Using blended finance to support infrastructure development in emerging economies

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By:

In brief

The 2030 Agenda for Sustainable Development adopted by the United Nations (UN) sets out 17 Sustainable Development Goals (SDGs); from poverty reduction, food security, healthcare and education to climate change mitigation. The achievement of many of these SDGs will require well-functioning infrastructure; from transport systems to power-generation facilities and water and sanitation networks.

Yet a huge investment gap exists in infrastructure development. According to the UN Conference on Trade and Development (UNCTAD), total investment in economic infrastructure – power, transport (roads, rails and ports), telecommunications and water and sanitation – in developing countries is less than USD1 trillion per year and will need to rise to between USD1.6 trillion and USD2.5 trillion annually until 2030.[1] Blended finance has been identified as an important tool for mobilizing private sector capital to bridge financing gaps in global development needs. This article looks at how blended finance has been used in emerging economies, some of the challenges identified and ways ahead.

What is blended finance?

Blended finance is a structuring approach (as opposed to an investment approach such as impact investing) and is not linked to any particular instrument or structure adopted. The UN defines blended finance as financing that "combines concessional public finance with non-concessional private finance and expertise from the public and private sector."[2] There is, however, no common official definition of blended finance. For example, the OECD adopts a broader definition which does not specify the use of concessional finance: "the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries."[3] Irrespective of the specific definition applied, the emphasis is on mobilizing private capital towards meeting development goals.

Structuring blended finance

While blended finance is not linked to any particular types of instruments, common blended finance structures may incorporate one or more of the following components: first-loss debt or equity, guarantees, insurances and technical assistance facility for capacity building and project preparation or design grants.

Two recent transactions in which DLA Piper was involved illustrate how some of these instruments can be structured in specific projects.

The Off-Grid Energy Access Fund (OGEF), which is part of the African Development Bank's Facility for Energy

Inclusion (FEI), is a USD100 million fund tasked with providing debt financing to off-grid solar, small-scale IPP and mini-grid projects across Africa. 30% of the equity was provided by donors at concession rates in the form of first-loss equity. This has enabled the mobilization of private capital by delivering risk-adjusted returns to the ordinary equity investors who might otherwise have been deterred by real or perceived risks around the technologies and a lack of track record associated with some of those projects as well as the investors' own operational and other constraints in investing in those markets.

The 58.6 MW Mazar-e-Sharif gas-to-power project is the first independent power project in Afghanistan which showcases the multi-pronged deployment of the IDA18 IFC MIGA Private Sector Window (PSW) – a blended concessional finance initiative by the World Bank to catalyze private sector investment in the world's poorest countries. The PSW uses concessional funding from the International Development Association (IDA) to backstop or blend with investments from the International Finance Corporation (IFC) or guarantees from the Multilateral Investment Guarantee Agency (MIGA) to support private investments. In the Mazar project, the World Bank Group provided upstream support to the Afghan government in developing a bankable contractual structure with appropriate risk allocation and subsequently financial support in the form of long-term debt financing by the IFC and political risk insurance by MIGA for the equity contributions and the loan advanced by a DFI lender. However, the security situation in the country and the vulnerabilities of its power sector were such that even MIGA and IFC would not have been able to support the project without IDA's concessional support under the PSW through of a combination of first-loss layer and pro rata risk sharing measures for MIGA and a guarantee for IFC against the termination payment risk. This has enabled the investment by the private sector sponsors as well as the financing provided by the other lenders in this challenging jurisdiction.

Current state of blended finance

Blended finance has been put forward as a key strategy to move the needle from billions of dollars in development aid to trillions of dollars in investment. The actual leverage ratio achieved has, however, been much lower. The Overseas Development Institute (ODI) has found that each USD1 invested by multilateral development banks (MDBs) and development finance institutions (DFIs) mobilizes on average USD0.75 of private finance for developing countries. This falls to USD0.37 for lower income countries (LICs).[4] Convergence puts the average leverage ratio of blended finance funds with concession capital at 4x.[5] While these ratios are calculated with different datasets and methodologies, what they show is that the reality is closer to billions to billions than billions to trillions.

Making blended finance work

Some of the barriers which have been identified as hampering the private investment in SDG-related assets include:

- **Lack of financial and impact performance data:** investors require reliable data on the performance of SDG-related assets to guide their investment decisions. The need for better data and transparency is recognized in the Blended Finance Principles of the OECD Development Assistance Committee (DAC).[6] Blended finance structures can be complex, often with bespoke structures involving the private investors. Complexity and presence of commercial elements add to the challenge in data collection and publication. The difference in definitions (as explained above) and the varying measurement and reporting methodologies adopted by participating institutions compound the difficulty.

  This calls for a better alignment and harmonization of conceptual and reporting frameworks across different institutions. More should be done to improve transparency at least at the aggregate and semi-aggregate levels. Obviously, the use of public capital comes with an expectation of a degree of transparency and accountability.

- **Investment climate and risk appetite:** attracting private capital to riskier, smaller and less-tested markets (such as the LICs) could be challenging even with the presence of concessional funding. Private investors will not come on board unless the investment opportunity has the right risk-return profile. In this regard, MDBs and DFIs have an important role to play by leveraging their unique experience and data access in operating in the emerging markets. There have been calls for them to adopt a higher risk tolerance and provide private investors with a higher degree of risk mitigation. In practical terms, this may require these institutions to take on more early-stage or pioneer risks and move away from less risky senior debt to the more risk-appreciative instruments such as subordinated debt, equity, risk-sharing facilities, guarantee and grants.[7]
- **National ownership:** blended finance needs to support national ownership of the development agenda and be aligned

with national priorities. Host governments have an important role to play in providing an enabling environment and managing the political, security and macro-economic risks. Commitment of national actors to the long-term success of a project will help ensure the sustainability of its impact and improve the business case for investment in it. This could be a challenge where the government does not have the necessary experience in procuring private investors in infrastructure projects.

National governments should be provided with access to reliable and well-organized information in terms of market practices and opportunities to allow them to devise a suitable blended finance strategy. They should also take advantage of the support by MDBs and DFIs in establishing policy and institutional frameworks for analyzing and structuring blended finance transactions and building capacities for achieving the SDGs.

Looking ahead

Despite these challenges, there has been a remarkable surge in the amount of development-themed capital coming on to the market in recent years. This includes philanthropists, donor governments and impact investors looking to generate beneficial social and environmental impact. As the market continues to develop and mature, there will be more opportunities for different sources of capital to partner up and to blend in the achievement of the SDGs.

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[1] United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2014*, https://unctad.org/en/PublicationsLibrary/wir2014_en.pdf

[2] United Nations, *Resolution adopted by the General Assembly on 27 July 2015: Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda) (A/RES/69/313)*, https://undocs.org/A/RES/69/313

[3] http://www.oecd.org/development/financing-sustainable-development/development-finance-topics/blended-finance.htm

[4] Overseas Development Institute, *Blended Finance in the Poorest Countries - the Need for a Better Approach*, April 2019 https://www.odi.org/publications/11303-blended-finance-poorest-countries-need-better-approach

[5] Convergence, *the State of Blended Finance 2019* https://www.convergence.finance/resource/13VZmRUtiK96hqAvUPk4rt/view

[6] OECD (2018), *Making Blended Finance Work for the Sustainable Development Goals*, OECD Publishing, Paris, https://doi.org/10.1787/9789264288768-en

[7] Overseas Development Institute, *Blended Finance in the Poorest Countries - the Need for a Better Approach*