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DFI INSIGHTS

PARTNERING FOR PROGRESS: GETTING STARTED ON BLENDED FINANCE

THE BASICS

Blended finance is a set of strategies that combine public or philanthropic funds to catalyse additional private sector investment in sustainable development initiatives that would not otherwise attract such financing due to their risk profile or lack of commercial viability. Blended finance approaches are characterised by three key aspects:

1. **They leverage concessional capital to mobilise commercial investment**, creating a funding structure that merges market-rate and concessional funding.
2. **They are focused on impact**, usually striving to work towards the achievement of Sustainable Development Goals (SDGs).
3. **They expect a positive financial return**, either at market rates or lower, depending on the sector.

There are two main types of blended finance structures:

1. **Concessional capital:** public or philanthropic investors offer financing at rates below market norms within the capital structure, aiming to reduce the overall cost of capital or offering an added safeguard for private investors.
2. **Credit guarantees:** public or philanthropic investors back investments by promising to cover losses in case of default or other specified events, thereby reducing the risk for private investors and potentially allowing for more favourable terms or lower interest rates.

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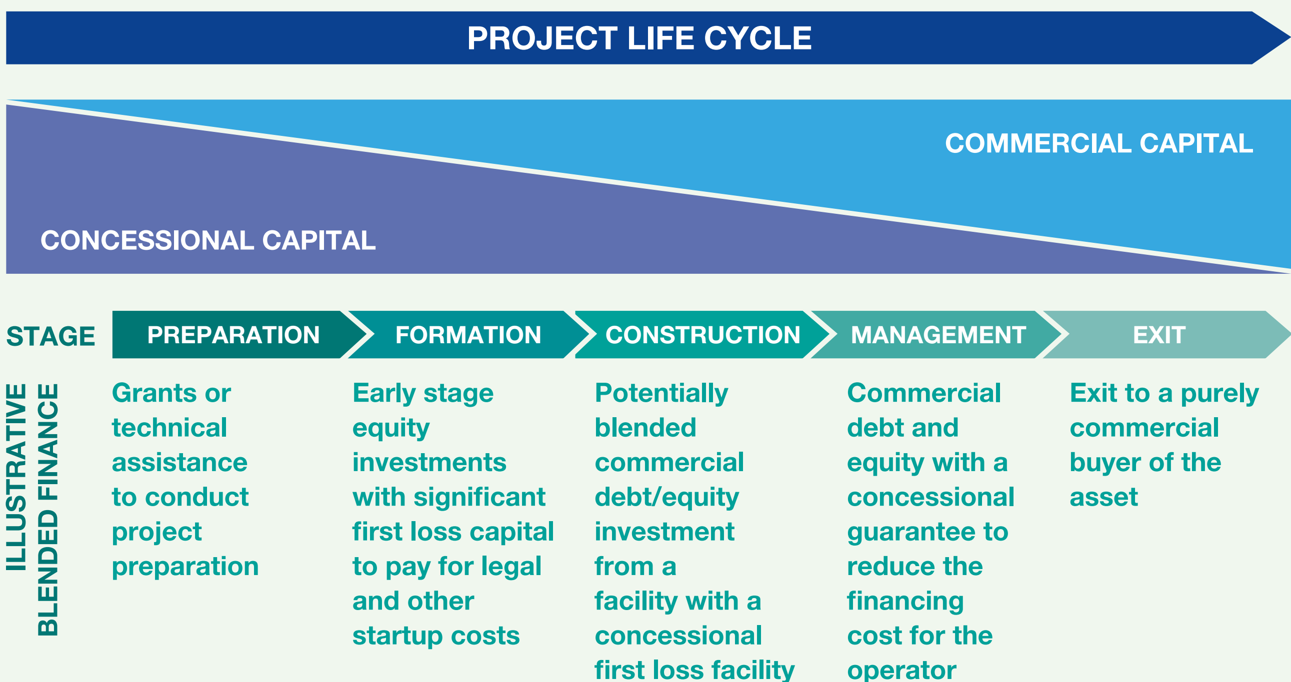
Blended finance can be applied at various stages of a project's lifecycle and at different levels, such as individual projects, multiple projects, funds investing in other funds, or institutionalised facilities that mix diverse forms of capital. Investment transactions can also rely on blended instruments to help make the investments more successful and impactful by providing support services before or after the investments are made. This can happen, for example, in the form of **technical assistance funds**, or **design stage grants**, where public or philanthropic entities fund the design or preparation phase of a transaction, such as planning, research, and conceptualisation.

EXAMPLE OF A SOCIAL IMPACT BOND STRUCTURE



WHY BLENDED FINANCE FOR DEVELOPMENT FINANCE INSTITUTIONS?

As the need for funds to accomplish SDG objectives grows, engaging alternative funding sources like the private sector becomes vital. However, developing countries often experience low capital market flows. This is often due to high perceived or real risks stemming from factors such as weak liquidity, local financial market inefficiencies, a challenging investment climate, high volatility, and macroeconomic, political, and regulatory risks.

Blended finance tries to address this by establishing acceptable risk-return profiles, which can motivate private sector investments in SDG projects in developing countries. This is done through incentives for successful performance outcomes or interest rate subsidies to enhance creditworthiness, limit downside loss exposure, and address funding shortfalls.

Challenge to private investment	Blended finance can mitigate by…
Risk in developing countries is high, while returns are low	■ Providing concessional loans to kickstart projects that wouldn't get the funding to start ■ Providing guarantees to make the risk/return rate more interesting and protect investors against capital losses ■ Aggregating many loans into a portfolio which diversifies risk across many borrowers and countries, sectors, and currencies (diversification alone can lead to 1-2 notch up-lift in risk rating)
Local currency volatility is high	■ Providing concessional funds to absorb currency risk
Lack of transparency and possible corruption	■ Diversifying investments across many countries and projects ■ Offering technical assistance to the projects to ensure transparency and best practice
Lack of scale	■ Creating portfolio solutions combining a series of small transactions

As a Development Finance Institution (DFI), you are particularly well-positioned to be a key actor for blended finance strategies, as DFIs can deploy a range of instruments concurrently and have the legitimacy and credibility to act in concert with private sector partners. As a matter of fact, through blended finance, your DFI can:

- **Create promising partnerships:** through blended finance arrangements, DFIs can establish solid relationships with other financial actors in the market.
- **Be a forerunner:** your DFI can create examples for investment in still relatively unknown fields or new technologies, thereby increasing market knowledge in these fields.
- **Increase the bankability of development projects:** by leveraging public or philanthropic funds alongside private capital, DFIs can structure innovative financial instruments that are more appealing to commercial investors who would otherwise be deterred by the high risks or low returns associated with such initiatives.
- **Expand their impact:** DFIs can go beyond what they could achieve alone, making a more significant contribution towards global development goals through strategic partnerships with private sector partners.
- **Increase staff capacities:** these activities allow staff to improve their skills in areas such as risk management, financial structuring and partnership development. This, in turn, helps DFIs attract more private investments and improve overall project performance. In some cases, technical assistance for internal capacity building may be provided through blended finance arrangements.

IMPLEMENTING BLENDED FINANCE IN YOUR DFI

- **Consider the existing ecosystem.** You first need to have a comprehensive understanding of the local market structure, political environment, and sector characteristics to help identify local market failures and possible solutions. Check whether this type of intervention is welcomed by other actors and in line with national development plans. Assess the inherent risks in the country and sector to pinpoint the most suitable blended finance tools (e.g. concessional loans or guarantees) and scale throughout all project phases.
- **Assess whether blended finance is the right instrument.** Remember that blended finance is helpful when you need to increase the mobilisation of commercial finance and correct market failures: if the system is already working, your DFI might not have to engage at all, following the principle of additionality. Your project should have an enabling effect and improve the investment climate to attract and retain private investment. If you are not interested in achieving commercial sustainability, other initiatives might be better suited for your aims. Plan an exit strategy once the market is performing optimally.
- **Use only the minimum concessionality needed to mobilise private investors.** This ensures an efficient use of resources, which improves sustainability. It also maximises leverage by attracting more private investors, showing that the project has the potential to generate returns and achieve its objectives without relying excessively on subsidised funding. It can be useful to calculate the **leverage ratio** as the commercial capital mobilised based on the concessional capital mobilised. Bear in mind that the appropriate ratio will depend entirely on the context and degree of market failure.
- **Focus on effective partnering.** To successfully engage commercial and private entities who would not typically invest in developing countries or SDG-focused projects, your DFI needs to uphold high standards of collaboration. Blended finance is only successful if all actors (especially local ones) are involved and consider the impact of the project as positive. Each party will have a different mandate, objective, and risk/return profile: make sure all actors can align their priorities and can compromise as necessary. Even if they might have different reasons for participating, they should have a shared interest in seeing the project succeed. Risk, for example, should be allocated in a targeted, sustainable, and balanced manner. Ensure that the financial resources provided by your DFI meet the requirements and preferences of investors.
- **Organise stakeholder consultations regularly.** Ensure regular communication and good oversight of the project on the ground, including all engaged stakeholders. This approach is also important to get local partnerships, co-design new projects, and scale up measures.
- **Anchor blended finance within best practice for development.** Ensure that the project aligns with the Sustainable Development Goals (SDGs), yields significant development outcomes, and adheres to local policy preferences. Commit to global best practice in development, such as ESG criteria and IFC Performance Standards. Consider that international guidelines for blended finance have been developed both by the OECD and IFC.
- **Monitor results and ensure transparency.** Monitor financial flows, commercial success, and development outcomes, and present transparent, verifiable, and easily digestible data on blended finance activities to donors and investors. Ensure the necessary resources are in place for monitoring and evaluation (M&E), including collaboration among partners, and promote transparency, data accessibility, and knowledge dissemination. Reach a consensus on performance indicators and the reporting schedule. The accumulation of evidence and lessons learned for application in future projects is paramount.

Blended finance often goes hand in hand with other complementary measures:

1. **Establish results-based financing models**, such as social impact bonds, which tie financial rewards to the achievement of specific SDG impacts.
2. **Leverage technical assistance programs** to enhance the quality of project execution, demonstrate the feasibility of potentially commercially viable projects, conduct the necessary studies and implement capacity building services. These efforts aim at generating systemic results such as sector reforms that go beyond individual projects.

KEY QUESTIONS AND IMPLEMENTATION STRATEGIES

- **How does blended finance fit into your DFI's mission and vision?** This is important to communicate effectively and onboard all staff in this effort.

- **What does the ecosystem for the project look like?** What are the main financing gaps? Which market failures can be identified?

- **Is blended finance the most effective financing approach?** This is key to ensure that the project is not deployed in well-functioning commercial markets and interested private investors are not crowded out.

- **How is the project contributing to a favourable investment climate that attracts and retains foreign and domestic investment?** Does the project align with local policy priorities and with other initiatives in the ecosystem? Try to ensure the project contributes to increased capacity of local financial institutions, involves local investors, and promotes local currency funding.

- **Are there adequate policy, sector, and investment frameworks for blended finance?**

- **Which actors need to be included?** Which investors would be interested in joining the initiative and be a right fit in terms of investment? Always aim to include national actors at all stages of the project.

- **What are the mandates, objectives and risk-return profiles of each actor that is involved in the blended finance transaction?**

- **How can the project build incentives that promote public-private cooperation and balance expectations on development outcomes and on financial risks and returns?** What type of blending would be more suitable at each stage of the project?

- **What would be an effective stakeholder consultation process throughout the investment cycle?** How can you ensure regular communication and good oversight of the project?

- **Which M&E processes should be put in place to promote transparency at each stage of the investment cycle?**

- **What will the DFI's exit strategy be once commercial markets are functioning?**

DEEP DIVE: WOMEN'S WORLD BANKING CAPITAL PARTNERS FUND II

Women's World Banking:

Women's World Banking (WWB) is a globally recognised organisation that fosters women's financial inclusion and empowerment in emerging markets. With its innovative investment approach, WWB aims to improve outcomes for women as customers, employees, and leaders while ensuring financial outperformance. A prime example of this mission is the establishment of their blended finance fund: WWB Capital Partners II (WWBCP II).

The Blended Finance Agreement and Actors:

WWBCP II is a 100 million USD private equity fund designed to invest in women-focused financial service providers in low-income countries, with a particular focus on Sub-Saharan Africa. The fund includes a 20 million USD first loss concessional equity tranche financed by a development aid agency, enticing Class A investors and DFIs to contribute 50 million USD.

It is structured into two investment pools, managing risk for Sub-Saharan Africa investments. The WWBCP II has received approximately 28 million USD in commitments from contributors like the EU, BMZ, KfW, DFC, EIB, MEDA Sarona, and Jica.

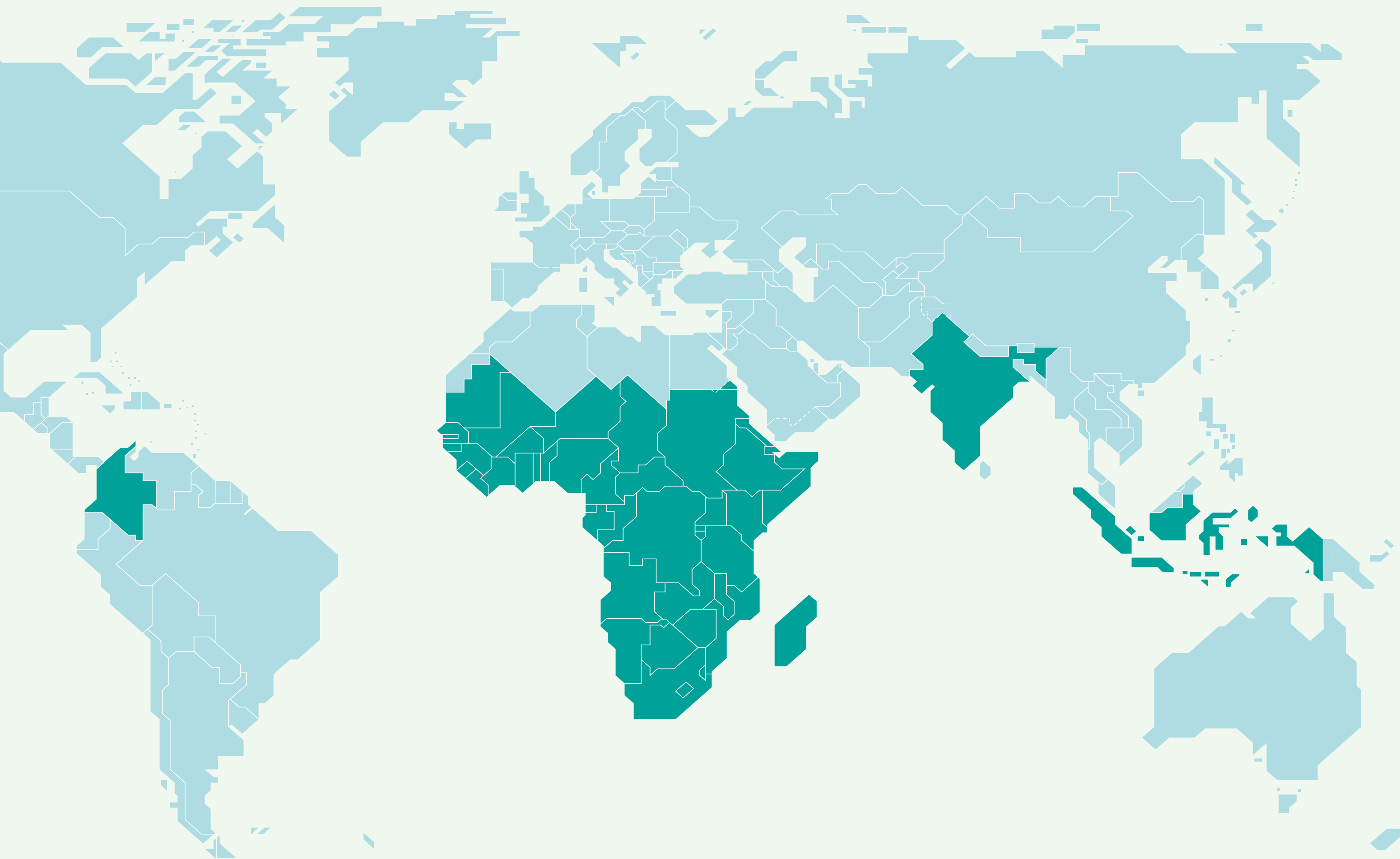
The dedicated technical assistance facility conducted by Women's World Banking Asset Management LLC performs gender assessments on each portfolio company, and the Fund seeks to reach at least 30% of its portfolio companies meeting the 2X Criteria, increase the number of women represented and empowered in all its companies and support them to provide products and services that significantly improve the livelihoods of women. The technical assistance facility also provides data-driven market and organisational gender analysis, leading to gender action plans tailored to each company.

Results:

The WWBCP II has successfully closed five investments thus far, including:

- An affordable housing finance company in India;
- A tech-enabled agri-insurance broker and advisor in Sub-Saharan Africa;
- A fintech community lender in Colombia;
- A peer-to-peer MSME lender in Indonesia;
- A deposit-taking microfinance institution in Uganda.

The diverse range of investments demonstrates the Fund's commitment to financial inclusion for women across Sub-Saharan Africa, Asia, and Latin America. By investing in inclusive finance providers that prioritise gender diversity, WWBCP II strives to improve financial returns and growth opportunities while empowering women in emerging markets.



FURTHER READINGS

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- Convergence Blended Finance Primer, accessed 11 March 2024
- How Blended Finance works, IFC website, accessed 11 March 2024
- How to mobilize private investment at scale in blended finance (Convergence, 2020)
- OECD DAC Blended Finance Principles (OECD, 2022)
- Scaling blended finance for the SDGs (Convergence, 2019)
- Women's World Banking Capital Partners II, supported by DFC and EIB, becomes 2X Challenge pioneer flagship fund (EIB, 2021)

July, 2024

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This paper is part of an intervention conducted by the Investment Climate Reform (ICR) Facility. The ICR Facility is co-funded by the European Union (EU), the Organisation of African, Caribbean and Pacific States (OACPS) under the 11th European Development Fund (EDF), the German Federal Ministry for Economic Cooperation and Development (BMZ) and the British Council. The ICR Facility is implemented by GIZ, the British Council, Expertise France, and SNV. This specific intervention is led by IPC GmbH on behalf of GIZ.

The contents of this publication are the sole responsibility of the author and do not necessarily reflect the views of the donors or the implementing partners.

The ICR Facility supports public and private stakeholders in African, Caribbean and Pacific (ACP) countries in creating a more conducive, sustainable and inclusive business environment and investment climate.

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