

OECD DAC BLENDED FINANCE PRINCIPLE 2 Guidance

Revised Note following
public consultation



OECD DAC Blended Finance Principle 2: Design blended finance to increase the mobilisation of commercial finance

Guidance Note and Detailed Background Guidance

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Background and Process

In 2017, members of the Development Assistance Committee have officially adopted the OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the SDGs. Therein, Principle 2 relates to designing blended finance to increase the mobilisation of commercial finance.

This document presents the Guidance Note on Principle 2 along with the Detailed Background Guidance. This document was developed by an OECD team including Astrid Manroth, Marie Fuchs and Wiebke Bartz-Zuccala under the oversight of Paul Horrocks and Haje Schütte. This Guidance Note benefited from the Senior Strategic Review of Christian Novak, Professor of Practice at McGill University - Institute for the Study of International Development.

This Guidance Note was developed through a participatory process and has benefited from comprehensive feedback from DAC Blended Finance Actors, MDBs/DFIs, private sector entities, philanthropy and civil society representatives during a workshop on 10 October 2019, as well as bilateral discussions and interviews. A public online consultation process was also conducted to reflect the experience of the broad development finance community, experts, practitioners, civil society organisations (CSOs) and other relevant stakeholders. The online consultation on the Guidance Notes lasted from 15 April until 10 July. This document reflects the comments and feedback received during the consultation process.

As blended finance is still a relatively new tool in the development co-operation toolkit and the blended finance environment is rapidly changing, new practices and approaches can develop quickly. The Detailed Guidance Note will thus be updated accordingly in the future. It should be noted that the guide should not be seen as a replacement for effective due diligence, although it should assist in ensuring key elements are identified.

1. Introduction

1. This Principle 2 Guidance Note and Detailed Background Guidance serve as guidance for the implementation of the OECD DAC Blended Finance Principle 2. Principle 2 specifically is the fundamental framework for understanding the context and conditions leading to effective and efficient designs of blended finance. The goal of blended finance is to unlock commercial finance to optimise total financing directed towards development outcomes. Key elements of Principle 2 in that respect are a) ensuring additionality of development finance, b) taking into account context-specific factors when crowding in, for instance by geography or sector, c) building markets while minimising concessionality, and d) ensuring commercial sustainability, e.g. a clear strategy for the exit of blended finance.

2. This Guidance Note first addresses channels for blended finance, then core concepts that apply to Principle 2, followed by a step-by-step approach to guide the implementation, developed in depth in the Detailed Background Guidance. Additionality, concessionality, mobilisation and commercial sustainability are the core four concepts underlying Principle 2. Additionality is required to ensure that development finance does not crowd out commercial finance and achieves additional development impact. Meanwhile, concessionality should only be applied when justified by market failures and based on good practice to minimise concessionality and avoid undue subsidies to the private sector. Creating leverage by mobilising additional commercial finance for development is the underlying rationale for the use of official development assistance for blended finance activities and a key element of Principle 2.

3. As well as providing implementation guidance, the Note and Detailed Background Guidance also highlight where improvements could occur in the development system, in terms of actors and markets. The Guidance Note serves as the overarching framing of the key elements that should be considered when applying Principle 2 to a project or program involving blended finance. Meanwhile, the Detailed Background Guidance provides further context and details and is targeted towards those actors that require further evidence and detailed guidance on how to put Principle 3 into practice.

4. The overarching goal of Principle 2 is to design blended finance to increase the mobilisation of commercial finance. Four sub-Principles underpin this goal. These shape the application of Principle 2 and require further depth and explication for users, which this Guidance Note and Detailed Background Guidance aims to achieve.

2. Principle 2: Design blended finance to increase the mobilisation of commercial finance

Sub-Principles:

2.A Ensure additionality for crowding in commercial finance.

5. In general terms, additionality of a development finance intervention can be defined as providing additional financial or non-financial input resulting in additional development outcomes that would not have materialized without the intervention, thereby contributing to amplified development impact. In the context of their private sector operations, MDBs have defined the principle of additionality as interventions by multilateral development banks (MDBs) to support private sector operations that make a contribution beyond what is available in the market, or is otherwise absent from the market, and do not crowd out the private sector.¹ In this context, additionality cannot be expected to automatically deliver development impact. Development finance interventions require a solid theory of change and results framework ex-ante, including baselines where feasible, as well as rigorous impact monitoring and evaluation during and after the intervention.

6. The OECD DAC Blended Finance Principle 2a) outlines a two-fold understanding of additionality in blended finance:

- a. Ensure additionality by deploying blended finance only for uses where commercial financing is not currently available for development outcomes, especially if it involves concessionality.
- b. Have an explicit focus on opportunities to crowd in financing from commercial sources into transactions that deliver development impact.

7. These two priorities reflect the established two-pronged understanding of additionality, which includes financial additionality as well as development additionality:²

- **Financially additionality** refers to transactions extended to an entity which cannot obtain finance from the private capital markets (local or international) with similar terms or quantities and for similar

¹ Multilateral Development Banks (MDBs) Harmonized Framework for Additionality in Private Sector Operations (2017)

² Additionality is an established concept in the DAC reporting on private sector instruments (PSI). As such, additionality should be assessed as part of the ODA-eligibility assessment of PSI vehicles at the institutional level, and at the activity level, ex-post, through the CRS system. For eligibility, it requires financial and/or value additionality on top of development additionality. [DCD/DAC/STAT\(2018\)9/ADD3/FINAL](#)

developmental purposes without official support, or if it mobilises investment from the private sector that would not have otherwise invested.

- **Development additionality** refers to the development impact of the investment that would not have occurred without a partnership between the official and the private sector.

8. In relation to designing blended finance, financial and development additionality are closely intertwined. Blended Finance Principle 5, focusing on monitoring blended finance for transparency and results, analyses this rationale in the context of additionality in blended finance evaluation (Winckler Andersen et al., 2019[5]). Blended finance Principle 1, promoting that blended finance is anchored to a development rationale, aligns the use of development finance in the context of blended finance as with the development additionality objective in private sector approaches.

9. **Blended finance interventions need to have both developmental as well as financial additionality** – blended finance should not be deployed if it cannot create additional development impact or if the same development impact can be achieved without the blended finance intervention through existing public or private financing channels. At the same time, there may be some trade-off between the extent of financial versus development additionality in any given blended finance transaction. For example, if the primary objective of a blended finance transaction is to achieve a high mobilisation ratio of commercial finance, this may result in a focus of the intervention on more established market and sectors, such as middle-income countries.

2.B Seek leverage based on context and conditions.

10. In the design of a blended finance transaction, Principle 2B aims to ensure that each of the core concepts are applied in a context-specific way reflecting several underlying drivers. The design of blended finance transactions needs to be anchored in the transaction-specific development objective and context. Several context-specific factors influence the nature of additionality, concessionality, mobilisation and commercial sustainability in blended finance and need to be taken into account when designing a blended finance transaction. These drivers include:

- **Geography:** Blended finance has a higher additionality in countries where less commercial finance is currently available, such as in Least Developed Countries (LDCs) or fragile and conflict-affected situations (FCS). The higher risk profile of these countries may require a higher share of concessionality in blending and result in lower mobilisation ratios than in less-risky geographies, such as middle-income countries (MICs).
- **Sector:** Underlying sector fundamentals are an important determinant of the impact of blended finance. Sectors with established regulatory and investment frameworks, a track record of private investment and underlying financial sustainability (or a reform path towards that) are more conducive to attracting commercial finance, resulting in higher mobilisation with lower concessionality through blended finance (and possibly not needing blended finance at all). Higher risk sectors with untested sector frameworks, high financial risks (e.g. in the absence of creditworthy off-takers or due to high-risk end-beneficiaries such as smallholder farmers) and lack of track record of private investment may offer higher additionality through blended finance, while likely requiring higher concessionality and initially creating lower mobilisation.
- **Stage in the project cycle:** Blended finance should respond to the dynamic nature of the project cycle. This is particularly relevant for large-scale infrastructure projects. The risks in the early stage project development can require a relatively high share of concessionality, offering high additionality, while only a few if any commercial investors may be forthcoming. During the construction phase, commercial finance can be mobilised from select investors willing to bear construction risk, such as commercial banks. Filling the financing gap will likely require ongoing development and concessional finance. During a project's operating phase, especially after a

successful start, blended concessional finance is in principle not needed anymore as cash flows ensure commercial viability which should attract commercial finance from, e.g. pension funds.

- **Market maturity:** The degree of maturity of an underlying market determine the additionality, concessionality and mobilisation in blended finance. In markets where commercial finance has not yet been deployed, additionality through blended finance is high, while initially higher concessionality may be required and mobilisation may be low. Mobilisation can be higher in financial markets with partial market failures, such as failure to provide the required maturities, such as long-term debt finance, or certain products, such as securitisation or hedging instruments.
- **Financial instruments:** The financial instrument chosen for a blended finance transaction is based on the transaction's development objective and analysis of the drivers laid out above. In broad categories, financial instruments for blended finance include grants, equity, debt, and guarantees, all of which can be provided on a concessional basis and through various forms and mechanisms (see section 3.4/Step 4a for discussion of financial instruments). Their additionality depends on the financing gap in the respective geography, sector and market. Different instruments have different levels of mobilisation – for example, a guarantee as an unfunded instrument by nature has a high mobilisation ratio³, while leverage ratios of funded financial instruments (grants, equity, debt) depend on the transaction-specific context.

11. **The dynamic nature of these drivers means that additionality, concessionality and mobilisation vary over the life of a blended finance transaction.** For example, as sector frameworks improve and markets mature, the same or a repeat blended finance transaction may have less additionality, require less concessionality and be able to achieve higher mobilisation rates of commercial investment over time. As a result, blended finance transactions require ongoing monitoring during their life and should be reviewed and adjusted due to changing drivers and context.

2.C Deploy blended finance to address market failures, while minimising the use of concessionality.

12. **Principle 2C seeks to deploy blended finance to address market failures, while minimizing the use of concessionality.** The rationale for deploying concessionality in blended finance is motivated by imperfect markets that do not provide the commercial financing required to meet development objectives. Concessionality can help overcome market failures and catalyse commercial finance that otherwise would not be forthcoming. At the same time, concessionality needs to be well-targeted, minimised and be of temporary nature in order to avoid unduly distorting markets.

- **Addressing market failures while avoiding market distortion**

13. Blended finance is one tool that can help address market failures particular to emerging markets and developing economies by addressing the inefficient allocation of goods, services and financial resources by strategically bringing together public and commercial stakeholders. At the same time, blended finance cannot replace structural solutions to address market failures, such as improving policies and regulation which are required to build markets and ensure commercial sustainability (cf. Section 2.4).

³ Guarantees are contingent obligations that only require a pay-out in case a guarantee event is called. As a result, they require less public finance compared to funded instruments such as grants or first-loss investment instruments. OECD data shows that guarantees have the highest mobilisation ratios in blended finance.

14. **The following are market failures and market inefficiencies that have been used as motivation for blended finance⁴:**

a. Market failures

15. **Public goods:** A public good is a service from which no consumer can be excluded ('non-exclusive') and where the consumption of the good by one person does not limit its consumption by another person ('non-rival'). Public goods cause a market failure because they are inadequately priced. For-profit firms cannot sell them profitably. Public goods are therefore not supplied or supplied in an insufficient quantity. An example for a public good is the provision of health or education services. Governments typically provide public goods to overcome the market failure. However, if the private sector is solicited to help provide public goods, blended finance could be used to close the gap towards achieving a commercially viable price.

16. **Externalities:** The consumption of a good or service that has an influence (positive or negative) on other humans without the market assigning a price to this benefit or cost is considered an externality. Governments can subsidise or promote production for positive externalities and tax or limit the production of negative externalities. Goods or services with positive externalities (such as infrastructure or social services) are often undersupplied by commercial markets. Market prices typically do not take into account additional benefits to third parties and are thus too low to meet requirements for commercial viability of private sector projects. Blended finance instruments can improve the commercial viability of such projects by e.g. lowering financing costs or provide top-up payments to improve the cash flow profile of a project to make it commercially viable or by providing risk mitigation instruments to increase the attractiveness of projects to private investors.

17. **Information asymmetries:** Information asymmetries can create barriers to market development in some segments or sectors. A case in point are credit markets for micro, small and medium enterprises (MSMEs), including the lack of availability for venture, or seed, financing. These businesses are often informal and lack audited accounts. Therefore, banks and other lending institutions often decline to offer loans to MSMEs or if they do, borrowing costs and collateral requirements are prohibitive. Information asymmetries may also exist in the case of public private partnerships where private stakeholders often have more information about a project providing them with more bargaining power vis-à-vis the public sector. On the other hand, lack of familiarity with a new market in developing countries can create a high perception of risk by private investors that may not correspond to actual risk. In the case of information asymmetries, blended finance can help create markets by addressing the challenges of information gaps through concessional financial support and risk mitigation to businesses and projects with development impact.

b. Market inefficiencies

18. **Catalyse markets:** Access to finance can be challenging for providers of development solutions due to challenging investment climates, lack of similar projects or high-risk characteristics. Examples include the case of first movers, where entrepreneurs incur demonstrably higher costs and risks when introducing new technologies, products or business models, such as the implementation of the first renewable energy project by an independent power producer (IPP) in a low-income country with an untested regulatory and institutional environment. Similarly, start-ups or informal SMEs often lack access to financial markets due to their inherently higher risk and lack of standard collateral. Market inefficiencies also exist from the perspective of the final beneficiary of a development finance transaction. Market finance is often not available to vulnerable, poor or remote population groups who lack access to finance because they cannot provide information about e.g. their creditworthiness in the format required by existing financial

⁴ From OECD Paper on Blended Finance Principle 4 (forthcoming)

market regulation and practices. Blended finance can provide concessional guarantees to backstop public sector obligations in untested regulatory and institutional environment; de-risk private finance in high impact, innovative sectors and new or challenging markets through the provision of grants, equity, subordinated debt, or guarantees; and meet minimum return requirements. If combined with the right enabling environment (cf. Section 2.5.1), providing blended finance to first time transactions in a specific country and sector context can create a demonstration effect that can help catalyse the development of a private finance market, including for currently unserved population groups.

19. **Affordability considerations for end-beneficiaries:** In user-funded sectors such as infrastructure, cost-recovery price including for commercial financing terms may temporarily exclude participation by certain low-income and/or vulnerable groups. Blending has been used to alleviate such affordability problems. However, blended finance cannot replace long-term sustainable solutions through structural reforms and targeted social safety nets. Nevertheless, there may be instances where affordability issues are temporary and blended finance is appropriate, e.g. in cases where temporary tariff support combined with policy reforms will over time create long-term market viability, or where technological changes are expected to eventually lower costs and make markets commercially sustainable.

20. **Project bankability:** Infrastructure projects require feasibility studies, social and environmental impact assessments, and technical designs before they reach the financing stage. A project that potentially has development impact may fail to achieve bankability because of the shortage of financing for project preparation that is very risky for commercial investors. Blended finance can provide reimbursable project preparation financing to support infrastructure projects development to bankability or invest concessional development capital in early stage projects. Blended finance can also provide support to governments to prepare a pipeline of bankable projects that can be auctioned off to investors.

c. Avoiding market distortion

21. **Avoiding market distortion is a key objective of blended finance.** The distortion of markets is a situation in which prices and production are at a higher or lower level than in a competitive market (OECD, 2008^[6]) based on local conditions. In particular, in the private sector context, where donors work with and through the private sector, the distortion of markets through concessional finance is a major concern. In blended finance, development finance that is used in the context of commercial finance should be additional.

22. **Concessional finance is neither a source of additionality nor necessarily a requirement to mobilise commercial finance.** However, concessional finance may be required to overcome market barriers or pioneer markets. For this reason, in the reporting on private sector instruments, transactions can be classified as financially additional. In this context, “Financial additionality aims to avoid market distortion i.e. institutions do not compete with other commercial finance providers, but rather support capital-constrained markets, and, where possible, crowd in investments.” (OECD, 2019^[17]) The DFIs reflect that the use of “concessional finance crowds-in sustainable private investments if it is structured to provide the missing element in the overall financing that makes private projects commercially financeable and if it successfully creates a demonstration effect of commercial replicability.” (AfDB, AsDB, AIIB, et al., 2017^[2]). The DFIs group also call for the application of explicit processes in project analysis to determine minimum concessional finance (AfDB, AsDB, AIIB, et al., 2017^[2]), without further defining the nature of such processes.

23. **Approaches that are currently used to determine the concessional finance needed to unlock commercial finance are not standardised and vary widely across blended finance stakeholders,** thereby creating market inefficiencies and possibly over-subsidisation. The lack of publicly available data on blended finance structures, the use of concessional finance, as well as the terms and volumes thereof, currently does not allow benchmarking the use of concessional finance in the context of similar deals in comparable contexts, jurisdictions or sectors.

2.D Focus on commercial sustainability.

24. **Principle 2D calls for ensuring commercial sustainability in blended finance.** This includes (i) coordinating blended finance transactions with accompanying policy reforms to ensure commercial viability of the underlying transaction and sector and (ii) exiting blended concessional finance once commercial sustainability has been achieved.

25. **Creating markets and achieving commercial sustainability requires accompanying interventions beyond the level of the individual blended finance transaction.** As a financial structuring approach, blended finance cannot compensate for missing underlying market fundamentals, which need to be in place to achieve long-term commercial sustainability. These include:

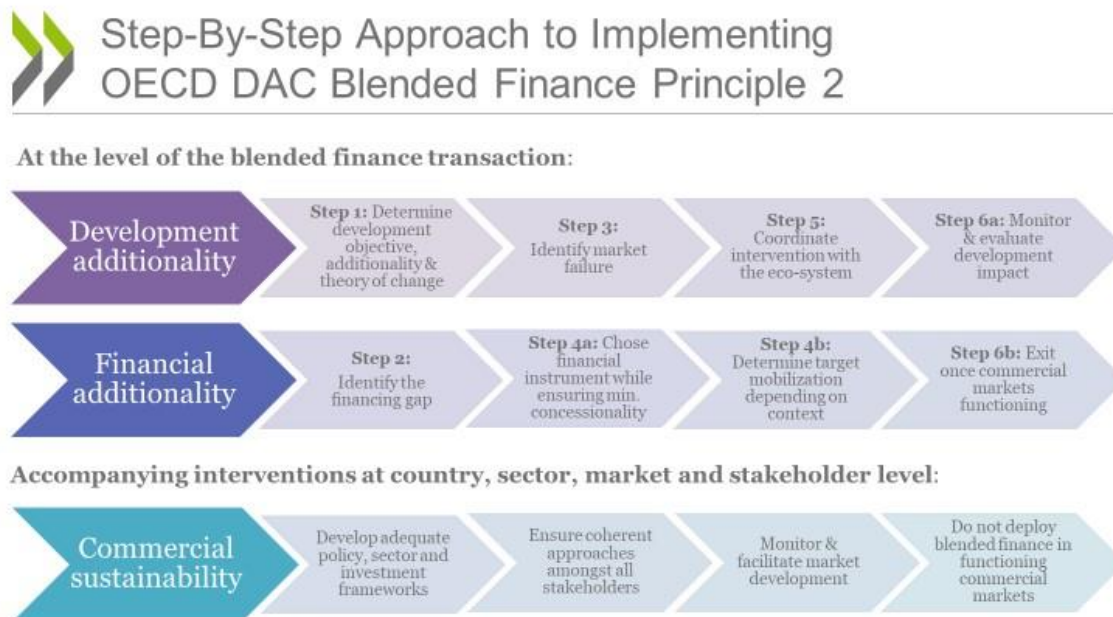
- A conducive investment climate at country level;
- Adequate sector policy and regulatory frameworks that enable and protect private investment;
- Developing capital markets that provide viable exits for blended finance transactions and ensure sustainable future commercial financing without concessionality; and
- Harmonised approaches by development partners to policy reforms and building markets to achieve long-term sustainability.

26. When designing blended finance transactions, donors and other blended finance actors therefore need to coordinate these transactions with accompanying relevant policy reform interventions and related technical assistance work and monitor their respective progress. Otherwise, blended finance may risk using public funds to over-subsidizing the private sector for risks that will nevertheless persist in the absence of market development.

A step-by-step approach to implementing Principle 2

27. **To assist OECD DAC donors to operationalise the key concepts laid out in the previous section in blended finance operations, a step-by-step approach is proposed** to implementing Principle 2. The proposed approach focuses on steps to be undertaken at the level of the blended finance transaction (a project, program or portfolio) in order to ensure development additionality, financial additionality, mobilisation and minimum concessionality. The Detailed Background Guidance below includes the description of each step, which clarifies the key objective, guiding questions and reference concepts as well as potential information sources. Figure 2.1 below lays out the proposed implementation approach.

Figure 2.1. A step-by-step approach to implement Principle 2



Source: Authors

Detailed Background Guidance

1. Introduction

28. **To facilitate practical use for DAC donors and other blended finance actors, the Further Guidance is organised around four core concepts and their key drivers.** Additionality, concessionality and mobilisation are the core concepts underlying Principle 2, while commercial sustainability needs to be ensured alongside them:

- **Additionality** refers to providing financial or non-financial input through a development finance intervention that would not have materialized without the intervention; in the context of blended finance, the concept of additionality includes financial additionality and development additionality (cf. section 2.1.1.),
- **Mobilisation** in the context of blended finance means the amount of commercial finance mobilised for development objectives through development finance; in line with the OECD definition of leverage, this means portraying the complete amount extended to the recipient through blended finance, while the budget of the DAC member only finances a portion of this amount (cf. section 2.2.1.)
- **Concessionality**⁵ is often a part of a blended finance transaction based on the rationale that it is required to overcome market failures and catalyse commercial finance that would otherwise not be forthcoming. At the same time, as per Principle 2c), the use of concessionality needs to be minimised, well-targeted and of temporary nature to avoid unduly distorting markets. How to determine minimum concessionality for a blended finance transaction is an ongoing debate amongst practitioners and an area where further work is required.
- **Commercial sustainability** requires that blended finance incorporates the long-term objective of creating commercial markets through accompanying measures alongside a blended finance transaction at country, sector, market and stakeholder level. Blended finance should not be deployed in markets and projects where commercial sustainability is unlikely to be achieved, as it would lock in subsidies in transactions that are financially unsustainable. In this context, 100% public and/or grant-based financing would be more appropriate.

29. In terms of key drivers, the practical implementation of these concepts in the context of a blended finance transaction will vary according to geography, sector, market maturity, the stage in the project cycle (especially for infrastructure projects) and the choice of financial instrument.

30. **The Detailed Blended Finance Guidance then proposes a six-step implementation framework that blended finance actors can follow** when designing and implementing blended finance transactions while ensuring adherence to Principle 2. The steps are listed below and should be understood as elements of a blended finance approach that is aligned with Principle 2, while they can be deployed in parallel or in an iterative way:

- Step 1: Determine development objective, development additionality and theory of change
- Step 2: Identify financing gap

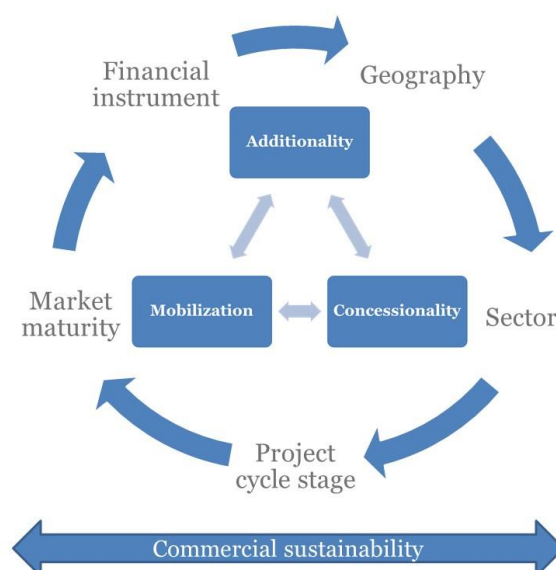
⁵ In quantitative terms, OECD defines concessionality as a measure of the "softness" of a credit reflecting the benefit to the borrower compared to a loan at market rate.

- Step 3: Determine market failure
- Step 4: Chose financial instrument while ensuring minimum concessionality
- Step 5: Coordinate with the eco-system
- Step 6a) Monitor & evaluate development impact
- Step 6b) Ensure commercial sustainability and exit blended finance in functioning commercial markets

2. Core concepts

31. **Principle 2 bases its approach to designing blended finance to increase the mobilisation of commercial finance on the core concepts of additionality, concessionality and mobilisation as well as commercial sustainability.** Sub-principle 2a) focuses on additionality to ensure that development finance does not crowd out commercial finance, public and concessional finance is only used in settings where commercial financing is not currently available for deployment towards development outcomes and that commercial finance mobilised achieves additional development impact. Creating leverage by mobilising additional commercial finance for development as per sub-principle 2b) is the underlying rationale for use of official development assistance for blended finance which however needs to be time-bound. According to sub-principle 2c) concessionality should only be applied when justified by market failures and based on good practice to minimise concessionality and avoid undue subsidies to the private sector. As highlighted in sub-principle 2d), blended finance transactions needs to be designed to ensure commercial sustainability over time, including a clear strategy towards the exit of concessional finance, to avoid market distortion and lock-in of subsidies.

Figure 1. Blended finance core concepts and their underlying drivers

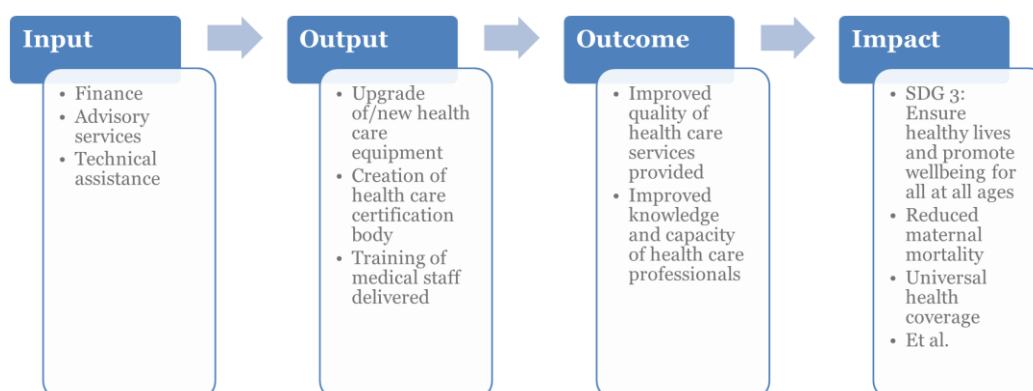


Source: Authors

2.1. Additionality

32. **Every development finance intervention needs to be anchored to a development rationale.** The OECD DAC Blended Finance Principle (1) stipulates that blended finance be used to maximize development outcomes and impact. Good practice for development finance interventions involves the development of a theory of change, often documented in a results framework. This typically starts with defining the development objective of a development finance intervention (e.g. a project, program or fund). Development finance is then understood to provide inputs to create outputs that achieve targeted development outcomes, which will contribute to higher-level development impact. Figure 2 below provides an example of such a results chain for the health sector.

Figure 2. Sample results chain for the health sector



Source: Authors

2.1.1. Definition

33. In general terms, additionality of a development finance intervention can be defined as providing additional financial or non-financial input resulting in additional development outcomes that would not have materialised without the intervention, thereby contribution to amplified development impact. In the context of their private sector operations, multilateral development banks (MDBs) have defined the principle of additionality as interventions by MDBs to support private sector operations that make a contribution beyond what is available in the market, or is otherwise absent from the market, and do not crowd out the private sector.⁶ In this context, additionality cannot be expected to automatically deliver development impact. Development finance interventions require a solid theory of change and results framework ex-ante, including baselines where feasible, as well as rigorous impact monitoring and evaluation during and after the intervention.

Two key components of additionality are:

- **Financially additionality** refers to transactions extended to an entity which cannot obtain finance from the private capital markets (local or international) with similar terms or quantities and for similar developmental purposes without official support, or if it mobilises investment from the private sector that would not have otherwise invested.
- **Development additionality** refers to the development impact of the investment that would not have occurred without a partnership between the official and the private sector.

⁶ Multilateral Development Banks (MDBs) Harmonized Framework for Additionality in Private Sector Operations (2017)

Table 1 below provides examples of both financial and development additionality in the context of blended finance operations.

Table 1. Examples of financial and development additionality in blended finance

| Financial additionality | Development additionality |
|--|---|
| <ul style="list-style-type: none"> • Provide financing where currently no market for commercial financing exists, e.g. in <ul style="list-style-type: none"> ○ Low-income countries (LICs) and fragile and conflict-affected situations (FCS) ○ First-time markets ○ High risk sectors • Provide financing at terms beyond what is available in the market [at sustainable rates] – e.g. <ul style="list-style-type: none"> ○ amounts ○ longer maturities/grace periods ○ local currency financing • Provide financing for riskier market segments not currently served by the market, e.g. <ul style="list-style-type: none"> ○ Project development capital ○ Construction finance • Financial innovation - providing financial instruments that are not offered by the market, e.g. <ul style="list-style-type: none"> ○ Patient, first loss equity ○ Mezzanine finance ○ Guarantees ○ Securitization ○ Derivatives/hedging solutions ○ Insurance products ○ Environmental/social impact bonds • Mobilisation of commercial/private sector investment for the SDGs that would otherwise not be forthcoming <ul style="list-style-type: none"> ○ Syndication ○ Co-financing ○ Risk-sharing mechanisms ○ Tiered blended finance funds | <ul style="list-style-type: none"> • Creating additional/better development outcomes in existing markets, e.g. <ul style="list-style-type: none"> ○ Increased job creation through SMEs in Africa • Creating development outcomes in new market segments in existing markets, e.g. <ul style="list-style-type: none"> ○ Increasing access to finance for women-owned businesses ○ Increasing CO2 reduction through scaled up financing for new technologies (such as off-grid renewable energy solutions) • Creating development outcomes in currently unserved markets, e.g. <ul style="list-style-type: none"> ○ Increase job creation through access to finance for SMEs in FCS ○ Increasing resilience through insurance solutions for small-scale farmers • Scaling up development outcomes through large-scale mobilisation of commercial finance, e.g. <ul style="list-style-type: none"> ○ Increase CO2 reduction by catalysing large amounts of commercial finance for renewable energy through de-risking and new investment products, such as blended funds • Capacity building and knowledge sharing |

Source: Authors, some adaptations from MDB's Harmonised Framework for Additionality in Private Sector Operations (2017)

2.1.2. Drivers of additionality

34. **Additionality in blended finance is case specific based on a transaction's country, sector, market and project characteristics.** Figure 3 illustrates, in a stylized way, the relationship between the key drivers and indicative degrees of additionality. In practice, an assessment of additionality is case-specific for each blended finance transaction based on its development objective, context and conditions and taking additionality considerations into account across multiple categories.

35. For example, in general terms, an SDG-aligned investment proposal in a middle-income country with a good investment framework and developed long-term capital markets would have low or close-to-zero financial additionality and would likely not justify the use of concessional blended finance. An investment proposal for a least developed country with poor investment climate and underdeveloped capital markets would have high additionality and could well justify the use of blended concessional finance to unlock additional commercial finance, which would otherwise not be forthcoming.

Figure 3. Stylized drivers of additionality in blended finance

| Drivers | High Additionality | Medium Additionality | Low Additionality |
|---|---------------------------------|--|--------------------------------------|
| Country characteristics | | | |
| Income level | LICs, LDCs, FCS | MICs | HICs |
| Investment climate | Weak, untested | Medium, limited track record | Established, strong track record |
| Sector characteristics | | | |
| Sector framework | Framework in place but untested | Framework in place with some track record, no framework in place | Strong and tested framework in place |
| Financial viability | Low | Medium | High |
| Stage of market entry | First mover | Second mover | Repeat transaction |
| Financial market characteristics | | | |
| No. of active development partners | Low | Medium | High |
| Capital market development | Undeveloped / short term | Short- to medium-term | Fully developed including long-term |
| Project characteristics | | | |
| Project cycle phase | Development phase | Construction phase | Operating phase |
| Technology | Untested | Limited track record | Established |

Source: Authors

2.1.3. Key take-aways for policy makers

36. **Assessing and ensuring additionality is important to minimise market distortion and prevent crowding out of private investment through blended finance.** Public finance should only be used to catalyse private finance through blended finance structures if there is a plausible degree of

certainty that private investment is required and is not forthcoming on its own and that blended finance delivers additional development outcomes over those delivered purely by the amount of public finance used for blending. Otherwise blended finance risks to unduly subsidize commercial finance and potentially distort markets as a result.

37. **Assessing additionality in blended finance is challenging as no single agreed definition and assessment methodology exists** amongst blended finance actors. As a result, every institution (donors, MDBs, DFIs) defines, identifies and assesses additionality in development finance, including in blended finance, slightly differently.⁷ This creates methodological challenges and confusion, especially from the perspective of private investors. A harmonised approach and methodology amongst public blended finance actors (donors, MDBs/DFIs) for assessing additionality in blended finance is therefore called for and donors should encourage progress towards harmonisation. The OECD DAC Network on Development Evaluation is addressing this policy challenge by exploring how to evaluate development additionality of blended finance.

38. **As providers of concessional finance for blending, donor governments need to keep the following guiding principles in mind** when assessing and ensuring additionality in a blended finance transaction:

- Blended finance transactions need to provide both development and financial additionality beyond what can be achieved through public or private finance alone;
- In terms of both development and financial additionality, the incremental outcomes catalysed by a blended finance transaction beyond what public and private finance alone would be able to deliver needs to be clearly identified, e.g. through a clear theory of change that can be monitored through key performance indicators for development impact and additional amounts of private finance catalysed for financial additionality;
- Additionality is transaction-specific and varies depending on context and is driven by country, sector, market and project characteristics;
- To enable ex post impact assessments for a selected sample of blended finance transactions, donors should request that ex-ante baseline data is collected on key results indicators and monitored during implementation;
- Donors should encourage and facilitate a harmonised approach towards assessing additionality in development finance, including for blended finance, and reporting on additionality in a standardised way.

39. Donors may have differing views on the relative importance of development vs financial additionality in the programs they support. Donor governments consulted for this work demonstrated varying approaches towards ranking additionality: some prioritise development additionality as the sine qua non starting point that determines the type of financial additionality required to deliver targeted development outcomes, while others considered development and financial additionality to be of equal importance, accepting trade-offs amongst them.

2.2. Mobilisation

2.2.1. Definition of mobilisation in the context of blended finance

40. **In the context of blended finance, leverage refers to the amount of commercial finance mobilised for development objectives.** The OECD defines leverage as having exposure to the full

⁷ While MDBs developed a Harmonized Framework for Additionality in Private Sector Operations in 2018, it acknowledges that 'MDBs use different operational frameworks to achieve it due to differing mandates'.

benefits arising from holding a position in a financial asset, without having to fully fund the position with own funds (OECD, 2008^[6]). The term leverage means portraying the complete financing amount in blended finance transactions extended to the borrower without having to fund these entirely through the DAC members' budget. In alignment with the OECD definition of blended finance⁸, leverage refers to how much commercial money can be mobilised for development finance.

41. **OECD defines mobilisation as the ways in which specific mechanisms stimulate the allocation of additional financial resources to particular objectives** ("direct mobilisation"). It implies a causal link between private finance made available for a specific project and the official flows that were used to incentivize them. Mobilisation is easily auditable, attributable, and measurable vis-à-vis time of commitment/financial close.⁹ In the context of blended finance, additional resources mobilised need to aim for the achievement of development objectives and results which should be defined before blending, as the OECD DAC Blended Finance Principle 1 promotes.

Box 1: Literature review – Leverage and mobilisation

Leverage in blended finance

In blended finance, leverage has been propelled by policy makers as a proxy indicator of the success of such transactions. The opinion of think tanks and policy researchers however currently illustrates a critical view on leverage in blended finance.

- In principle, the rationale behind leverage implies that more finance will be freed up for further investment, in reality we can observe that not financial resources but the limited availability of bankable projects are the bottleneck (Carter, 2018^[7]).
- Leverage is only a statistical measure which doesn't make a statement towards additionality, impact, or catalysing effects (Attridge and Engen, 2019^[8]).
- In consequence setting a leverage target has the effect of implementing a specific ratio whereas it does not yet mean that more financial commitments have been made (Carter, 2018^[7]).

Blended finance practitioners have developed an alternative understanding of mobilisation in alignment with the MDB and DFI definition of Blended Finance¹⁰. Mobilisation is understood as private investment mobilised consisting of private indirect mobilisation and private direct mobilisation. (AfDB et al., 2018^[9]). It is important to note that this definition of mobilisation differs from the OECD understanding of mobilisation first in incorporating private indirect mobilisation, that is a project supported by MDBs or DFIs without MDB or DFI involvement in arranging the transaction (AfDB et al., 2018^[9]). Second, the understanding of private direct mobilisation may include DFI own account finance and is not required per definition to include commercial finance (AfDB, AsDB, AIIB, et al., 2017^[2]).

42. **Commercial finance can be mobilised from a variety of private-sector actors.** Private sector actors include commercial banks, institutional investors (asset managers, pension funds, and insurance

⁸ OECD definition of Blended Finance is "the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries", with 'additional finance' referring primarily to commercial finance. (OECD, 2018^[25])

⁹ <http://www.oecd.org/dac/stats/principles-for-mobilisation.pdf>

¹⁰ MDB/DFI definition of blended concessional finance for private sector projects: "Combining concessional finance from donors or third parties alongside DFIs' normal own account finance and/or commercial finance from other

companies), national investment funds (such as sovereign wealth funds), private equity funds, venture capital funds, and project developers. Commercial actors' interests typically have the objective of investing at repayable, profitable terms. Private investors also share a risk-based approach towards investing that requires adequate returns to compensate for perceived and actual risks of investing in emerging markets and developing countries. Furthermore, private investors' activities are subject to financial sector regulation. For example, the prudential requirements of the Basel III regulation for commercial banks and the Solvency II regulation for insurance companies set high capital charges for high-risk investments in emerging markets, thereby providing disincentives for commercial banks and insurance companies to invest in development finance. Similarly, anti-money laundering regulation also increases transaction costs for private investments in higher risk countries, while these can be donor focus countries due to high development impact opportunities. Impact investors such as foundations or mission-driven organizations are an additional source of capital that can be mobilised for development objectives through blended finance. Impact investors can operate with more flexibility regarding their risk appetite and expected returns compared to purely commercial private investors. In terms of limitations, commercial investors can be less familiar with the investment climate, sector characteristics and other relevant factors in developing countries compared to donors and development partners.

43. **The mobilisation potential of private commercial finance through blended finance depends on the transaction's risk-return profile.** The risk profile is determined by risk factors such as the transaction's country risk, regulatory risk, market risk, technical risk, financial risk, foreign currency risk etc.¹¹ In developing countries, these risk factors can be – or be perceived to be – high from the perspective of a private investor. In turn, investors demand commensurate risk-adjusted returns to be compensated for the perceived and actual risks of a transaction. In this context, blended finance can help lower risk for private investors through concessional subordinated instruments or guarantees and/or help stabilise returns, while ensuring minimum concessionality.

44. **Mobilisation in blended finance is therefore a function of context-specific country, sector, market and project characteristics.** From the perspective of a commercial investor, markets with stable macroeconomic fundamentals, a conducive investment climate, established sector frameworks and developed capital markets are less risky, can generate stable returns and therefore typically attract higher private investment. In contrast, developing markets with challenging market fundamentals, such as LDCs or FCS, untested regulatory frameworks and undeveloped capital markets attract less or no commercial capital due to their high risk and high ensuing return requirements. Figure 4 below illustrates the relationship between key drivers and mobilisation in a stylized manner.

45. **This points to an inverse relationship between additionality and mobilisation:** Due to the relatively high risk nature of countries, sectors and transactions with high additionality (such as LDCs), mobilisation potential for commercial finance through blended finance is ex-ante lower compared to countries with lower additionality (such as MICs). For these reasons, high mobilisation cannot be understood to automatically reflect high development impact.

46. **Additional eco-system factors are relevant in the context of mobilisation.** The availability of a pipeline of bankable projects for private investment is a key pre-requisite to mobilisation and an ongoing bottleneck to the mobilisation of commercial finance for the SDGs. Donors should therefore focus on supporting pipeline creation. Similarly, connections between the public and private sector need to be

investors, to develop private sector markets, address the Sustainable Development Goals (SDGs), and mobilise private resources." from the DFI working group on blended concessional finance for private sector projects summary report (AfDB, AsDB, AIB, et al., 2017^[2])

¹¹ See OECD Guidance Note on Blended Finance Principle 4) for a detailed discussion of risk factors in blended finance transactions.

improved, so that commercial investors become aware of investment opportunities and donors can tailor their concessional support to the needs of the private sector.

Figure 4. Stylized drivers of mobilisation potential in blended finance transactions

| Drivers | High Mobilization Potential | Medium Mobilization Potential | Low Mobilization Potential |
|---|--------------------------------------|--|--|
| Country characteristics | | | |
| Income level | MICs | LICs | LDCs, FCS |
| Investment climate | Established, strong track record | Medium, limited track record | Weak, untested |
| Sector characteristics | | | |
| Sector framework | Strong and tested framework in place | Framework in place with limited track record | Framework in place but untested, no framework in place |
| Financial viability | High | Medium | Low |
| Stage of market entry | Repeat transaction | Second mover | First mover |
| Financial market characteristics | | | |
| Number of active private investors | High | Medium | Low |
| Capital market development | Fully developed including long-term | Short- to medium-term | Undeveloped, short-term |
| Project characteristics | | | |
| Project cycle phase | Operating phase | Construction phase | Development phase |
| Technology | Established | Limited track record | Untested |

Source: Authors

2.2.2. Drivers of mobilisation – evidence from OECD data

47. **Blended finance to date has not met expectations to catalyse the ‘billions to trillions’ in commercial finance that are required to achieve the SDGs.** Based on OECD data, between 2012-17, total private sector mobilisation amounted to USD 157 billion, equivalent to roughly the level of annual net ODA. This requires an improved understanding of how the underlying drivers impact mobilisation as well as ongoing inefficiencies in existing practices. Historic data can help manage expectations regarding the mobilisation effect of blended finance and realistic target setting. Historic data on key drivers of mobilisation may also give an initial explanation for ex post observed mobilisation effects.

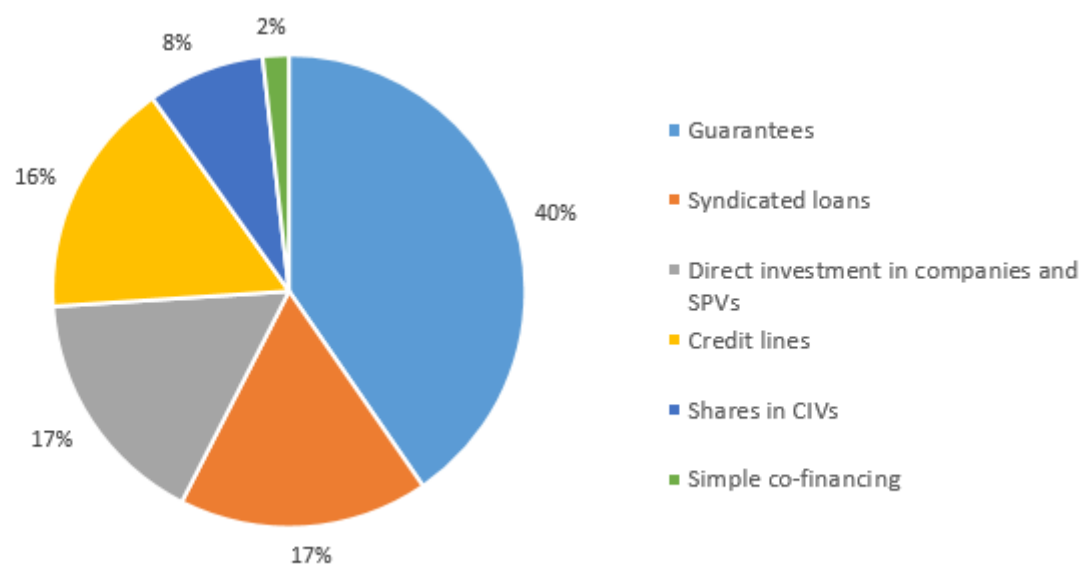
48. **The OECD data on mobilisation of commercial finance show useful initial pointers** across blended finance instruments, sectoral, and geographical distributions. At the same time, significant data gaps persist. Going forward, systematic reporting on mobilisation in the creditor reporting system will allow for more robust analysis.

2.2.3. Financial Instrument

49. The OECD amounts mobilised from the private sector as a result of official development finance interventions, including private funds of both international and domestic origin, show a total mobilisation of 157 billion USD from the private sector between 2012 and 2017. Thereof, guarantees by official development actors have mobilised the highest proportion of the total amounts (40%). Syndicated loans,

direct investment in companies and SPVs, as well as credit lines each mobilised between 16% and 17% (Figure 5).

Figure 5. Amount mobilised from the private sector, instrument distribution



Note: Amounts mobilised from the private sector 2012-2017

Source: OECD-DAC statistics, database accessed on 10th July 2019un

50. **Guarantees have received much public attention in blended finance due to their high mobilisation effect.** Not only the OECD mobilisation data but also other stakeholders in data collection have found guarantees to have a high mobilisation effect (Convergence, 2018^[10]). This can in part be attributed to their unfunded nature, which results in mobilising large underlying commercial finance. At the same time, guarantees are an effective tool in providing tailored risk mitigation to the private sector. Syndicated loans as well as credit lines both represent debt instruments, whereas direct investments can be either equity, debt or mezzanine capital (OECD, 2018^[11]).

51. Blended finance instruments include grants, equity, and debt instruments as well as guarantees or insurance. These may be deployed through mechanisms such as funds, syndication or securitisation. Some actors in the blended finance sphere are better equipped to provide a certain blended finance instrument, calling for making use of comparative advantages in developing and providing blended finance instruments.

2.2.4. Sector

52. In each sector, an investor is facing different particularities that influence an investor's willingness and ability to finance a specific project thus driving mobilisation. In general, some factors affecting mobilisation in specific sectors include:

- **Financial viability:** Some sectors, such as a power sector in a country that has cost-reflective tariffs, are sufficiently revenue and cash flow generating that they can attract private investment. Other sectors, like social sectors, are not financially viable on their own, do not create sufficient revenues and cash flows and require additional public finance or subsidies.

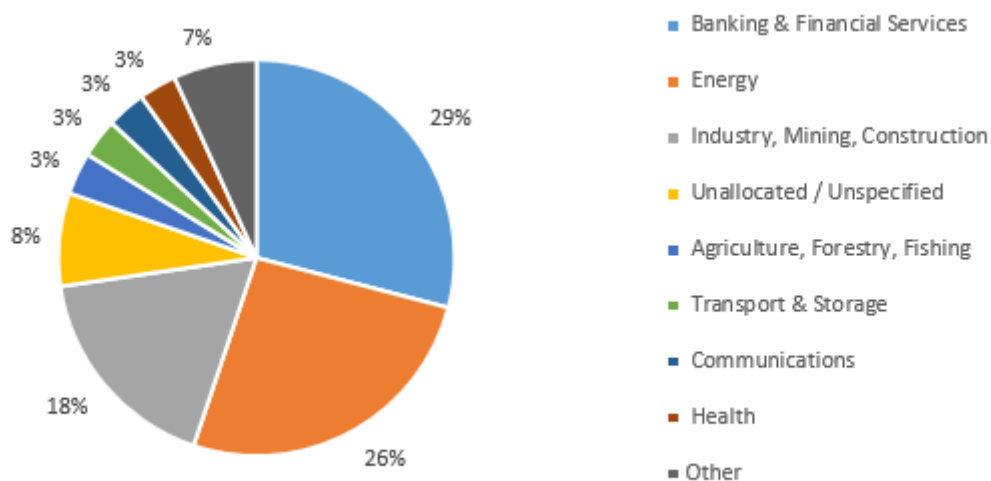
- **Regulatory frameworks:** Incomplete, weak or untested regulatory frameworks increase uncertainty from the perspective of a private investor, requiring higher returns or risk mitigation. As a result, mobilisation potential is higher in sectors with established and proven regulatory and investment frameworks.
- **Track record:** Sectors that have already received private investment benefit from a track record which provides comfort to investors and therefore have higher mobilisation potential than sectors where blended finance help unlock the first commercial investment.
- **Technology:** Established and proven technologies that are commercial viable are conducive to attracting commercial investment, while private investors are reluctant to invest in technologies that are new, unproven and have not demonstrated their technical and commercial viability. Blended finance can help de-risk the latter.
- **Others:** Future upscaling opportunities of a blended finance approach seemed to have a considerable impact. Additionally the portfolio structure of the commercial investor is a relevant input factor. Commercial investors are facing sector exposure limits and aim at minimising the correlation with the existing portfolio.

53. Figure 6 depicts the percentage sectoral distribution of the amounts mobilised from the private sector between 2012 and 2017. Banking and Finance (29%), Energy (26%), and Industry, Mining, Construction (18%) attract the majority of capital. All remaining sectors received an average share of approximately 3% or less.

54. **Revenue generating sectors are shown to attract more commercial finance than the social sectors.** Both banking and financial services as well as the energy sector together attract more than half of the amount mobilised while other sectors such as agriculture, health, and water remain between 2% to 4%.

55. The OECD survey on blended finance funds and facilities¹² equally shows that the majority of blended finance is being invested in the energy sector, followed by the banking and financial services sector, transport and industry.

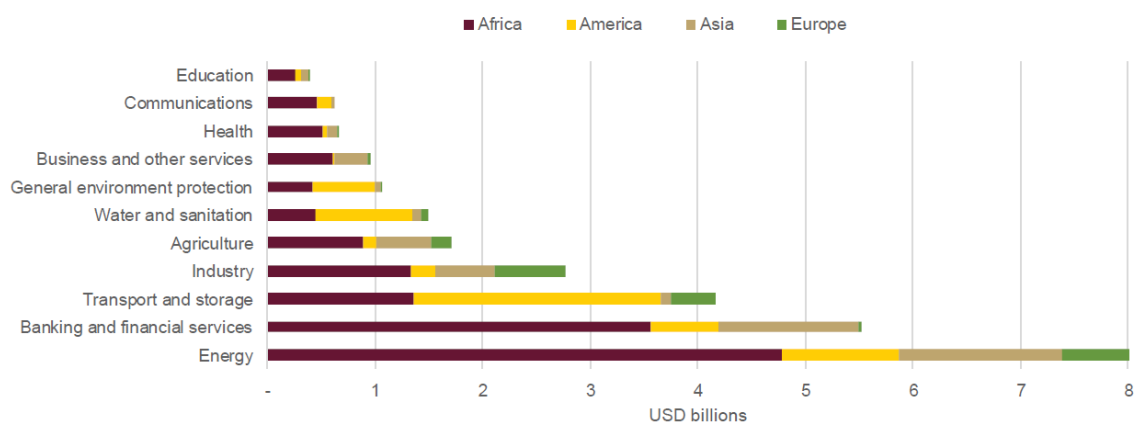
Figure 6. Amounts mobilised from the private sector, sectoral distribution



¹² https://www.oecd-ilibrary.org/development/blended-finance-funds-and-facilities_806991a2-en

Note: Amounts mobilised from the private sector 2012-2017
 Source: OECD-DAC statistics, database accessed on 10th July 2019

Figure 7. Blended finance funds investment by region and sector



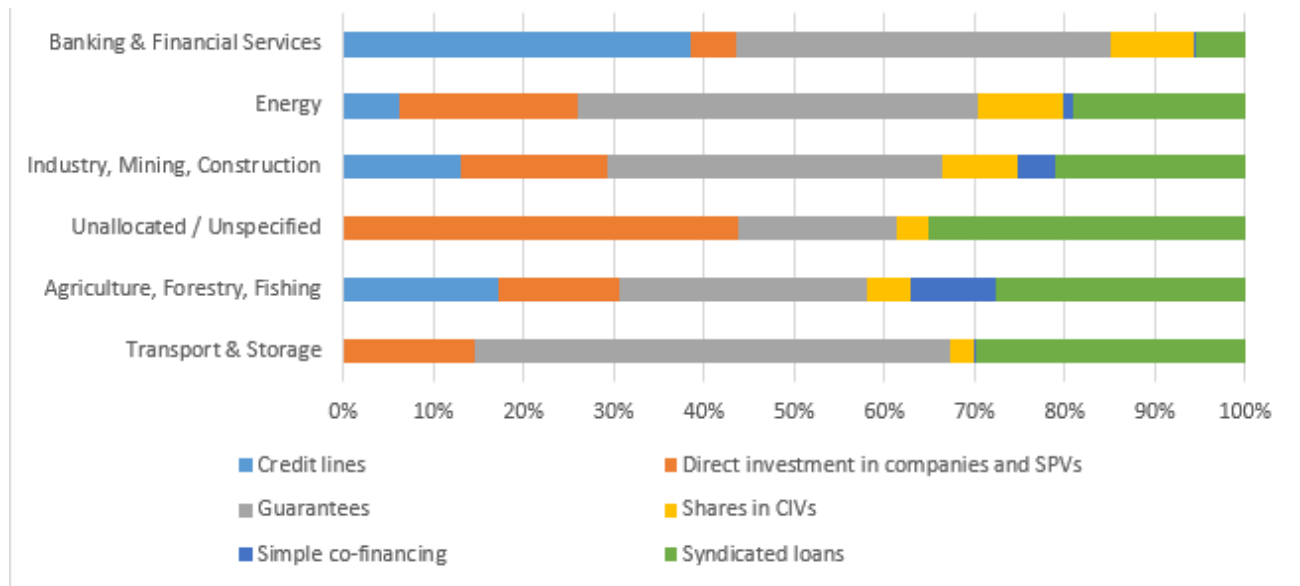
Source: (Basile and Dutra, 2019^[12])

56. **The amount mobilised from the perspective of the instruments deployed are sector dependent.** In the financial sector, private finance is largely mobilised through guarantees as well as credit lines. Guarantees broaden the FI's ability to conduct lending by extending the FI's risk absorption capacity. EIB's financial sector risk-sharing guarantee provides an example for this approach.¹³

57. In the energy and transport sectors, development financiers focus on providing guarantees as frequently required to cover political and regulatory risks in public-private partnerships in infrastructure, such as independent power producers, thereby improving project risk ratings. In addition, mobilisation of commercial capital occurs through direct investments in companies or through syndicated loans. Syndicated loans allow risk sharing among the debt providers. This is particularly relevant in emerging markets and developing economies as a limited amount of available information exposes commercial investors to higher risk and can reduce single ticket lending sizes.

¹³ https://www.eib.org/attachments/country/acp_fs_risk_sharing_guarantees_en.pdf

Figure 8. Instruments used for mobilising the private sector in the top six recipient sectors



Note: Amounts mobilised from the private sector 2012-2017

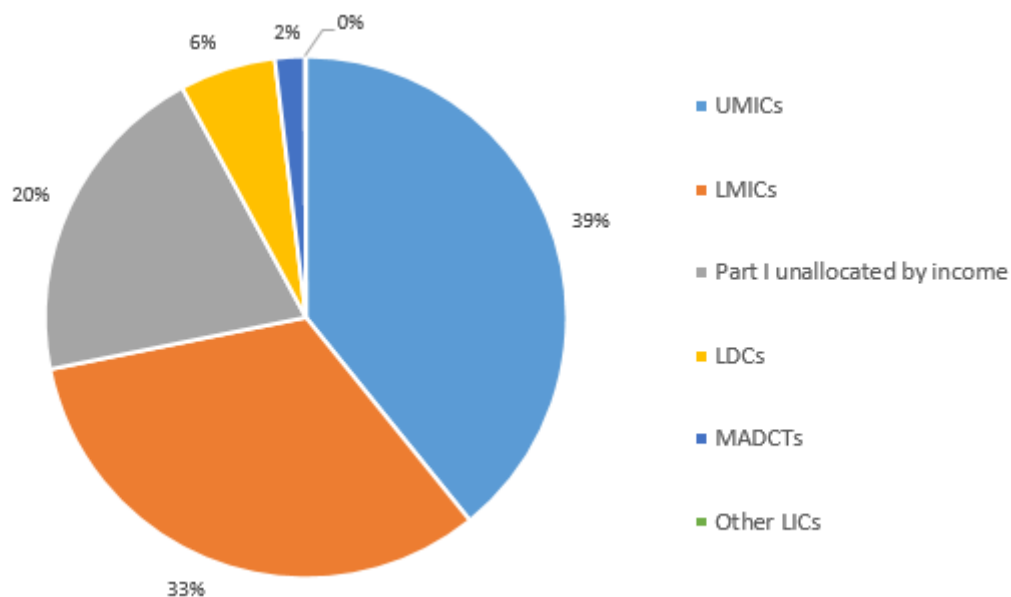
Source: OECD-DAC statistics, database accessed on 10th July 2019

2.2.5. Geography

58. **As many investors evaluate investment opportunities based on country risk, the geographical dimension has major implications on the mobilisation effect of a blended finance transaction.** Each country is inherently different in a variety of dimensions and risk considerations as well as the availability of information to verify risk models are especially country-specific.

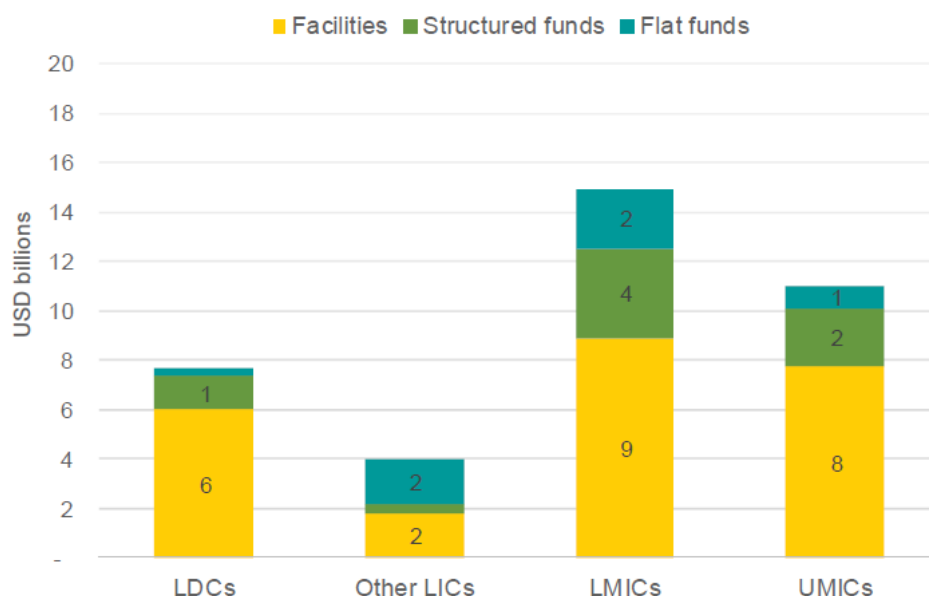
59. **Middle income countries seem to remain in their position of being the primary beneficiaries of private finance mobilisation,** attracting 72% of the amount mobilised from the private sector (UMICs 39%, LMICs 33%). Least developed countries have yet to find a standing in blended finance only attracting 6% of the amounts mobilised. This is confirmed by the OECD Survey of Blended Finance Funds and Facilities, which found that lower middle-income countries received the highest share of blended finance, followed by upper middle-income countries and only then by LDCs and LICs.

Figure 9. Amounts mobilised from the private sector, by recipient income group



Note: Amounts mobilised from the private sector 2012-2017
 Source: OECD-DAC statistics, database accessed on 10th July 2019

Figure 10. Investment recipients by income group

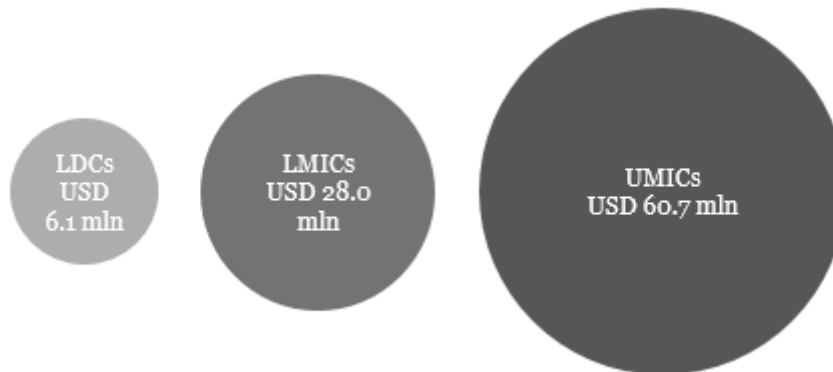


Source: (Basile and Dutra, 2019[12])

60. Taking a deeper look into mobilisation in LDCs the OECD mobilisation data reveals, that not only is mobilisation in LDCs in sum much lower than in middle income countries, but if the private sector is mobilised in an LDC the average deal size remains at approximately 10% of the average deal size of UMICs. Attempting to explain the low mobilisation volumes in LDCs, the particularly weak enabling

environment of LDCs could be a major cause in addition to a limited pipeline of bankable projects, the higher actual and perceived market and financial risks etc. The lack of an investment friendly climate raises the required risk premium of commercial investors, thus increasing project financing costs (UNCDF, 2018^[13]). In light of commercial investor's low appetite for risk, given the need to preserve a triple-A rating and institutional incentives to push towards 'easier' deals investment in LDCs remains below other developing countries (OECD/UNCDF, 2019^[3]).

Figure 11. Average amount mobilised per transaction



Note: Amounts mobilised from the private sector 2012-2017
Source: OECD-DAC statistics, database accessed on 10th July 2019

61. **From the perspective of a commercial investor, the geographical dimension of a blended finance transaction is also relevant because of country risk** which is an essential input factor for commercial investors risk modelling. A higher country risk calls for a higher risk premium. Country risk is modelled by rating agencies who assign sovereign ratings to individual countries. One interviewee stated to distinguish strictly between speculative grade countries (Moody's/S&P/Fitch Ba3/BB-/BB- and below) and investment grade countries (Moody's/S&P/Fitch: Baa3/BBB-/BBB- and above) in their approach to conducting business. Country risk as an input factor for commercial mobilisation additionally becomes evident when observing the default risk of project finance bank loans. While in developed economies country risk only accounts for the minority of defaults, it has been the single largest reason for defaults in EMDEs (39.2-43.5%) between 1983 and 2016 (Davison et al., 2018^[14]). In the study set, almost all observed country risk defaults were caused by currency transfer or local currency devaluation.

2.2.6. Stage in the project cycle

62. **The project stage is driving commercial investment, in particular in infrastructure projects.** That is, certain type of risks associated with an investment vary across the project lifecycle. Following an infrastructure project cycle helps to identify the risk involved in financing a project, thus allowing for conclusions on mobilisation.

- In the development phase, a project developer is required to conduct a phase of in-depth preparation ensuring the commercial viability of the proposed concept. The business model is not yet developed and its success is subject to a high degree of uncertainty. Together with extensive bidding procedures these factors drive perceived risk at this stage (OECD, 2015^[15]). The capital intensity of infrastructure projects calls for high upfront costs, while the project will likely not generate cash flows in the beginning (OECD, 2015^[15]).

- In the subsequent construction phase, a project is again facing a high level of risk, in particular as financial closure has been reached and revenues are not yet generated.
- Over the ongoing maturation of the project lifecycle, namely the operational phase and the termination phase, activities gain routine and more stable cash flows are generated (OECD, 2015^[15]).

63. **Each of the project phases is subject to a variety of different risks.** Some risks are only present in a limited period such as project feasibility and contract negotiations in the development phase or refinancing risk in the operation and termination phase. Other risks on the other hand remain present throughout the entire project life, including for instance the political risk of social acceptance (OECD, 2015^[15]).

64. **Default and recovery studies additionally support distinguishing between project phases.** Moody's research found out that ultimate recovery rates for any project finance bank loan¹⁴ in the construction phase (70.7% between 1983-2016) are generally lower than in the operational phase (80.9% between 1983-2016) (Davison et al., 2018^[14]). Additionally, a greater variability in recovery rates could be observed in the construction phase as opposed to the operational phase. Taking a closer look at defaults of project finance bank loans specifically in the infrastructure industry, defaults due to construction risk are the most common source of defaults (28.6%). Strikingly however, an observation of the subgroups points out that while in developed countries construction risk accounts for a majority of defaults (31.8%-35.3%) the situation is reversed for EMDEs. In EMDEs country risk is the principal cause of default (50.0%-60.0%) and construction risk only accounts for a much lower proportion of defaults (20.0%-33.3%) (Davison et al., 2018^[14]). This might drive the perceived risk of commercial investors in early stage infrastructure investment. Moody's found that the financiers of such projects tend to charge higher loan margins during earlier project stages by pricing in the incremental risk of a construction phase (Davison et al., 2018^[14]).

65. **Differentiating between the stages of the project cycle is consequently required for tailor making blended finance structures** in line with investor specific needs, thus optimising mobilisation effects. The FMO-funded Climate Investor One blended finance vehicle has developed a structure to differentiate the use of blended finance and concessionality along the project cycle (see Box 2).

Box 2. Climate Investor One

Climate Investor One ("CIO") is a global investment vehicle founded in 2015 by Netherlands Development Finance Company (FMO) and Phoenix InfraWorks (as anchor sponsors/investors) to finance renewable energy projects in emerging markets globally.

CIO comprises three investment funds tailored towards an integrated financing approach covering all stages of a project life cycle in an infrastructure project i.e. from development, construction to operations. The investments funds targeting a total commitment of USD 1 billion at final close are:

i) Development Fund (DF): At early project stage, CIO provides financial, technical, environmental, social development and structuring support through this fund. The fund attracted USD 50 million in donor capital i.e. grants to co-finance up to 50% of project development with the private sponsor.

¹⁴ The values given do not distinguish between the sectors and are not infrastructure specific but generally hold for project finance bank loans of unspecified sector type.

ii) Construction Equity Fund (CEF): CEF aims to reduce the complexity associated with multi-party negotiations associated with typical project finance delays by providing up to 75% of equity financing for the construction phase, thereby eliminating the need for debt financing during construction. The fund has raised USD 800 million from commercial and institutional investors with the following layered structure:

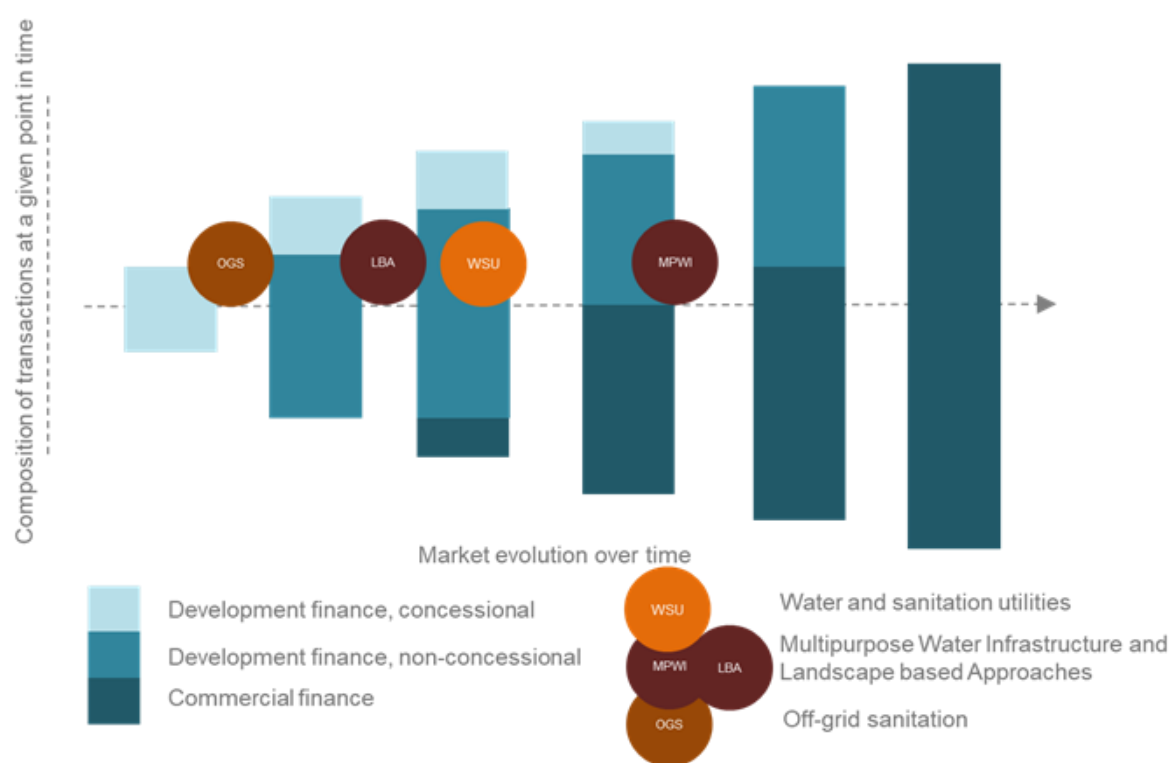
- 20% Tier 1 capital, a first-loss tier from donors;
- 40% Tier 2 ordinary equity from commercially oriented investors such as FMO and other DFIs;
- 40% Tier 3 capital i.e. preference shares from institutional investors such as Export Credit Agencies and pension funds.

iii) Refinancing Fund: Target size of USD 800 million by way of refinancing of up to 50% of equity with long-term senior debt to leverage equity returns during the operational phase. This fund would allow mainstream commercial investors such as commercial banks and pension funds to invest in operating projects that have been developed through the development and construction equity funds.

2.2.7. Market maturity

66. Blended finance is by nature a time bound development finance intervention. While undeveloped markets call for a stronger support from official donors, more mature markets ought to increasingly achieve autonomy in attracting commercial financiers. Figure 12 illustrates this stylised transition from purely concessional development finance to purely commercial finance. In theory, blended finance interventions are tailored to the market development stage. They are thereby able to progressively foster market evolution over time enabling an increasing mobilisation effect in later stages of market development. This ought to increase the overall financing available for the sustainable development goals. The OECD report on blended finance in water and sanitation explores this stylised representation with the existing development solutions in the water and sanitation sector.

Figure 12. Stylised representation of the current state of transaction level mobilisation and market evolution over time



Source: (OECD, 2019^[4]),

2.2.8. Concessional

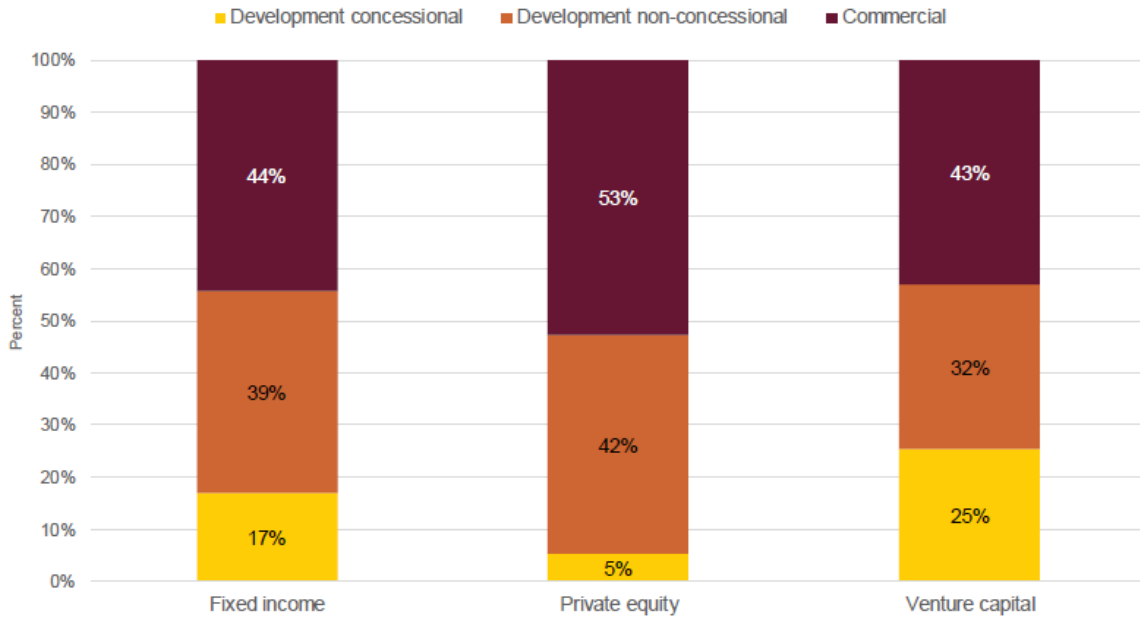
67. **The share of concessional involved in blended finance is an additional driver of mobilisation.** Blended finance as a financial structuring approach may use concessional development finance to attract commercial finance for the SDGs. Concessional finance is used to lower the risk for private investors and/or enhance returns to unlock commercial finance that would otherwise not be forthcoming. The nature and size of the concessional element in blended finance is therefore a key driver of mobilisation. At the same time, undue subsidies to the private sector need to be avoided and Principle 2c) on minimum concessional needs to be respected. Section 2.3 below discusses concessional in more detail.

68. **The OECD Survey on Blended Facilities and Funds provides some benchmarks regarding the current relationship between concessional and mobilisation in blended finance.** On average, blended funds use 42% of concessional finance to raise 25% in commercial finance and 32% of non-concessional development finance. This means that on average, blended finance funds have used concessional finance to mobilise 1.36 times in non-concessional development and commercial finance, while the ratio of purely commercial finance to concessional finance stands at 0.6.¹⁵ The amount of concessional deployed also varies by financial instrument. The same OECD survey shows that the share of concessional capital in blended finance funds was highest in venture capital funds (25%), a high risk market segment, followed by fixed income funds (17%) and private equity funds (5%). The mobilisation

¹⁵ As the data in the survey is self-reported from participating institutions, some data limitations apply.

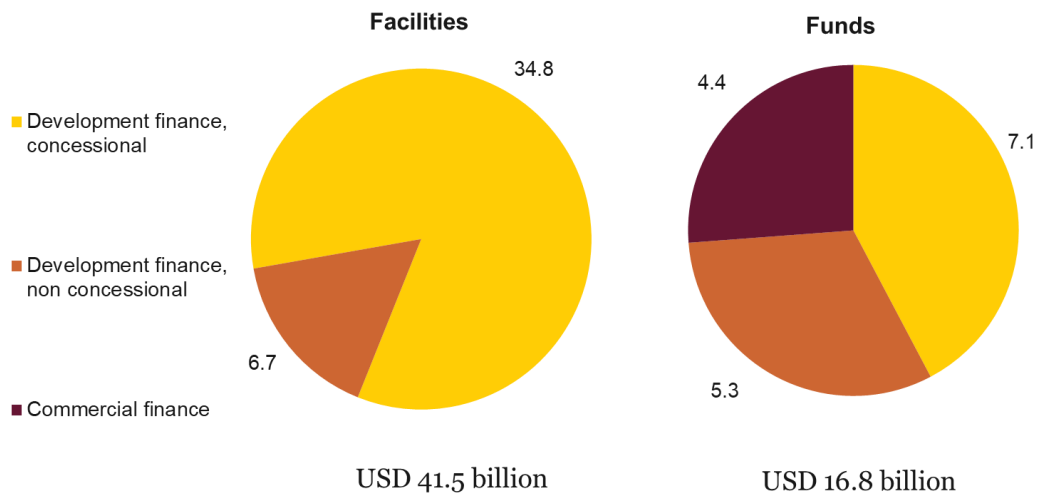
ratio of commercial capital to concessional capital was 1.7 times for venture capital funds, 10.6 times for private equity funds and 2.6 times for fixed income funds (Basile and Dutra, 2019^[12]).

Figure 13. Sources of capital by broad asset category



Source: (Basile and Dutra, 2019^[12])

Figure 14. Sources of capital (mandate and terms) in blended finance CIVs



Source: (Basile and Dutra, 2019^[12])

2.2.9. Data limitations

69. **Additional data will help further improve guidance to policy makers regarding the level of mobilisation they can expect for concessional finance in a specific context.** Commercial investors

derive their investment decisions largely depending on the risk they model for an investment. A proven track record, including reliable risk approximation data allows for a more precise and reliable risk modelling. While in developed economies default and recovery data can be easily obtained, data availability is a major concern in emerging markets and developing economies (EMDEs). Interviews with commercial investors revealed that infrastructure is considered the easiest in EMDEs. The rating agency Moody's has been engaging in research for comparing default and recovery rates in infrastructure in EMDEs (Davison et al., 2019^[16]). Other sectors receive less commercial attention, especially if they require pioneering an investment. Some commercial investors therefore look to development finance institutions to conduct first time investment or co-invest alongside them and scale up their investment once some track record has been created.

70. **Making existing data sources public, as well as refining and harmonising reporting on mobilisation will further help build markets through blended finance.** The GEMs database to which over 20 MDBs and DFIs report their loan performance data is widely recognised as the most comprehensive database for historic default data in emerging markets. Efforts to make this data available to private investors need to be accelerated. Donors also have an interest in gaining access to the GEMs database. In addition, OECD is refining their reporting to the creditor reporting system to also include data on private finance mobilised. Using the available data sources in a transparent manner to make country, sector and market specific mobilisation data available to all blended finance actors will help build markets by providing relevant benchmarks for mobilisation targets.

2.2.10. Key take-aways for policy makers

71. **Understanding context of a specific project or program is critical to setting the right expectations and targets** for mobilisation through blended finance. In order to avoid over-optimistic mobilisation expectations on the one hand and undue subsidies to the private sector on the other, policy makers need to build a good understanding of the investment perspective of private investors and the key drivers of mobilisation in blended finance transactions. In summary:

- Risks related to country, sector, market and project characteristics determine the willingness of private investors to provide capital to development projects and programs at commensurate risk-adjusted returns; initial mobilisation will generally be lower in high-risk and unstable countries with weak or untested sector frameworks, limited commercial viability and first-time transactions; choosing the right financial instrument and level of concessional finance, if any, can help address these risks in order to mobilise private capital.
- Available data points show that mobilisation of private capital is highest in MICs and that the majority of blended finance is being deployed in MICs; it is questionable whether this ensures the highest additionality for blended finance. On the other hand, the cost of deploying blended finance in high risk contexts (such as LDCs or FCS) also need to be compared to purely public sector financing options. Blended finance should only be applied if it is the most effective tool in a donor's toolbox to achieve a targeted development impact.
- Ongoing data challenges currently limit a more in-depth analysis and discussion of the mobilisation potential through blended finance in specific contexts; policy makers need to facilitate the publication of GEMs data and accelerate transparent and harmonised reporting requirements for mobilisation of private capital by MDBs and DFIs, including for blended finance;
- When deploying concessional capital for mobilisation purposes, undue subsidies to the private sector need to be avoided (see next chapter).
- Effective co-operation and collaboration among blended finance stakeholders can lead to increased mobilisation. The structuring of blended finance transactions should be a shared effort, where combined expertise and expectations are considered. Leveraging more from the deal

structuring experience of commercial and investment banks would be of considerable additional value.

2.3. Concessionalality

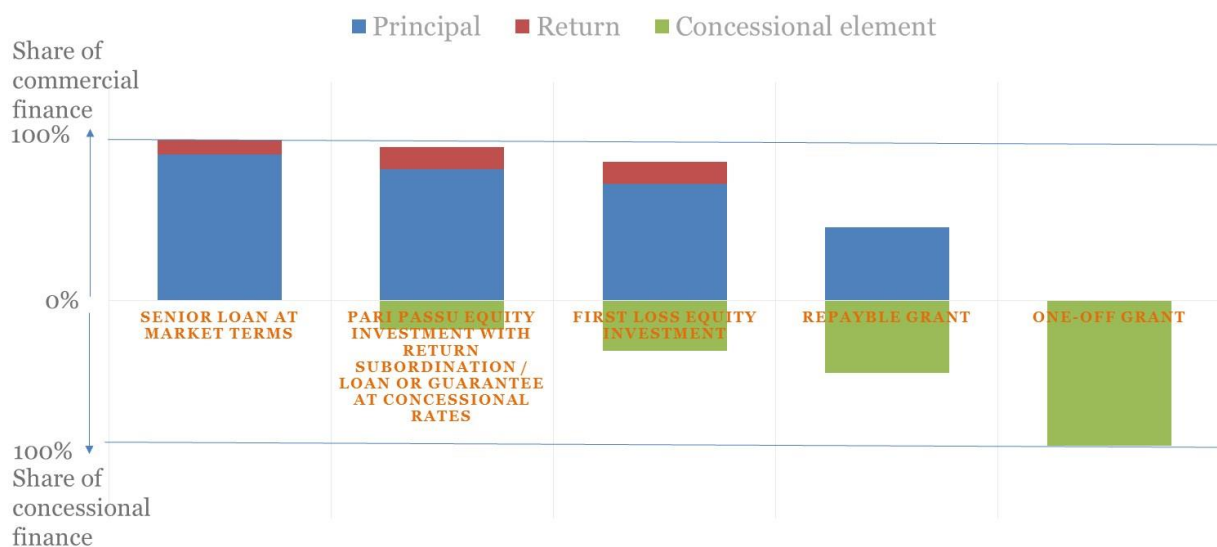
2.3.1. Drivers of concessionalality

72. This section lays out key factors to consider in a qualitative and quantitative manner in the context of a blended finance transaction.

Drivers of concessionalality: Instrument

73. In the financing of e.g., renewable energy, which caters to the public good of sustainability, concessional viability gap payment may be required to compensate the commercial investor for entering a pioneering market segment with a high level of investment and technical risk. By definition, viability gap payments are highly concessional and non-repayable, and as such are of higher concessionalality than a guarantee for de-risking, for example. When deploying blended finance a development finance context, the choice needs to focus on the financial instrument with the lowest level of concessionalality required to achieve the target objectives. Figure 17 illustrates the level of concessionalality involved in selected financial instruments in a stylized manner and Table 3 in Section 3.4 below provides a more detailed overview.

Figure 15. Stylized representation of concessionalality in blended finance instruments



Source: Authors

2.3.2. Drivers of concessionalality: Sector and Geography

74. The sector and the geography influences investment risks associated with a blended finance transaction. High political and regulatory risks in developing countries may require the use of concessionalality in a blended finance transaction in countries where regulatory systems are untested and actual and perceived risks are high, in particular for long-term investment such as infrastructure investments. This is in particular the case if the respective government is the off-taker e.g. of health services or energy. When investment risks are known, data is available and as such can be quantified,

such information will influence the level of concessionality needed to unlock commercial investment. Available data on similar transactions in the same or similar sectors and geographies can help guide the decision on the level of concessionality required in a specific blended finance transaction to e.g. achieve comparable risk-return parameters.

2.3.3. Drivers of concessionality: Project Cycle

75. In pioneer markets and during the early-stage development phase of a project, high volumes and/or levels of concessionality may be required to mobilise initially small amounts of commercial finance. For example, when piloting innovative technologies for energy generation, the private sector is missing a track record as well as facing high technological risks. Moreover, often, large-scale infrastructure investments are associated with a significant need for resources to conduct environmental and social impact assessments that assess the long-term effects of such projects. Significant (concessional) resources may be needed initially for technical assistance or viability gap funding in order to develop and conduct a project, while in the operation phase, less concessionality is needed, if at all.

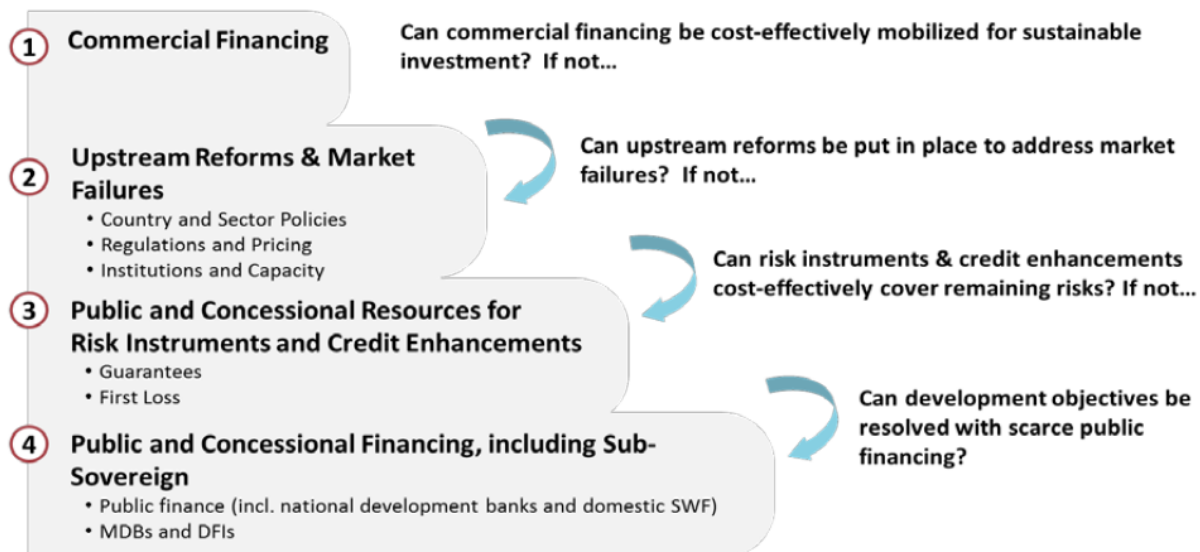
2.3.4. Drivers to concessionality: Market maturity

76. Concessionality should be a dynamic concept taking into account the market maturity in a blended finance transaction. While a higher level of concessionality in immature markets may be justified a close observation is required throughout the time perspective to allow for reducing concessionality in a gradually emerging market. Commercial investors are thereby slowly crowded into financing an evolving market and prevented from being crowded out.

2.3.5. Approaches to minimum level of concessionality

77. **In general terms, if commercial finance is available in a given market, it should be prioritized so that limited public funding is being used where other sources are not available.** The World Bank cascade approach (World Bank Group, 2017^[18]) lays out a sequenced approach to determining the type of development finance required in a given market. It implies the subsidiary application of highly concessional investments within the toolbox of development financing instruments as last resort in markets where commercial finance is not available and financing gaps cannot be addressed through reforms nor risk mitigation instruments.

Figure 16. World Bank cascade approach



Source: (World Bank Group, 2017[18])

78. **Determining the level of concessionality *ex ante* of a transaction is crucial to get blended finance right.** However, determining the amount of concessionality needed to unlock commercial investment while not over-subsidizing is a complex exercise that needs to take the drivers discussed above into account. Moreover, any financial instrument can be concessional in character, including debt, equity, guarantees and other risk enhancement instrument, as well as grants. Quantitative approaches to minimum concessionality include the mathematical models to set the amount of development finance needed to facilitate a transaction with the target risk/return profile. As the DFI guidelines put it, ‘concessional finance crowds-in sustainable private investments if it is structured to provide the missing element in the overall financing that makes private projects commercially financeable’. This could be, for example, the

79. In the context of the private sector, a joint measurement approach of concessionality would facilitate cross-country and cross-institutional comparison. Simultaneously, it would allow for better quantifying minimum concessionality while also fostering a better public understanding of donor efforts. The goal is to fine tune subsidization of the private sector by governments, while not discouraging engagement of the private sector (Carter, 2017_[19]).

80. At the same time, there is no harmonisation on how to determine concessionality *ex post*, though a couple of approaches have been established. Key terms and concepts include discount rates, the interest rate used to convert future income streams to its present value (OECD, 2008_[6]). The TOSSD preliminary reporting directives propose for instance for loans only a binary “Yes” or “No” code indicating the concessionality of a loan according to the IMF and World Bank definition. According to this definition, a loan is concessional loans if it includes a grant element of at least 35%¹⁶.

¹⁶ [http://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/Emerging-Reporting-Instructions%20-V1.3-validatedbyTF WEB.pdf](http://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/Emerging-Reporting-Instructions%20-V1.3-validatedbyTF_WEB.pdf)

81. On the DFIs side, harmonisation efforts have not concluded yet. There are three prevailing approaches in measuring concessionality (AfDB, AsDB, AIIB, et al., 2018_[20])¹⁷

- **Cash flow difference with MDB/DFI modeled commercial pricing:** The methodologies focus on varying calculations of discounted project cash flows. Institutions either observe the discounted cash flow difference or the discounted concessional flows. The latter one is currently used by World Bank and IMF with slight modifications. Concessionality is determined using the institutions' own pricing method for approximating the commercial price for financing a project.
- **Cash flow difference with simplified commercial pricing:** The methodologies rests on calculating discounted project cash flow differences. The commercial price for financing a commitment is approximated using a simplified risk factor framework. The EU applies this approach through taking into account project risk and available collateral.
- **Modelling revenues and expected losses:** The methodology attempts to mirror pricing models of commercial banks. Concessionality is determined through the Net Present Value of expected revenue, expected losses and required return.

82. This shows that amongst blended finance practitioners, no uniform definition of concessionality and measurement approach exists which limits market transparency. A harmonised approach towards defining and measuring concessionality in blended finance is therefore called for.

83. For specific instruments, the European Commission and EIB have developed a methodology to determine the concessional element in the pricing of the new guarantee instrument under the EU's External Investment Plan (Box 3 below).

¹⁷ The 2018 report of the DFI Working Group on Blended Concessional Finance for Private Sector Projects provides an in depth explanation of the approaches used for determining concessionality.

Box 3. Determining concessionality in the pricing of the EFSD guarantee

Under its External Investment Plan and as part of the European Fund for Sustainable Development, the European Commission (EC) has created a new guarantee instrument that is being available to accredited implementation entities on a concessional pricing basis. In order to evaluate the underlying risk of the guaranteed programs and projects, the EC with the support of a dedicated risk-management team at EIB and other DFIs (GTAG) evaluates the expected loss under the program. Based on data available from participating DFIs in the GEMs database, GTAG then determines a commercial pricing range for the respective guarantee based on its risk profile. The EC then decides at what concessional price it makes the guarantee available to the implementing entity. The difference between the commercial pricing determined by GTAG and the subsidized price at which the EC provides the guarantee to implementing DFIs is recorded as the concessional element of the instrument. This approach provides the EC with a standardised methodology in recording and managing concessionality of the guarantee portfolio. It also helps compare proposals submitted with regards to their level of requested concessionality and implied efficiency of the proposed use of the guarantee instrument, enabling the EC to choose proposals with minimum concessionality as feasible.

(Source: GTAG)

2.3.6. Key take-aways for policy makers: Approaches to determine concessionality in blended finance transactions

84. **Blended finance and in particular blended concessional finance can play a role in overcoming market failures and crowd-in commercial investment in developing countries.** Because market failures harm market development as well as the emergence of self-sufficient financial markets, blended finance can serve as a tool to overcome the very market failures the commercial investors are facing thus unlocking their financing potential. To find a balance between mobilising commercial investors and not crowding out commercial investment, efforts to minimise concessionality in the development finance element are indispensable. Concessionality may not even be needed in all cases. The use of concessionality should only be justified if it addresses market failures, enables crowding in and avoids crowding out of commercial investors, without over-subsidization. While a quantitative approach to measuring concessionality has not yet been agreed upon, to work towards finding the minimum level of concessionality, donors should follow the following steps:

- Identify and assess the market failure the blended finance programme should address; identify the source of the market failure and verify if accompanying reform measures are undertaken to address it in a sustainable manner; ensure that blended finance is only used to address temporary market failures;
- Conduct an analysis of the drivers of concessionality in the context of operation; including
 - Identify the gap in the financing structure that concessional finance can help close to mobilise commercial finance
 - Choosing a financial instrument that enables crowding in of commercial finance while minimizing concessionality
 - Take into account sectoral and geographical variables that undermine commercial investment
 - Assess the project cycle's influence on the level of concessionality required, e.g. whether a greenfield project, a new technology or R&D is targeted, or the expansion of a power plant, etc
 - Assess the degree of market maturity, e.g. the level of competition, alternative sources of financing, etc.

- Work towards transparency by disclosing the donor effort in blended finance programmes, including the analysis of drivers assessed before, the amount of concessional funds provided¹⁸, terms and conditions, of concessional finance, etc. in order to contribute to the establishment of market-wide benchmarks.
- Enable equal access to donors' concessional funds. When deploying concessional funds, establish fair and equal access procedures that all market participants, public or private, can understand the objectives, terms and conditions for accessing donors funds. This may include tendering processes (cf. Box 5) and allocating finance to the institution proposing blended finance structure with the minimum need for concessionality.
- Engage in a continuous dialogue with other donors. A continuous dialogue is necessary for fostering progress in moving towards harmonisation of principles to determine concessionality among development actors, including on reporting. Co-ordination on blended finance programmes and transactions is crucial particularly when a concessional element is part of a programme. Structural coordination is needed beyond single transactions in order to avoid excessive reliance on concessional finance (see also (OECD, 2019_[4])).

85. Nonetheless, concessionality and blended finance itself is not a universal solution to all market failures and development challenges. It is thus crucial to understand the root causes of market failures in a given context and condition and streamlining blended finance efforts accordingly. Further engagement in the form of policy reforms and dialogue is likely to be needed to achieve a holistic approach to addressing market failures.

2.4. Commercial sustainability

86. Principle 2d) calls for blended finance approaches to focus on commercial sustainability. Concessional blended finance aims to address market failures, to unlock commercial investors with the overall objective of creating development impact. Blended finance is intended to temporarily intervene in a market with the purpose of enabling access to commercial finance. The long-term objective of creating commercially sustainable markets needs to be incorporated in blended finance approaches, while it cannot be achieved at the level of the blended finance transaction alone. Achieving commercial sustainability therefore entails:

- Accompanying interventions to develop adequate policy, sector and investment frameworks
- Facilitating capital market development
- Incorporating exit strategies in blended finance.

2.4.1. Development of adequate policy, sector and investment frameworks

87. **Blended finance can only catalyse commercially sustainable markets if sustainable underlying market fundamentals are in place.** From the perspective of a commercial investors, commercial sustainability requires two preconditions: financial viability (to achieve returns) and limited uncertainty in form of limited volatility of cash flows (to limit uncertainty about the level of returns).

88. **Market fundamentals to ensure financial viability include sector policy and regulatory frameworks that allow for cost recovery of investments at risk-adjusted returns.** In the power sector, for examples, this means that tariffs need to be cost-reflective and include elements to repay investments. In addition, off-takers of power sold by e.g. private independent power producers need to be creditworthy

¹⁸ This includes both the amount of concessional finance provided by a donor for a given blended finance transaction and also the concessionality embedded in the terms of the donor financing.

and be able to pay their bills to private suppliers without ongoing dependence on state subsidies. Such market fundamentals need to be developed before or in parallel to a blended finance transaction through accompanying measures from development partners, such as technical assistance, budget support or results-based development finance.

89. **Market fundamentals to limit uncertainty for private investors include stable macroeconomic policies and investment frameworks** that adequately protect private investment in the country. These measures can also be facilitated through accompanying development interventions.

90. **Sustainable markets also need to be created to provide access to finance for underserved population groups**, such as women, remote and other vulnerable population groups, who may lack access to finance due to their lack of access to traditional collateral, their inability to provide repayment histories or their small transaction sizes. In this context, blended finance can catalyse markets by de-risking innovative financing mechanisms that need, however, to be embedded in sustainable market solutions to ensure their long-term viability.

91. Blended finance transactions therefore need to be designed and implemented in close coordination with development interventions focused on creating sustainable market fundamentals in countries, sectors and for population groups where they are not yet in place. Blended finance is not sustainable in environments where minimum market fundamentals are not in place or are not being developed to attract commercially sustainable investments.

2.4.2. Facilitating capital market development

92. **To ensure commercial sustainability, the development of local capital markets needs to be facilitated as part of or in parallel to blended finance transactions.** Blended finance is often used to provide finance at maturities and terms that are not yet available in local capital markets or are not available at affordable levels of return or interest rates. This reflects the limited development of local capital markets that need to be addressed to ensure that blended finance results in commercial sustainability. Underdeveloped capital markets in EMDEs often suffer from structural inefficiencies and capacity constraints.

93. Structural inefficiencies include e.g. short-term deposit structures that prevent commercial banks from lending with longer-term maturities; the absence of a liquid stock and bond market; high interest rates on government bonds in local currency that make interest rates for non-government borrowers prohibitively expensive; or ineffective banking and capital market regulation (such as excessive collateral requirements). Addressing structural inefficiencies in local capital markets requires ongoing improvements in monetary policy and supporting interventions from development partners.

94. Capacity constraints can arise through lack of knowledge of e.g. local commercial banks or pension funds of new sectors and technologies that skews their risk assessment and prevents them from making financing available. Blended finance can contribute to capacity building through e.g. credit lines to local financial institutions as well as associated technical assistance facilities. Capacity building for capital market development can also be provided through parallel development interventions from other development partners.

2.4.3. Incorporating exit strategies in blended finance

95. **To facilitate commercial sustainability and avoid market distortions through long-term dependence on subsidies, blended finance needs to integrate exit strategies.** Blended finance needs to be phased out once the investee generates sufficient cash flows and markets are developed enough to attract commercial investors.

96. **Observing the current practice of blended finance, systematic exit strategies are not yet reflected in many blended finance approaches and limited formal exit structures are currently in place.** Exits need to be integrated at the level of the blended finance transaction and at market level. At the level of blended finance transactions, certain financing instruments have in-built exit structures, such as closed-end blended finance funds¹⁹ or project development grants that are repayable at successful project close. Exit strategies need to systematically be included in the design of a blended finance instrument. At the level of the market, exit strategies need to include reducing levels of concessionality in repeat transactions and a time-bound strategy when concessional finance is no longer deployed as a result of the number of preceding transactions and/or full commercial market development.

97. Exit indicators can be defined within the due diligence of a transaction in the beginning. Nonetheless, these triggers must be flexible enough to allow for the best suitable exit reaction through continuous monitoring. A complete exit of the concessional investor is not feasible in each context and condition. Especially in the context of fragile states and least developed countries blended finance may only have temporary effects (UNCDF, 2018[13]). Hence, the presence of the development finance might be indispensable in enabling private sector investment.

98. Indicators for triggering a potential exit scenario can be distinguished into financial indicators as well as developmental indicators.

- Financial indicators that can trigger an exit scenario include the stage of capital market development, return thresholds being achieved, available data on actual risks and loss rates vs initially perceived risks or private investor response to auction processes.
- Development indicators that can encourage an exit of blended finance include the achievement of the development objective on the positive side but also a significant gap towards the achievement of the target objective which may signal a failure by private finance to achieve its targets.

99. Another dimension of exit indicators may observe the individual maturity levels of market maturity and investee maturity.

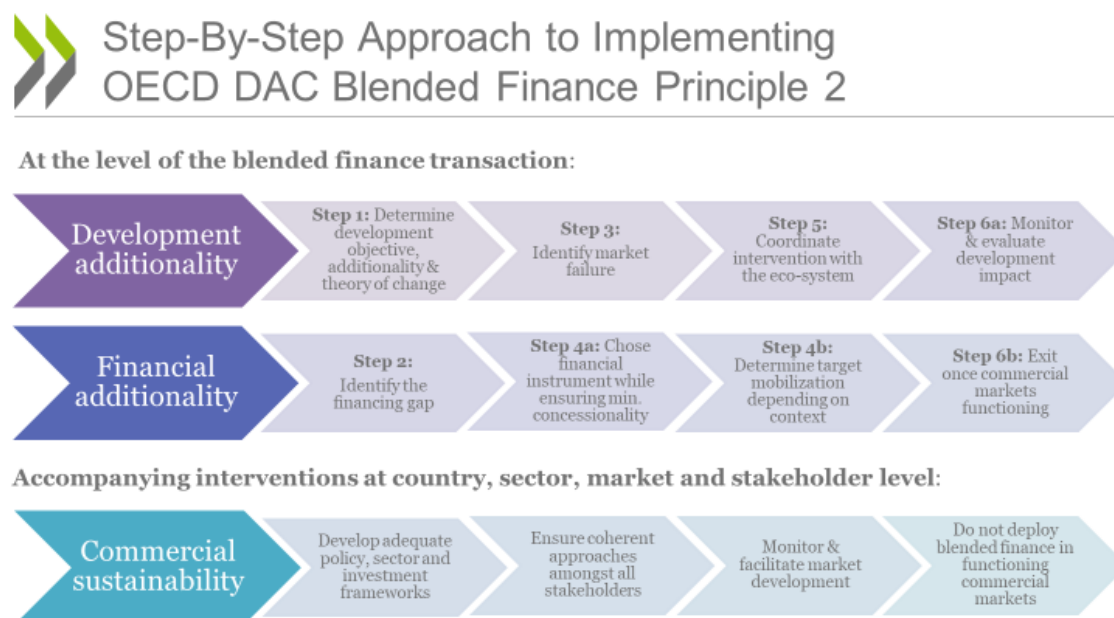
- Market maturity indicators refer to changes in the economic environment of the transaction, the enabling environment. They could include recent sector reforms, regulatory reforms, tax reforms. Moreover, the competitive environment of the borrower and expected industry growth can indicate changes in the ecosystem. A sound enabling environment can indicate more attractive conditions for commercial investors and a reduced need for concessionality.
- Investee or borrower maturity indicators observe the investee or the project itself. They could include creditworthiness, being the ability and willingness to repay or use capital efficiently. Co-investors, the creation of tangible assets within the project or investor specific liquidity need are potential exit indicators.

¹⁹ The 2018 Blended Finance Funds and Facilities survey revealed 61% of all observed funds and facilities had a fixed end term (Figure 5.1). The majority of fixed term vehicles had an operational period ranging between five and fifteen years.

3. A step-by-step approach to implementing principle 2

100. To assist OECD DAC donors to operationalise the key concepts laid out in the previous section in blended finance operations, a step-by-step approach is proposed to implementing Principle 2. The proposed approach focuses on steps to be undertaken at the level of the blended finance transaction (a project, program or portfolio) in order to ensure development additionality, financial additionality, mobilisation and minimum concessionality. The description of each step clarifies the key objective, guiding questions and reference concepts as well as potential information sources. While these steps are being discussed sequentially, in practice, some of them can and will likely be conducted in parallel. In addition, transaction-level analyses and design needs to be coordinated with and accompanied by interventions at the country, sector, market and stakeholder level to ensure commercial sustainability of blended finance as further discussed in chapter. Figure 17 lays out the proposed implementation approach.

Figure 17. Step-by-step implementation framework



Source: Authors

3.1. Step 1: Determine development objective, development additionality and theory of change

101. Principle 2a) seeks to ensure additionality in blended finance and on crowding in commercial finance for transactions that deliver development outcomes. In other words, blended finance needs to contribute towards achieving the SDGs and do this in a manner that delivers incremental development impact beyond what existing or potential public and private development finance interventions can deliver.

102. As a starting point, providers of concessional finance for blending purposes need to identify the development additionality of the proposed transaction. In this context, donors may find it useful to assess the viability of blended finance, by answering the following guiding questions²⁰:

1. SDG alignment:

- a. Is the blended finance transaction's targeted development outcome aligned with the SDGs and/or the SDG targets and/or the recipient country's development and sector strategies? [If no, the use of blended finance should be reconsidered]
- b. Has the incremental development outcome that is targeted to be delivered through blended finance over existing or potential future public and private finance been clearly identified? [If not, additional analysis may be required]

2. Nature of development additionality:

a. *Creation of new development impact* ('scope additionality'²¹):

- i. What is the likelihood that the targeted development impact would not be delivered without the transaction? [If low, the deployment of blended finance should be reconsidered]
- ii. Does the transaction create development outcomes in new, previously unserved countries?
 1. Does the transaction create development outcomes in high risk countries, such as FCS, LDCs?
- iii. Does the transaction create development outcomes in new, previously unserved sectors or sub-sectors?
- iv. Does the transaction create new development outcomes for new, under-served population groups, such as
 1. Women
 2. Youth
 3. Indigenous peoples
 4. Other vulnerable population groups?

²⁰ This indicative list of guiding questions is not meant to replace an in-depth due diligence of a particular blended finance transaction. In this context, compliance with good practice environmental and social guidelines as well as other applicable governance, procurement and fiduciary standards in blended finance is taken as a given and not mentioned explicitly.

²¹ While the concept of deepening vs expanding of development impact is a general one, the World Bank Group termed them 'scope additionality' and 'scale additionality' in the context of the IDA Private Sector Window. (World Bank Group, 2017)

- v. Does the transaction create development outcomes in previously underserved stages of the project life cycle, such as early-stage project development?
 - vi. Is the transaction the first blended finance transaction in its target market? [If not, further analysis is required to assess the need for blended finance]
- b. **Expanding existing development impact** ('scale additionality'):
- i. Has the same development impact already been delivered through blended or purely commercial finance? [If yes, further deployment of blended finance should be reconsidered]
 - ii. Is the transaction aiming to scale up development outcomes in countries with existing development and/or blended finance interventions?
 - 1. If the target countries are MICs, why can the same impact not be delivered through commercial finance? Why is a blended finance intervention still required?
 - iii. If the transaction is aiming to scale up development outcomes in sectors with existing blended or commercial finance, why is this transaction still required?
 - iv. If the transaction is targeting already served end-beneficiaries, why is blended finance a more effective way to scale up impact compared to purely public or purely commercial finance?
 - v. If the blended finance transaction is not the first or second transaction involving commercial finance in its target market, why is a blended finance approach still required? [Normally blended finance should phase out after 1-2 catalytic transactions]
- c. **Market creation**
- i. Does the blended finance transaction have positive economic spill-overs that benefit the economic development of other sectors?
 - ii. How does the blended finance transaction contribute to building sustainable markets? What is the expected market-level impact?
 - iii. What is the likelihood that commercial finance will become the major/only source of finance in the target market over the next [3-5] years? [If assessed as low, the deployment of blended finance should be reconsidered]
 - iv. Is accompanying capacity building / technical assistance provided/in place to ensure that the transaction can achieve its target impact?
- d. **Efficiency:**
- i. Does the scale of the targeted development impact justify the cost (time, transaction costs, net cost²²) of a blended finance approach?
 - ii. Can purely public or purely commercial finance deliver the same development

²² Some donors use the concept of net cost and compare the targeted unit of development impact to its net cost (using the project's net cost = nominal project amount minus the net present value of discounted repayments).

outcomes in a more efficient manner²³?

3. **Additionality in the eco-system**

- a. Are other development partners already delivering similar development outcomes in the target market? If so, why is another intervention required? Can the same result be achieved through a collaborative approach? Would additionality in complementary markets be higher?
- b. Is there a track record of commercial investment for the same development outcomes or are commercial investors willing to fully finance the transaction at commercially viable and affordable terms? [If yes, blended finance risks crowding out private investment and should be reconsidered]

4. **Theory of change and results framework:**

- a. Is a credible theory of change in place that indicates a robust probability of achieving the targeted development outcomes?
- b. Have clear impact indicators and a clear results framework been identified?
- c. Is baseline data available or being collected to allow for an ex post impact assessment as required?

103. When comparing several blended finance proposals, donors can assess them based on a simple checklist or decide to weigh development impact categories in line with their individual development priorities and preferences.

104. Potential information sources for the analysis of development additionality include country and sector development strategies and analyses, benchmark transactions in similar markets, regular information exchange with development partners, recipient governments as well as interactions with the private sector and CSOs, including at local level.

3.2. Step 2: Identify financing gap

105. After or in parallel to determining the likelihood of significant development additionality, the financial additionality needs to be determined for a blended finance transaction. In order to assess the need for concessional public funds for blending, donors need to understand the financial viability of the transaction, the availability of commercial finance in the target market as well as the supply and demand situation for blended finance. Concessional finance for blending should generally only be made available to transactions that are not financially viable on their own, that cannot obtain commercial finance from capital markets at the required terms and that cannot be served by existing blended finance supply.

1. **Financial viability of the transaction**

- a. Is the transaction financially viable with private finance only? [If yes, the deployment of blended finance should be reconsidered as in theory no development finance should be required unless market failures persist – see Step 3]
- b. Is the transaction financially viable with without concessional finance?

²³ A blended finance project would be more efficient than purely public finance if (i) more development outcomes are achieved than with purely public finance or (ii) the same development outcomes are achieved as by using purely public funds but the cost is shared with the private sector.

- c. If the transaction is not viable without concessional finance, how large is the financing gap? Can it be closed with a reasonable amount of concessional finance?
- d. Can the concessional element be phased out within a reasonable time frame to ensure commercial sustainability?

2. Availability of commercial finance in the target market

- a. Assessment of the stage of capital market development – e.g.
 - i. What is the stage of capital market development (undeveloped/short-term nature/long-term nature)?
 - ii. Has a long-term government bond been issued? If so, what are the terms (maturity, interest rate)?
 - iii. Has a corporate bond been issued? If so, what are the terms (maturity, interest rate)?
 - iv. What is the longest loan maturity offered by commercial banks? Have commercial banks lent to the target sector? At what terms and conditions (maturity, interest rate, collateral requirements etc.)?
 - v. Have international investors been active in the target market? If so, at what terms and conditions?
- b. Availability of commercial finance at the required terms
 - i. Have local capital markets provided financing to the target sector before? [If yes, at what terms – grace period, maturity, interest rate / tenor, return requirements collateral requirements?]
 - ii. If not, what is the nature of the financing gap – financing volume? Terms (grace period, maturity, interest rate / tenor, return requirements)?
- c. Are there market gaps in terms of financing instruments (e.g. derivatives, securitization, mezzanine debt etc.)?
- d. Have commercial markets provided financing for similar transactions in similar markets? If so, at what terms?
- e. Have commercial markets been approached for the target transaction (e.g. formally through a call for proposals or informally) and what is the feedback?

3. Supply-demand situation of blended finance

- a. Are other blended finance solutions already in place that could help fill the financing gap in the target country and sector (such as blended finance debt funds for renewable energy or agriculture in Africa)?
- b. Do existing blended finance solutions have capacity to meet the additional demand?
- c. If not, could existing blended finance solutions be scaled up (e.g. through additional first loss capital)?
- d. Only if the answer to questions 3.a.-c. is negative, should a new blended finance approach be considered.

Information sources for the analyses required for this step include country-specific capital markets analyses (such as the IMF's Financial Sector Assessment Program), private sector assessments for developing countries (such as the IFC's Country Private Sector Diagnostic), benchmarks from existing

transactions (e.g. available in the Convergence blended finance database) and regular interaction with development partners, recipient governments as well as interactions with the private sector and CSOs, including at local level.

3.3. Step 3: Identify market failure

106. Understanding the underlying market failure is at the heart of justifying the use of concessional finance for blending without crowding out commercial finance. Donors therefore need to understand market failures in specific contexts to identify if and how blended finance can help address them efficiently.

107. By way of a summary overview, market failures and market inefficiencies arise due to:

- The nature of the underlying good – for example, public goods with positive externalities are under-supplied as private markets do not price in the benefits to society, such as social infrastructure;
- Inefficient information – Information failure or asymmetric information creates misallocation of resources, resulting e.g. in lack of access to finance for specific sectors, such as SMEs or certain population groups (e.g. women, youth) that cannot meet the information requirements of traditional lenders;
- Structural market inefficiencies – monopolies and/or missing/ineffective regulation can create market distortions; for example, incomplete sector frameworks can prevent private investment due to high uncertainty; similarly, prudential regulation for institutional investors can provide disincentives to invest in projects in developing countries with positive development impact.
- First mover challenges – markets may not be willing to provide financing for first-of-its-kind investment proposals, e.g. for untested technologies, or, alternatively, transaction and financing costs for first movers may be prohibitively high.
- High risk profile - From the perspective of commercial investors, high risk investment proposals (including in high risk environments such as FCS) as well as high uncertainty regarding future cash flows can result in reluctance to provide commercial finance.

108. As a result, commercial finance for developing outcomes in EMDEs is either absent or incomplete, e.g. not available with the required amounts, terms or instruments. Also, as commercial investors base their return requirements on the risk profile of a transaction, they may require excessively high returns for high risk investment proposals in developing countries that may not be feasible or undermine the financial viability of a transaction.

109. In all of the above cases, blended finance can help provide incentives through concessional finance to overcome market failures through specific mechanisms and instruments. Table 2 provides an overview of the types of blended finance that can be provided in response to market failures:

Table 2. Positive incentives through blended finance to overcome market failures

| Type of market failure | Potential incentives through blended concessional finance |
|--|---|
| 1. Public goods / positive externalities | Viability gap payments; return enhancements; results-based payments |
| 2. Inefficient information | First loss capital; risk-sharing arrangements; concessional guarantees; long-term debt; return enhancements |
| 3. Structural market inefficiencies | First loss capital/guarantees; return enhancements; liquidity guarantees; long-term debt |
| 4. First mover challenges | First loss capital/guarantees; patient capital/early stage development capital; subordinated debt; risk-sharing arrangements; min. return guarantees/mechanisms |
| 5. High risk profile | First loss capital/guarantees; risk-sharing arrangements; partial risk guarantees; patient capital; long-term debt; min. return guarantees/mechanisms |

110. Sources of information to identify the market failure are country and sector analyses, reference benchmarks such as the World Bank's doing business indicators, capital markets analyses, market testing/feedback regarding the specific transaction, benchmark transactions in the same/similar markets, and regular interaction with development partners, recipient governments as well as interactions with the private sector and CSOs, including at local level.

3.4. Step 4a: Choose financial instrument while minimizing concessionality

111. Minimizing concessionality is at the heart of good practice implementation of the OECD DAC Blended Finance Principle and aligned with the DFI's Enhanced Principles for Blended Concessional Finance in Private Sector Operations. In order to minimise subsidize while catalyzing markets, donors and blended finance practitioners need to:

- Identify the financial instrument that is best placed to address the financing gap identified under step 2 and the market failure identified under step 3;
- Understand the level of concessionality involved in the respective financial instrument;
- Deploy approaches to minimise concessionality ex ante and over time; and
- Measure and report on concessionality in transparent manner.

112. Regarding the choice of financial instrument and the level of concessionality involved, Table 3 provides an overview of financial instruments that can be used in a concessional manner for blended finance, examples of their use to address market failures and the (theoretical) level of concessionality involved.

Table 3. Concessional instruments for blended finance²⁴

| Financial Instrument | Example of Concessional Use in Blended Finance | Examples of deployment vis-à-vis market failures | Level of concessionality involved |
|-------------------------------|---|---|--|
| Grant | <ul style="list-style-type: none"> • Technical assistance • First loss grant • Project development capital • Performance-based incentives | <ul style="list-style-type: none"> • Early-stage project preparation • De-risking investments in start-ups/new technologies • Viability gap payments to public goods • De-risking investments in high-risk geographies (e.g. LDCs, FCS) | <ul style="list-style-type: none"> • 100% concessionality in the case of grants (less in case of repayable grants) |
| Equity | <ul style="list-style-type: none"> • First loss capital • Junior equity • Patient capital / long time to exit • Catalytic capital / undefined time to exit • Hybrid instruments | <ul style="list-style-type: none"> • Direct investment as venture capital or private equity into first movers (technology and/or markets) • Equity investment in during the construction phase • Equity investment to sectors with imperfect information (e.g. SMEs) | <ul style="list-style-type: none"> • Difference between (actual or theoretical) market-level return for underlying risk profile/structure and expected return by donor • 100% concessionality in case of loss of principal (for lost amount) |
| Debt | <ul style="list-style-type: none"> • Subordinated debt • Long-term debt • Local currency debt • Below-market interest rates • Longer grace periods • Reduced collateral requirements • Deferrals • Stand-by products | <ul style="list-style-type: none"> • Direct investment of long-term senior or subordinated debt in high risk markets or sectors • Credit lines to financial institutions at maturities and terms not provided by the market for on-lending to underserved sectors (e.g. agriculture) or population groups (e.g. women) • Debt investment to sectors with affordability constraints (e.g. social housing) • Funded construction take-out facility for commercial banks | <ul style="list-style-type: none"> • Difference between (actual or theoretical) market-based interest rate for underlying risk profile/structure and provided interest rate by donor • 100% concessionality in case of loss of principal (for lost amount) |
| Guarantees / Insurance | <ul style="list-style-type: none"> • Partial Credit/Risk Guarantees • Political Risk Insurance • Unfunded liquidity support facilities • (Partial) currency risk mitigation • Disaster risk insurance | <ul style="list-style-type: none"> • Partial risk guarantee covering regulatory and off-taker risk in the power sector • Guarantees covering losses from foreign exchange risk in markets where no hedging instruments are available • Guarantees covering local currency loans • Guarantees for underserved population groups (e.g. women, youth) • Insurance products for smallholder farmers with affordability constraints | <ul style="list-style-type: none"> • Difference between (actual or theoretical) market-based guarantee/insurance fee for underlying risk profile/structure and provided fee by donor • 100% concessionality in case of pay-out (for paid-out amount) |
| Mechanisms | <ul style="list-style-type: none"> • Structured funds - involving a first loss / subordinated donor tranche and/or return subordination • Syndication – involving credit enhancement for commercial investors • Securitization – involving e.g. first loss guarantee on a portfolio basis • Results-based finance • Public-Private Partnerships • Risk sharing arrangements | <ul style="list-style-type: none"> • Structured private debt funds for agriculture in Africa • Credit-enhanced co-lending programs with institutional investors • Risk sharing mechanisms for first-time securitization transactions | <ul style="list-style-type: none"> • Difference between (actual or theoretical) market-based price for concessional instrument in mechanism and provided price (if any) by donor |

113. In terms of approaches to ensuring minimum concessionality, donors should :

- Apply quantitative methods to ensure minimum concessionality where feasible; in case concessional finance is channeled through intermediaries such as MDBs/DFIs, donors should request access to models used and/or methodologies applied to ensure minimum concessionality:

²⁴ The OECD defines concessionality only in the context of loans, taking into account the grant element. For example, a grant element of 35% is needed to classify a loan as concessional in the context of TOSSD reporting. [http://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/Emerging-Reporting-Instructions%20-V1.3-validatedbyTF WEB.pdf](http://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/Emerging-Reporting-Instructions%20-V1.3-validatedbyTF_WEB.pdf)

- For blended finance transactions involving debt finance, risk-based approaches such as expected loss models²⁵ can be used as reference point to size the share of concessional finance in a blended finance project or fund; in this context, the expected loss can serve as a cap for the concessional element, as it would mitigate the losses which commercial investors could reasonably expect; where possible, donors should look for some *pari passu* risk sharing with the implementing entity to align incentives and avoid skewed risk allocation towards the donor;
- While there is no readily available methodology that can be applied to determine the amount of minimum concessional finance required to enable acceptable commercial terms through blending in equity finance transactions, project returns in blended finance transactions should not exceed average returns for the industry/sector in a given country²⁶;
- While the availability of historic debt repayment or equity return data may be limited in developing countries as input into quantitative models, available benchmark data can be used from comparable industries, sectors and geographies.
- Use tenders to test market demand for concessional finance: Current practice are open calls for proposals (see Box 6) which are useful ways to test market demand while they typically provide a relatively high degree of flexibility by applicants regarding the use of concessional finance. Going forward and where feasible, donors should consider bidding out concessional finance based on a set of standardised criteria, such as a given amount of concessional finance seeking the highest development outcomes or seek a minimum amount of concessional finance for a given target of development outcomes. Cost to the donor per unit of development output can provide a useful reference point in the context of ensuring minimum concessional finance.
- Making concessional finance available to all implementing entities at equal terms.
- Consider setting a maximum amount for concessional finance – this can be done as a limit on the concessional amount as a percentage of total project costs based on context-specific risk analysis and benchmarks; or trying to establish a link between the size of concessional finance in relation to the market gap identified (such as the difference between a commercially viable tariff vs affordable tariffs) to determine a cap for concessional finance.
- Monitor concessional finance over time – as risk profiles and markets evolve, the need for concessional finance in a given context and blended finance transaction may change. Donors therefore need to actively monitor blended finance transactions over time as well as market developments around them and re-assess the level of concessional finance required. For example, the risk profile of projects improves and requires lower or no concessional finance once they reach their operating phase; or growing track record and progress in market development of local capital markets may close the gap in terms of maturity and return requirements that blended concessional finance initially aimed to fill.
- Build in mechanisms to reduce concessional finance over time – some donors have started to think about structures that have an in-built mechanism to reduce concessional finance over time. For example, in structured blended finance funds, concessional finance for first loss tranches could over time be replaced through excess returns, thereby reducing the concessional finance deployed for the donor, while ensuring financial sustainability. Similarly, over time and as investment track record has been

²⁵ See Implementation Guidance Note for OECD Blended Finance Principle 4 for a detailed discussion of risk allocation and risk analysis in blended finance.

²⁶ As a concrete measure, a project's internal rate of return should not be higher than average industry/sector equity returns in a given country, while additional standard commercial finance terms should also be respected as applicable (e.g. min. debt service coverage ratios in case additional debt finance is involved in a blended finance project/fund). (AfDB, 2019)

built in a give market, concessionality can be redeployed to areas that help accelerate market building, such as technical assistance.

Box 4. Examples of competitive approaches for blended finance used by donors

Providers of concessional funds for blended finance include OECD DAC governments, the EU and philanthropic organizations. Some of them have adopted competitive approaches to test the market demand for the type of concessional finance required to achieve financial and development additionality through blended finance. Examples include:

- o **Global Affairs Canada:** As part of its new 5-year CAD 1.6 billion ODA innovative finance program, the Government of Canada has launched an International Assistance Innovation Program (IAIP) which allows for ongoing submission of proposals for repayable concessional capital. The program has defined eligibility criteria in the areas of sustainable development impact, financial and impact additionality, financial sustainability and minimum concessionality. While the program does not set target sectors, preference may be given to proposals addressing gender inequality, demonstrating greater additionality, showing financial returns for strong development impact, working in LDCs, FCS and transition countries and showing strong impact measurement capacity.
- o **European Commission (EC):** As part of the European Fund for Sustainable Development and the EU's External Investment Plan, the EC has developed a new concessional guarantee instrument. The guarantee is implemented through development finance institutions who make proposals to the EC within given submission windows. In the first round, concessional guarantees have been made available for a total of EUR 1.5 billion guarantee funding under 5 windows: financing for MSMEs and agriculture; sustainable energy and connectivity; sustainable cities; digitalisation; and local currency financing. In the first round, 28 guarantee instruments have been committed.
- o **SECO Switzerland:** Under SECO 17, the Swiss government has launched a call for proposal for technical assistance (TA) funds for impact investing. The objective of the TA funds are to reduce perceived risks and help build an investment pipeline that attracts private investment. The call focused on two specific goals (job creation, CO2 emission reduction) and sought to seek innovative private sector solutions and private sector know how and achieve value for money through competition. Eligibility and award criteria included development impact, reliability of team and methods, level of outcome, co-financing, geography and additionality. On this basis, five impact fund managers were selected in the field of renewable energy, energy efficiency and SME support to receive and manage the TA funds.
- o **MacArthur Foundation** – As part of its impact investing allocation, the MacArthur Foundation has launched a first call for proposal for USD 150million in investments to be made under its Catalytic Capital Consortium (C3) initiative in collaboration with the Omidyar Network and Rockefeller Foundation. The C3 initiative aims to make patient capital available for high impact investment propositions for all 17 SDGs. Over 100 proposals were received for a total financing volume of USD 3 billion and are currently being evaluated in a 3-step process. Evaluation criteria include the categories management factors, investment execution factors, impact execution factors, additionality, outcomes and capital gaps.

114. Lastly, donors need to ask their implementing agencies to report on the use of concessionality in a transparent manner. MDBs/DFIs and fund managers need to regularly and publicly report on the amount

of concessional finance used in blended finance transactions, returns achieved as well as the impact generated. Reporting on the key parameters achieved in blended finance transactions²⁷ in a transparent manner will enable to create a much needed depository of reference data that can inform the structuring of future blended finance transactions. This will contribute to developing the market for blended finance by creating a data set that will allow to compare the use of concessionality in different contexts and devise benchmarks to ensure minimum concessionality. In addition, harmonised methodologies on measuring concessionality in blended finance across financial instruments need to be developed amongst all blended finance actors to build market transparency that will help donors assess the efficiency of using public funds for blending.

115. A good practice example of a structure that minimised concessionality while addressing market failures to mobilise institutional investors is the Danish Climate Fund (see Box 5).

Box 5. Minimum concessionality - Example Danish Climate Fund

The Danish Climate Fund was Denmark's first structure to mobilise institutional capital for the SDGs, in this case incentivizing Danish institutional investors to investment in climate projects which reduce greenhouse gas emissions such as renewable energy, energy efficiency and transport schemes in Europe and emerging economies. The fund had a relatively small total amount of DKK 1.5 billion (EUR 200 m) through pari passu co-investments from the Danish government Danish institutional investors who benefited from a 10% first loss cover from the Danish government. While the government invested pari passu with commercial investors, government returns are subordinated in the return waterfall as follows: The first returns are allocated to private investors with a guaranteed return of 6%, the subsequent returns are allocated to the government investment for a return level of 6%, subsequent returns are shared equally between public and private investors for a return level up to 12% and excess returns above 12% are allocated to the government. The concessional element in this transaction is therefore limited to the small 10% first loss cover to commercial investors and the initial return subordination of the government. Based on this minimum level of concessionality, the EU accepted that no government subsidies are involved according to EU definitions. The fund is managed by Danish DFI IFU and has a 4-year maturity. A flagship investment by the fund was in the Lake Turkana Wind Projects in Kenya (see case study A.4 in Annex A). The successful experience of the Danish Climate Fund has subsequently informed the creation of the larger Danish SDG Investment Fund (see case study A.3 in Annex A).

Source: Pension Denmark

3.5. Step 4b: Determine target mobilisation

116. Based on the choice of financial instrument and related to ensuring minimum concessionality is the determination of the target mobilisation through blended finance. As discussed in chapter 2.2, mobilisation is context-specific. In order to determine target mobilisation for a specific blended finance transaction, donors need to consider the following elements together in order to determine the mobilisation potential for a blended finance transaction:

- Country characteristics: As a reflection of relatively better market fundamentals, mobilisation potential of commercial finance is higher in MICs compared to LICs, LDCs and FCS. Consequently,

²⁷ Reporting can be tailored to address potential concerns around confidentiality.

the share of concessionality deployed in MICs vs e.g. LDCs or FCS to mobilise commercial finance should be significantly lower.

- Sector characteristics: Mobilisation depends on the robustness of a sector's framework as well as its financial viability. Mobilisation potential is higher in sectors that are financially viable (or moving towards financial viability), have a tested regulatory framework for public-private partnerships and have already attracted private investment. Consequently, low to no concessionality should be required to mobilise commercial finance in these sectors, e.g. in the case of repeat auctions for renewable energy IPPs that allow for commercially viable tariffs. On the other hand, higher concessionality would be required to mobilise commercial investment in a first-time transaction e.g. in the water and sanitation sector that has not yet achieved financial viability.
- Capital market development: Capital markets that fully developed in the sense that they have a track record of commercial finance with the required maturities, terms and instruments should be able to mobilise commercial finance for development outcomes without needing blended finance. Mobilisation potential is equally high for capital markets that already have a track record of financing target sectors and instruments but with certain limitations regarding e.g. the required maturities. A small amount of concessionality should then suffice to unlock long-term commercial finance at sustainable rates. In contrast, un- or underdeveloped capital markets in high-risk countries will require a relatively higher share of concessionality to mobilise a lower overall amount of commercial finance.
- Project characteristics: High risk project characteristics such as early-stage development, new technologies or first mover transactions have a lower commercial mobilisation potential than operating projects with proven technologies and markets, thus requiring a higher share of concessionality.
- Choice of implementation channel: The mobilisation potential of blended concessional finance also depends on the implementation channel for the concessional donor funds. Implementing entities should have a track record in mobilizing commercial investment. While MDBs/DFIs have a long-standing track record in doing this, their understanding that their own account private sector operations count as commercial finance does not always result in the highest possible mobilisation of private sector finance through blending²⁸. Working directly with private sector implementation entities, such as sustainable asset managers, can increase mobilisation ratios of private sector investment. In addition, several NGOs have started to become active in impact investing, e.g. in the environmental space, and can also be considered as implementation channels for blended concessional finance. In all cases, alignment with good practice environmental, social, governance and fiduciary standards needs to be ensured.
- The behavior of commercial investors: Commercial investors such as commercial banks or institutional investors (pension funds, insurance companies, asset managers) are generally risk-averse. They prefer to invest once a credible track record has been created in the respective country, sector, technology etc. In the context of blended finance, such as a structured blended finance funds, this may mean that mobilisation potential from private investors is lower in years 1-3 until an investment track record has been created, but has significant potential for increase in subsequent years based on historic reference data regarding actual risks and returns. Seeking a high mobilisation ratio of private investment from day 1 may therefore require a higher share of concessionality, which should, however, reduce over time. Similarly, a higher share of

²⁸ The DFI Working Group on Blended Concessional Finance for Private Sector Operation's joint 2018 update report states that in 2017, DFIs financed a total of USD 8.8 billion in project volume through blended concessional finance, of which USD 1.2 billion were concessional finance, USD 3.3 billion private sector investments and USD 3.9 billion DFI own account investments. This illustrates that the concessional element in blended finance has mobilised slightly more commercial finance from DFIs than from the private sector.

concessionalities may be required initially to help overcome investors' risk perception, while concessionalities should be commensurate to address actual risk based on comparable data and/or a developing track record over the life of the blended finance transaction.

- **Benchmark transactions:** In the absence of readily available data on mobilisation ratios by country and sector, donors can look to benchmark transactions as a reference. Similar transactions in similar geographies, sectors and project stages can provide a reference point for mobilisation potential and the level of concessionalities required. Similar blended finance transactions in the same country and sector provide a minimum mobilisation reference and upward ceiling for concessionalities, as repeat / follow-on transactions should have higher mobilisation ratios and need less concessionalities (if any). For example, one MDB is setting decreasing concessionalities ceilings for the first to the third transaction in a given market and expects the fourth transaction to be fully financed from its own account finance (commercial development finance). Again, a central repository of collecting relevant blended finance data, including on mobilisation in specific sectors and geographies, would serve to improve efficiency in the blended finance market, including setting informed mobilisation targets.

117. Based on the above factors, donors then need to set initial context-specific mobilisation targets for crowding in commercial finance and minimizing concessionalities. In general, mobilisation should increase as the transaction and underlying market mature, thus lowering the need for concessionalities and eventually resulting in phasing out concessional finance in a given blended finance structure, sector and market.

118. These targets need to be monitored and reported on during the life of a blended finance transaction. Harmonised definitions should be used across donors and implementing entities to report on mobilisation, separating mobilisation data from market-based development finance through MDBs and DFIs from mobilisation data related to investments from the private sector.

3.6. Step 5: Coordinate intervention with the eco-system

119. OECD DAC Blended Finance Principle 2 sets out to design blended finance to increase the mobilisation of commercial finance. Principle 4 focuses on effective partnering for blended finance, including aiming for scalability. This means that blended finance transactions cannot be designed in isolation but need to take the wider eco-system into account. In addition, private institutional investors prefer to invest with minimum ticket sizes. Furthermore, reducing the number of blended finance vehicles in favor of scaling up existing instruments reduces transaction costs and improves efficiency. Collaboration in blended finance therefore improves the mobilisation potential of blended finance and, as long as development additionality is ensured, can accelerate the delivery of development outcomes.

120. Donors therefore need to situate any blended finance transaction in its wider eco-system and seek opportunities for collaboration. Guiding questions in this context include:

- How does the proposed transaction fit into the wider eco-system in the respective market?
- Are other donors already providing concessional finance to address market failures in the same target market? (If yes, donor coordination should be sought)
- Are existing blended finance vehicles at the regional, sector or country level already active in addressing market failures in the target market? If yes, can they be scaled up? (If yes, donor collaboration should be sought)

121. In addition, donors should actively explore pooling their concessional resources to enable blending at larger scale and with transparent and harmonised criteria for all implementing entities. Multi-donor trust funds are one mechanism of doing so. An established example of such multi-donor trust funds for blending are the Climate Investment Funds.

122. Furthermore, multilateral donors like the EU and specialised entities such as the UNFCCC's Green Climate Fund receive proposals for use of their concessional funds for blending in private sector operations on a bilateral basis from their accredited entities. In reviewing such proposals, they should identify opportunities for and facilitate collaboration between accredited entities in the design of blended finance instruments. This can make a significant contribution towards building more diversified risk portfolios for blending that could attract larger scale private investment from e.g. institutional investors.

123. At the level of country governments, blended finance should be integrated in development strategies and sector investment plans as one financing mechanism for achieving the SDGs for projects and programs that cannot mobilise commercial finance on their own. National or sector-level coordination platforms involving governments, development partners, private sector and CSOs can serve as useful mechanism to identify market failures, coordinate support to reform efforts and identify investment opportunities that may require support through concessional finance to reach bankability and mobilise commercial investment.

3.7. Step 6a: Monitor and evaluate development impact

124. In order to ensure ongoing development additionality during the implementation of the blended finance project or program, development outcomes need to be regularly monitored and reported on using the results framework developed for the transaction. In addition, the cause of the market failure that required the blending intervention should also be monitored in terms of ongoing progress to address it and facilitate the creation of sustainable markets. The OECD has developed guidance for Principle 5, which addresses this topic. Donors should require regular impact reporting from the implementing entities of blended finance. Current market practice are at least an annual development impact report, while specific blended finance vehicles, such as structured funds, also report semi-annually or even quarterly to their investors.

125. In addition, donors should consider restructuring and possibly exiting a blended finance investment in case the expected impact is not being achieved to avoid the cost of a subsidy to the private sector without achieving development benefits.

126. At the end of the life of a blended finance transaction, donors may wish to conduct an ex post impact assessment to assess if the expected development outcomes correspond to actual development outcomes. Impact assessments should include an analysis how the concessional element in blended finance contributed to catalyzing development impact that otherwise could not have been achieved.

3.8. Step 6b: Exit once commercial markets are functioning

127. Principle 2d) calls for ensuring commercial sustainability in blended finance. This includes (i) coordinating blended finance transactions with accompanying policy reforms to ensure commercial viability of the underlying transaction and sector and (ii) exiting blended concessional finance once commercial sustainability has been achieved.

128. Regarding the coordination of the design of blended finance transactions with accompanying policy reforms, donors need to ensure that market failures that cannot be addressed at the level of the blended finance transaction are in parallel being addressed through appropriate interventions. Otherwise blended finance risks providing ineffective subsidies to a target structure and market without ensuring commercial sustainability. Accompanying interventions for this purpose can be technical assistance, advisory services, budget support operations, results-based development finance etc. This requires that blended finance donor teams coordinate with their policy, country and sector teams internally and with other development partners externally.

129. In terms of exiting blended finance once commercial markets are functioning, donors need to consider the following when making concessional finance available for blended finance interventions:

- Assessing the likelihood that the transaction will be financially sustainable without the concessional element after a reasonable time frame for the specific sector and geography (if low, the use of concessional blended finance should be reconsidered)
- Build in a clear exit strategy of the concessional element at the design stage of blended finance, such as
 - A repayable grant mechanism in case of successful project development
 - A limited maturity through closed-end blended finance funds that returns the donor capital after a defined time period
- In the case of open-ended blended finance funds or other structures that lock in concessional finance for a long-term horizon *ex ante* (such as project finance), build in market testing mechanisms at regular intervals to validate the need for concessional finance, such as
 - Market the blended finance fund to private investors and assess their appetite to take-out the concessional finance
 - In open-ended funds where a take-out for concessionality is not available, use existing concessionality to invest in new, higher risk markets and sectors that still justify the use of concessionality from the perspective of financial and development additionality; in existing markets, leverage concessionality to create a higher private sector mobilisation factor over time
 - In a project finance structure, exit an asset (e.g. through asset sale of an infrastructure PPP) once it has reached the operating phase.
- Exit mechanisms should as much as possible aim to attract local investors (such as local commercial banks, local pension funds, insurance companies)

Annex A. Case Studies

Box A.1. Creating assets vs creating markets - Managed Co-lending Portfolio Program (MCP)

| | |
|-----------------------|--|
| Development financier | IFC |
| Sector/Country | Unspecified, blending on portfolio level |
| Financing solution | Instrument: debt (emerging market private sector loans) Mechanism: syndication (managed co-lending) |

- IFC builds loan portfolio that mirrors IFC own account portfolio - similar to index investment
- Investors sign upfront to an agreement to contribute to a portfolio within the boundaries of agreed upon eligibility criteria for deals
- IFC identifies deals and allocates exposure alongside IFCs own exposure according to agreement
- Depending on the type of partner financier, the managed co-lending program can take the shape of three different iterations: Trusts funds for sovereign investors, B loans for institutional investors and Credit mobilisation of insurance companies.
- In certain situations IFC provides an option for additional credit enhancement on a first-loss basis

Source: (IFC, 2018^[21])

Box A 2. Concessional finance should be tendered – Kigali Bulk Water

| | |
|-----------------------|---|
| Development financier | PIDG Technical Assistance Facility (TAF), Emerging Africa Infrastructure Fund (EAIF), DevCo (IFC managed PIDG facility), African Development Bank (AfDB), IFC's Public-Private Infrastructure Advisory Facility (PPIAF) |
| Commercial financier | Metito consortium of Metito Utilities Ltd. and Metito Overseas Ltd. |
| Sector/Country | Water and Sanitation/ Rwanda |
| Financing volume | USD 60.9 million |
| Financing solution | PPP involving multiple financing instruments along the project cycle including <ul style="list-style-type: none"> • Senior and junior debt (EAIF, AfDB) • Equity (Metito) • TA grant for viability gap, up-front costs (TAF) • Initial financial support and TA for feasibility assessment, PPP structure development to government (DevCo) • TA and capacity building to government (PPIAF) |

- First large scale water treatment facility financed through a PPP model in Sub-Saharan Africa (except South Africa)
- Impact: provide 40 mega-litres clean drinking water per day to Rwandans, equalling 40% of Kigali's water supply needs
- IFC did competitive bidding for commercial element
- Metito founded Kigali Water Limited (KWL, Metito subsidiary) for building, operating and maintaining the facility. After expiration of the contract between Metito and the government, KWL will be transferred to the Water & Sanitation Corporation of Rwanda (WASAC, government body)
- Symbolises a holistic blended finance arrangement of multiple instruments and mechanisms from development actors in close coordination

Source: (Metito, 2017^[22]), (PIDG, 2017^[23]), (OECD, 2019^[4])

Box A 3. Crowding in additional finance and testing the market – Danish SDG Investment Fund

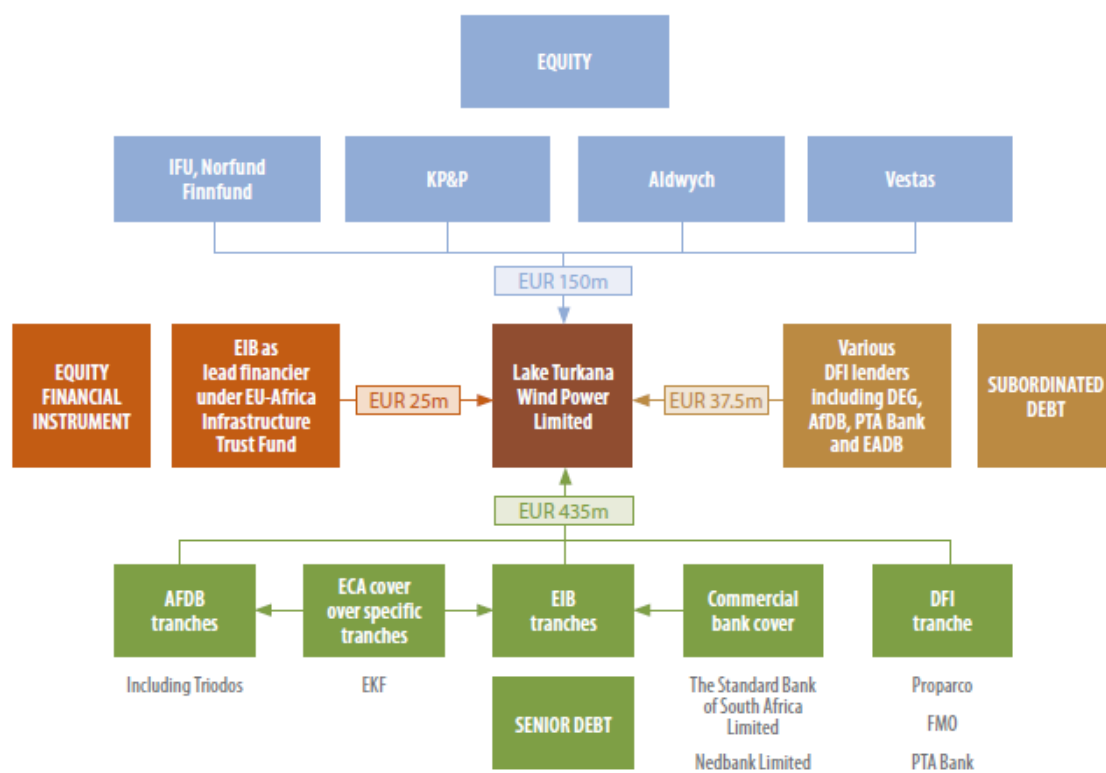
| | |
|-----------------------|--|
| Development financier | IFU |
| Commercial financier | <ul style="list-style-type: none"> • Pension funds: PKA, PensionDanmark, PFA, ATP, JØP/DIP, PenSam and SEB Pension & Försäkring • Private investors: Navest, Secure SDG Fund and Chr. Augustinus Fabrikker Akts |
| Sector/Country | Mainly renewable energy, energy efficiency, agribusiness and food, industry, water and sanitation, services / ODA eligible countries |
| Financing volume | DKK 4.85 billion (DKK 1 = USD 0.15 as of August 2019), individual transaction volume DKK 25 Million – DKK 250 million |
| Financing solution | <ul style="list-style-type: none"> • Fixed end term fund (expected fund duration duration 11 year, individual transaction 4 years with option for 2 year extension) • Founded in a 60/40 cooperation of private and public investors • Preferred return model, loss sharing according to contribution |

- The objective of the fund is to a) work towards increasing SDG achievement through bringing together public and private parties, enhancing development relevant, inclusive and sustainable investment in key SDG areas as well as b) generate a financial return for investors
- Minority equity investment in ODA eligible countries
- Geographical distribution: 30-40% Africa, 30-40% Asia, 10-20% Latin America, 10-20% Europe and MENA
- Expected return to the investment portfolio of 10-12%, preferred return model where the first 6% go to private investors, the second 6% to IFU and any remaining return is distributed
- The fund is expected to operate on market terms to bring return to its investors.
- Through the Danish SDG investment fund IFU is able to leverage its capital and knowledge thereby mobilising new commercial investors

Source: Facts provided directly by Denmark (unpublished)

Box A 4. Lake Turkana Wind Power Project

| | |
|-----------------------|---|
| Development financier | EU-DEVCO via the African Infrastructure Trust Fund (EU-AITF), EIB, IFU, Finnish Fund for industrial Cooperation Ltd. (Finnfund) |
| Sector/Country | Energy/ Kenya |
| Financing volume | EUR 623 million |
| Financing solution | Power Purchase Agreement between private and public stakeholders and the Kenyan Power Company agreeing to a fixed feed-in-tariff over 20 years, blended finance solution to tackle unexpected difficulties in reaching financial close <ul style="list-style-type: none"> Equity financial instrument: Blended concessional financing (EU-ATIF) below market rate with repayment after reimbursement of senior debt holders and non-concessional financing (EIB) |



- Impact: facilitate increasing availability of low cost energy while minimising fuel imports and carbon emission thereby meeting the growing electricity demand using renewable energy sources
- Largest wind power project in Kenya
- Estimated capacity of 310 MW of wind energy, representing 15% of Kenya's currently installed energy production
- Potential dividends will be used for financing rural electrification or social projects
- EIB is structuring and managing the financial instrument but is similarly senior lender in a group with the commercial investors
- Google will acquire the shares from Vestas in the project upon completion.

Source: (EIB, 2019^[24]), (OECD, 2018^[25]), (EU-AITF, 2014^[26])

Box A.5. Setting concessionality – EU Malaria fund

| | |
|-----------------------|--|
| Development financier | kENUP Foundation, EIB, IBB (public promotional bank of the Federal State of Berlin) |
| Sector/Country | Health / endemic areas in equatorial regions (e.g. India, Kenya, Tanzania, Gabon, Nigeria, Niger) |
| Financing volume | |
| Financing solution | <p>50/50 public-private cooperation embodied in a layered fund structure</p> <ul style="list-style-type: none"> • Provision of venture loans at reduced terms to scale up scientifically promising projects which have not been adopted by large pharmaceutical companies yet • Loans are interest bearing but payback obligation is suspended in case of project failure • Public: 40% first loss capital from European Commission, 10% additional capital from five bilateral donors (all pari passu in first loss) |

- Aims at addressing market failures in infectious diseases with significant impact on global public health
- Targets: reduce root causes of migration, support control and potential eradication of malaria, extend deal-flow in tropical disease prevention by scaling up promising mechanisms, serve as a role model for similar funding instruments addressing medical needs with underlying market failures
- Fund wants to be a proof-of-concept for public-private partnerships in innovation funding for addressing market failures
- Fund works with an initial portfolio of pre-selected companies: portfolio was built as a result of a call for proposals published by kENUP for 24 months, companies of the initial portfolio must submit financing requests following operating procedures and are not guaranteed any funding before final fund operating procedures have been set
- Initiated by the kENUP Foundation, fund will be managed by Investitionsbank Berlin (IBB) and domiciled in Germany
- Investment decisions are made by an independent investment committee, EIB as well as an expert team from the National Academy of Medicine (Washington DC) may give non-binding guidance
- Through interviews came to conclusion of needing 14% target return, modelled 50% public contribution through Monte Carlo Model
- Currently in the process of attracting private investors

Source: (kENUP Foundation, 2019^[27])

Box A 6. Innovative risk mitigation – Elazig Hospital, Turkey

| | |
|-----------------------|---|
| Development financier | First-time combination of risk mitigation from MIGA's political risk insurance and EBRD's unfunded liquidity facilities |
| Sector/Country | Health / Government of Turkey's Health Transformation Programme |
| Financing volume | €360 million availability payment based greenfield project structured as a public-private partnership, involving €72million in equity and €288million in senior debt (in 3 tranches of deferred draw down bonds) |
| Financing solution | <ul style="list-style-type: none"> • First project bond for a greenfield infrastructure project in Turkey • A1 Bonds were rated Baa2, two notches above Turkey's credit rating¹ Vigeo Eiris certified the Elazig project bond as a 'green and social' bond – the first such certification for an infrastructure project in Turkey • With a 20 year maturity, the bond had the longest maturity for the Turkish Integrated Health Campuses PPP Programme |

- MIGA provided a 20-year political risk insurance guarantee for the benefit of the project's A1 Bonds that is designed to mitigate the risks of (i) currency inconvertibility and non-transferability, (ii) breach of contract, and (iii) expropriation
- As part of the credit enhancement, EBRD provided to undrawn contingent subordinated liquidity facilities totalling a combined €89m. These EBRD facilities comprise
 - (1) Construction Support Facility (CSF) during the construction period via a Letter of Credit to provide timely liquidity to the EPC Contractor in certain events, including construction delays, replacement costs and senior bond recovery in the event of termination during construction. The CSF mitigates the EPC contractor counterparty risk during the construction phase by providing an unfunded liquidity facility issued in a form similar to a standby letter of credit for the benefit of the project company on behalf of the EPC Contractor. The CSF can be drawn to fund any breach by the EPC Contractor of its payment obligations towards the project company under the EPC contract, most likely to occur in the event of (i) liquidated damages arising out of construction delays, (ii) EPC Contractor replacement costs, and (iii) senior bond recovery in case of termination due to EPC Contractor default.
 - Revenue Support Facility (RSF) covers debt service and other costs under certain circumstances during the operational period in the event of a Ministry of Health (MoH) non-payment. The financing structure includes a subordinated, standby revolving facility that functions in a form similar to a debt service reserve facility, ensuring timely debt service in case of MoH default on its payment obligations. The RSF is sized to provide approximately three years debt service on average to complement MIGA's political risk insurance by servicing debt payments to bridge MoH's obligations or prepaying bondholders until the arbitration process is completed, after which MIGA honours its payment obligations. The RSF cannot be used to support debt payments in case of cash flow shortfalls arising from operational and underperformance reasons.

As a result of these two credit enhancement products, Moody's assigned the A1 bonds an investment grade rating of Baa2, two notches above Turkey's sovereign rating of Ba1.

Source: Global Infrastructure Hub, Case Study Elazig Hospital PPP

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