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Blending 2.0: Could mobilising private capital work in poorer countries, too?

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Blending 2.0 describes the strategic use of government development financing for mobilising *additional* private funds in developing countries and emerging economies. In light of the financing needed to achieve the global sustainability goals amounting to USD 5 to 7 trillion (UNDP), this approach to the use of funds is constantly gaining in importance.

Three quarters of OECD members offer blended financing and are expanding their portfolio of instruments. A total of 167 new funds and facilities were set up between 2000 and 2016. Canada, South Korea and the USA are establishing new development banks intended especially to promote the private sector. The organisation *Convergence* is using a database to collect the blended financing approaches applied by various bodies, from commercial and institutional investors to development banks and charitable trusts. Funds are the most commonly recorded approach to blending (55%), followed by project financing (18%) and corporate financing (16%).

The OECD principles for blending

The OECD has defined five principles to ensure the best possible use of blended financing in terms of development policy:
The use of blending should be justified *firstly* by the developmental impacts and *secondly* by the additionality of concessionary funds. To avoid distortions of markets and competition, these funds should not be used for investments that could have been financed by private funds alone.
Thirdly, projects supported by blended financing should take national development priorities into account and, in particular, should strengthen local markets.
Fourthly, cooperation between public-sector development banks and actors from the private sector should be based on an effective partnership, i.e. it should respect their different goals (impact vs. profit) and should also ensure that risks are shared equally between the two parties.
Fifthly, transparency and impact assessments regarding the funds spent and the financing structure should facilitate the accountability of all stakeholders involved towards the general public, allow access to relevant market information and enable knowledge transfer among the parties.
Furthermore, all approaches should enable maximum access for target groups, and successful approaches should be scaleable to ensure the efficient and effective use of funds (e.g. using fund structures).

Trends in low-income countries

In poor and fragile countries, grants are the primary instrument used to finance development cooperation. The majority of private capital mobilised by blended financing is invested in middle-income countries; just a quarter of this capital goes to low-income countries. The mobilisation of private capital in low-income countries faces various challenges, such as poor availability of well-prepared projects, increased investment risks and volumes that are too low. Furthermore, government development financing in poorer countries focuses more on social services and less on sectors that are profitable for and, as a result, compatible with private investments.

One target area for blended financing in poor countries could be the promotion of the private economy of the so-called *missing middle*, which is too small and risky for commercial banks and too large for microfinance institutions. This sector of local small and medium-sized businesses is often a force for innovation and contributes to economically efficient development and formal employment. Despite reforms designed to improve the investment climate, trust in these markets is still too low. To mobilise private investments here, concessionary funds could be used to reduce risks for the private sector.

Breaking down investment barriers

Demand for blended financing tools differs greatly depending on the transaction. Development banks are able to offer a broad mix of financial instruments and non-financial incentives for private investments, such as access to market knowledge, research results and empirical data. In many cases, legal and financial expertise is required during the design phase. Grants for feasibility studies or advice on ensuring bankability generate incentives and can be designed to be paid back based on the level of success. To improve the profitability of projects, investment grants can reduce capital costs or payment allowances (success-based, for example) can increase private income (*viability gap funding*).

In the case of smaller investments between USD 50,000 and 1 million, as anticipated in the missing *middle markets* in poorer countries, costs for local banks are high in relation to the volume, while profits are too uncertain. This is where the protection of investments using credit and risk guarantees is gaining ground as a blended financing tool (21% of transactions in the *Convergence* database). Guarantees provide additional security for the institute issuing credit and therefore enable loans to be granted for private investments worthy of promotion under development policy.■

Literature

Convergence (2018): The State of Blended Finance.

UNCDF (2018): Blended Finance in the Least Developed Countries, New York.