Grant-funded technical assistance facilities that can be utilized pre- or post-investment to strengthen commercial viability and developmental impact (iv) Grant funded technical assistance on transaction design or preparation including project preparation.

Determining the opportunities and implications of blended finance on development outcomes can be assessed based on project type and sector in which blended finance is most suitable. For the SDGs, blended finance is more suitable for achieving aspects under SDG 8 and 13 on Decent Work and Economic Growth and Climate Action respectively as they have both the economic (profit motive) and development rationale to which private sector can be interested in partnering. Whilst for Agenda 2063, aspects of Aspiration 1's targets are suited for blending.[7]

Blending of development finance offers institutions mechanisms to address systematic barriers, drive greater capital flows to projects and companies with development impact through shifting the investment risk-return profile. It also enables the sharing of local market knowledge and experience to bridge knowledge and capability gaps whilst also building local capacity to help support local markets and shaping policy and regulatory reform to help improve the local investment climate (OECD-WEF, 2015). However, there are challenges that have been known to severely limit private capital from scaling in these markets and these include:

- Local markets often do not function efficiently with local financial markets in developing economies being particularly weak and returns are perceived to be low

[5] https://www.oecd-ilibrary.org/docserver/1c142aae-en.pdf?expires=1592897449&id=id&accname=guest&checksum=B9914C19322832BCF20A89292D8EABDC
[6] https://www.uncdf.org/bfldcs/executive-summary
[7] https://mo.ibrahim.foundation/sites/default/files/2019-10/African_Governance_Report_2019.pdf

- Private investors have knowledge and capability gaps, which impede their understanding of the investment opportunities in often unfamiliar territories
- Private investors have limited mandates and incentives to invest in sectors or markets with high development impact
- Local and global investment climates are challenging, including poor regulatory and legal frameworks
- Organisational capacity – there are usually inefficiencies in technical expertise of staff within borrower countries to structure manage and execute transactions;
    - Inadequate staff incentives to explore and execute the transactions
    - The extent of an organisation's external partnerships.

These challenges ought to be identified and concerns arising from them be addressed if African LDCs are to continuously engage blended finance within the ethos of ascertaining sustainable and non-risky financing for public infrastructure and services development.

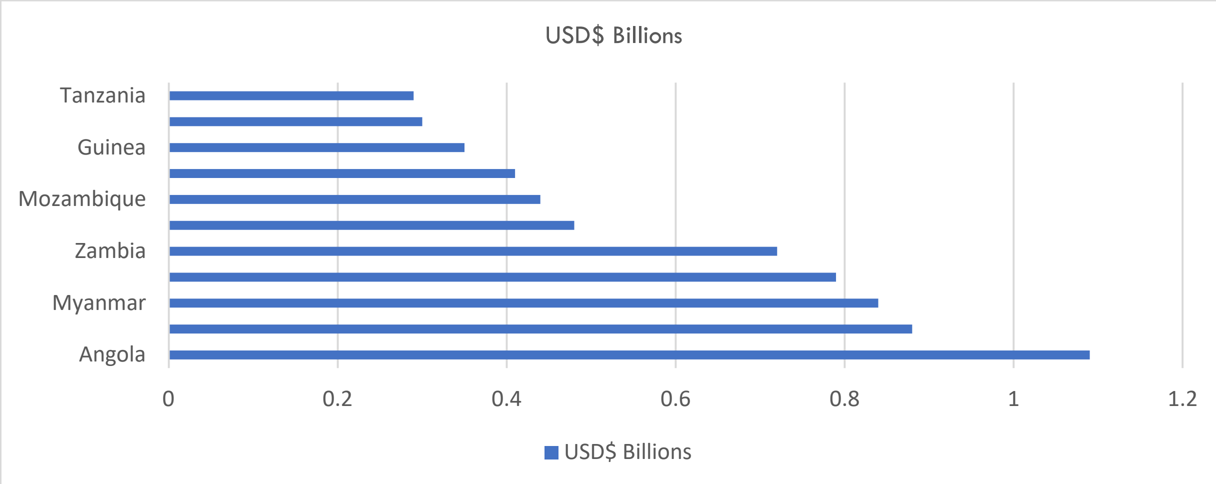
IV. State and Trends of Blending in Africa

Forty-eight countries across the globe are categorised as LDCs, of these 43 have benefited from private finance mobilised by official development finance at least once between 2012 and 2017. The LDCs in the sub-Saharan Africa region collectively received the biggest share of private finance mobilised, at approximately 70% in the period, 2012-2017. However, in 2016-2017, LDCs in sub-Saharan Africa received a lower share of private finance (58%), while Asian LDCs (predominantly South and Central Asia) represented 41%. Central America received under 1% of private finance mobilised[8].

Figure 1 below shows the top recipient countries for the time period 2012-2017. Angola was the largest recipient of private finance mobilised for the 2012-2017 period, mostly due to a few large transactions, and so this may not be a predictor of future trends (UNCDF, 2018)[9]. Senegal, Bangladesh, Zambia, Cambodia and the Democratic Republic of the Congo – in descending order of volumes mobilised – also feature amongst the top 10 recipients for the whole time series. Myanmar more recently appeared as an important recipient of private finance mobilised, with two large deals in the telecommunications industry during the last two years. Overall, LDCs benefiting from the most private finance mobilised tend to be those with larger economies and/or those with large natural resource endowments.

[8] https://www.oecd-ilibrary.org/docserver/1c142aae-en.pdf?expires=1592897449&id=id&accname=guest&checksum=B9914C19322832BCF20A89292D8EABDC
[9] UNCDF, 2018

Figure 1: Top Ten LDC Blended Finance Destinations



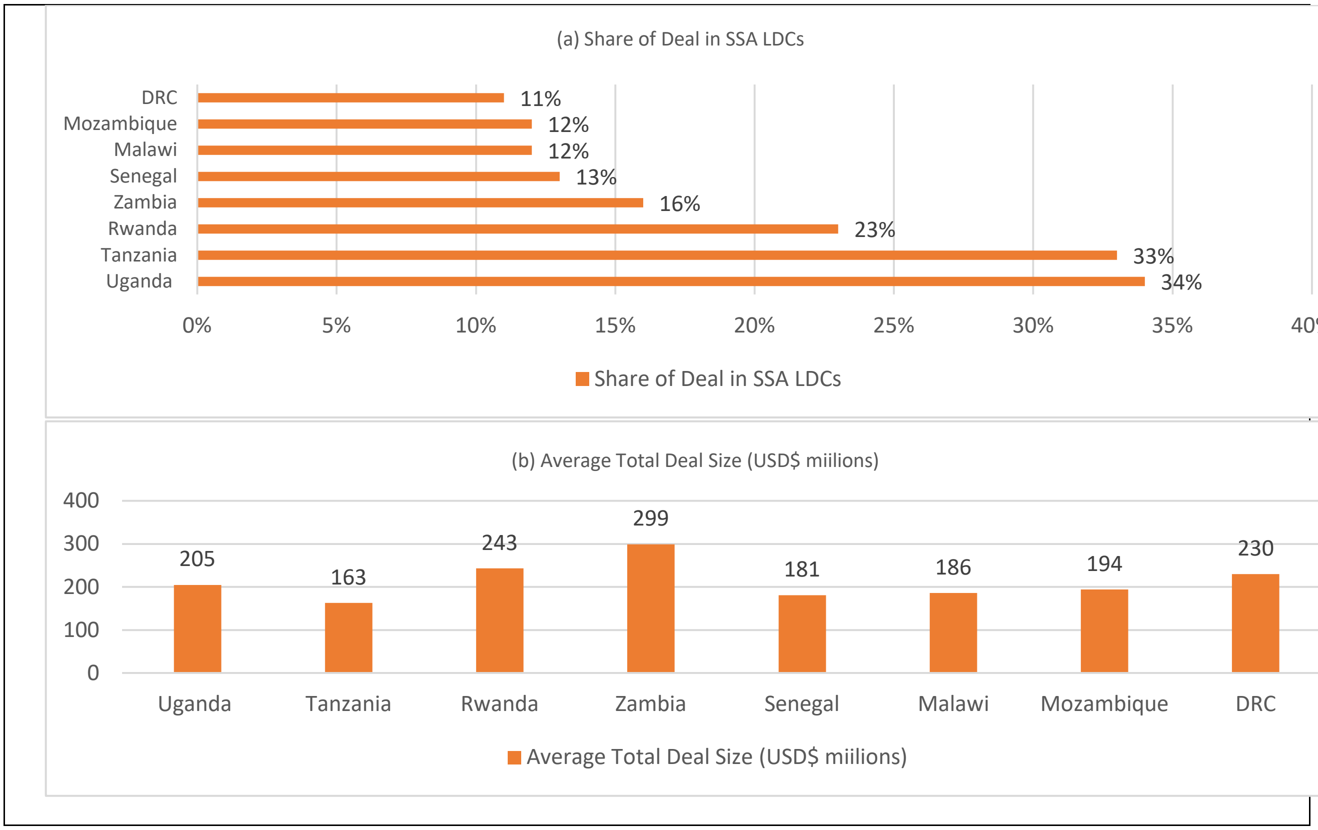
Source: OECD 2019

As can be seen from figure 1, blended finance transactions vary significantly in geographical scope, from a single-country infrastructure project to a global equity fund. According to Convergence data, the vast majority (88%) of blended finance transactions targeting one or more LDCs since 2005, focus on sub-Saharan Africa region. Within sub-Saharan Africa, the most frequently targeted LDCs have been Uganda, Tanzania, Rwanda, Zambia, Senegal, Malawi, Mozambique, and the Democratic Republic of the Congo (Figure 2). The first two – Uganda and Tanzania – are also among the top five developing countries globally most frequently targeted by blended finance deals[10].

Figure 2 below also highlights that 8 countries dominate the blended finance deal share in the sub-Sahara region with Uganda at the top accounting for atleast 34% with an average deal size of $205 million per year between 2012 and 2017. DRC accounts for a 11% share of blended finance deals in the region with an average deal size of USD$230 million. The difference between these top 8 blended finance destinations is based upon geography, resources endowments and sectors in which finances are disbursed towards or sectors in which private sector realises profit with limited risks as illustrated in Figure 3.

[10] https://www.oecd-ilibrary.org/docserver/1c142aae en.pdf?expires=1592897449&id=id&accname=guest&checksum=B9914C19322832BCF20A89292D8EABDC

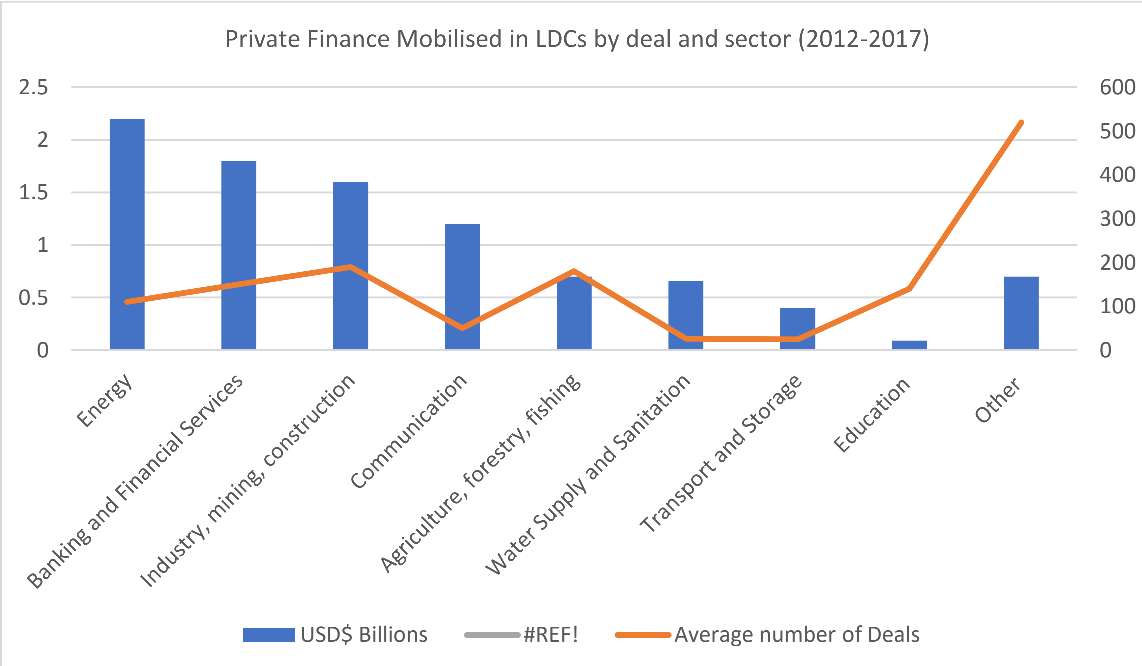
Figure 2: Blended Finance Disbursement in SSA (Top 10)



Source: OECD Blended Finance in LDCs 2019

When assessed by sector, it can be noted as featured in Figure 3 that blended finance deals largely materialise in the energy, financial services, mining and construction sectors with a significant rise in communication as a result of ICT advancements globally. Between 2012 and 2017, least developed countries received an estimated USD$2.2 billion investment in the energy sector through atleast 110 deals. A similar trend is shown on private finance mobilised to the banking and financial services sector as well as the mining and construction sectors where between USD$1 and USD$1,5 billion was mobilised with atleast 160 deals. This is contrasted to finances towards the social sectors i.e. education where only USD$ 90 million was mobilised over the 2012-2017 period.

Figure 3: Private Finance mobilised in LDC's by deal and sector (2012-2017)



Source: OECD 2019

V. Concerns with the blending of ODA and impacts on development effectiveness

Whilst blended finance may be used to maximise financing for development within varying sectors as per assessment of appropriateness of blending and the projected developmental and economic outcomes, it is important to note that blended finance poses a number of risks and challenges in the structuring and implementation of projects and these include:

- **ODA and development finance inflation[11] -** The lack of a common methodology to account for ODA for blending and mobilized finance has been at the core of double-counting and making it possible for donors to report privately mobilised finances as ODA money, yet it is not spent in a concessional way.
- **Diversion of Official Development Assistance from other aid modalities -** New accounting methodologies have intended or unintended incentives for using blending that is because in addition to ODA, donors can report significant amounts of mobilized finance Moreover, it is also possible that blending projects are easier to align with donors' political and economic priorities, compared with other forms of ODA such as the support of national private sector companies.

[11] https://eurodad.org/files/pdf/58a1e294657ab.pdf

- **Concentration of donor aid on pre-assumed sectors and/or countries** - strong financial sustainability requirements in blending facilities, or the managers and/or the absence of incentives to focus on pro-poor projects, often times lead donors to focus on countries and sectors with a lower risk profile, such as middle-income countries leaving out countries most in need of additional financing for development.

- **Limited demonstrable development effects** - Weaknesses in monitoring and evaluation systems, or inadequate definitions of additionality often times allow projects to continue in the absence of demonstrable impacts or on the basis of financial performance.

- **Inefficient coordination with bilateral aid agencies and other donors -** The use of indirect channels of support and, often, the transfer of responsibility to external managers or project leaders makes it difficult to coordinate donors and their alignment with country plans thereby making projects detached from national priorities.

- **Poor project ownership and accountability -** Transparency is a challenge in many blending projects as several of the actors involved lack independent complaint mechanisms. These issues make it difficult for affected stakeholders to channel their concerns and hold donors accountable. The participation of public and private stakeholders in project decisions is also a major challenge in blending projects, especially those involving the private sector.

VI. Making Blended Finance Work in Africa: The Way Forward

Recognising that blended approaches can help mobilise the much-needed additional resources for LDCs due to the perception that they can create demonstration effects that narrow the gap between actual and perceived risks of investing in LDC markets, it is important that blended approaches need to be considered and deployed carefully. In signing the Addis Ababa Action Agenda, Member States have agreed on a set of overarching principles for blended finance and public-private partnerships (PPPs). The OECD principles on blended finance provide a policy framework to ensure the sustainability of blended finance, while initiatives such as the multi-stakeholder Tri Hita Karana Roadmap and the UNCDF action agenda on LDCs are also focused on improving the effectiveness and efficiency of blended operations and as such:

- Blended finance solutions should respect national ownership, be aligned with national priorities and applied as part of a broader national sustainable development financing strategy that takes into account domestic and international, public and private sources of finance.

- Transparency and accountability remain an important tenet of development effectiveness and as such, in crisis contexts, where ODA plays an essential role, blended approaches must be particularly more transparent and accountable, and they should avoid doing harm by widening inequalities amongst the affected.

- Technical assistance plays an important role in blended finance transactions in LDCs, including by helping to put in place the right capacities and institutions to identify, analyse and structure blended operations; and to strengthen investees' operational efficiency and environmental, social and governance (ESG) compliance and as such, local presence in project country by either investors or fund managers is important, as this can help build local capacity in understanding the risks and opportunities attached to blended investments.

- Civil society organisations and other development-oriented institutions need to further research on blended finance and its impact on development effectiveness in order to strengthen policy interventions on financing development.

- Lastly, if blended finance continues to become an increasingly important modality of development co-operation, then development partners will need to ensure that this does not come at the expense of support for African LDCs where blending has been more challenging.

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