

“The only way to achieve the sustainable development goals is to use more public capital strategically for unlocking private investment, particularly for infrastructure.”

Amadou Hott,
Vice-President, Power, Energy,
Climate and Green Growth,
African Development Bank

Overview

Blended Finance has emerged as a catalyst to incentivize private capital flows and accelerate development impact in emerging economies. While this approach to public-private financing has leveraged a limited amount of development finance and philanthropic capital to reduce the uncertainty and risks normally associated with investing in underserved markets, it has been insufficient to catalyse the estimated \$4.5 trillion a year that is required to meet the Sustainable Development Goals (SDGs) by 2030.¹ National governments and agencies must adapt and take proactive steps to use Blended Finance to drive a portion of the \$218 trillion global capital markets flows to these high-potential emerging markets.² This primer seeks to highlight the steps governments must take to facilitate the enabling conditions for Blended Finance and highlight critical areas for success to meaningfully catalyse private capital that will support projects that are strategically important and impactful.

What is Blended Finance?

Blended Finance is the strategic use of development finance and philanthropic funds (“public funds”) to mobilize private capital flows to emerging and frontier markets. It allows investors and lenders to reduce the costs related to risk-return expectations in emerging and frontier markets by leveraging a broader suite of financial instruments, access to reputational support, and local expertise that public funders can provide, thereby increasing the potential for deal viability.³ By combining development finance and philanthropic capital, including Official Development Assistance (ODA), with private investment and lending in a structure to manage and alleviate the allocation of risk-and-return expectations, investors may be able to consider projects

that would otherwise be beyond their typical investment scope. Blended Finance can be defined by three key characteristics:

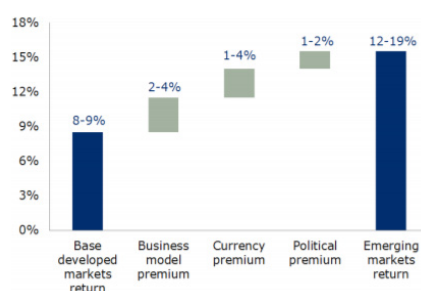
- **Leverage:** Use of development finance and philanthropic funds to attract private capital into deals;
- **Impact:** Investments that drive social, environmental and economic progress;
- **Returns:** Financial returns for private investors in line with market expectations, based on real and perceived risks.

Challenges Addressed by Blended Finance

Blended Finance can be used by the public sector to address a number of core fiscal challenges:

- **Increasingly stressed sovereign public budgets and balance sheets:** Critical national and regional projects have traditionally been funded through direct government borrowing. However, public balance sheets are increasingly under pressure and cannot continue to meet increasing obligations that may harm their credit ratings and compromise future long-term borrowing while the need for infrastructure continues to grow.⁴ Blended Finance offers governments an opportunity to reduce the dependence on government debt and sovereign guarantees, helping to ensure that publically available funds can be most effectively leveraged to access commercial debt and equity.
- **Risk-return profiles that are not competitive with developed markets:** Developing market returns tend to be attractive in the face of a low yield environment in most developed countries, but commercial financiers are reluctant to commit to transactions in less familiar markets due to real and perceived risks which inflate return expectations (as shown for infrastructure in Table 1).⁵

Table 1: Infrastructure IRRs



Blended Finance provides governments with a framework to help align incentives and potentially reduce the risk premium through co-financing and co-investment, enabling more national projects to access private capital to proceed and accelerate development.

- **Lack of a pipeline of well-prepared and bankable projects:** Many priority projects in developing countries lack the adequate depth and breadth of preparation to fulfil the requirements of commercial investors.⁶ This threshold for “bankable” projects differs across industry sectors and investor profiles, requiring a degree of understanding of project preparation and structuring at the national planning level to attract investors. As noted by the development banking community, “the critical barrier to achieving an uplift in infrastructure investment in emerging and developing economies is not a lack of available finance but an insufficient pipeline of bankable projects ready to be implemented.”⁷ Blended Finance can help ensure an appropriate alignment between national priorities and commercial financing early in the process, ensuring agency resources are deployed effectively and projects suitable for commercial funding can be prioritized and fast-tracked.

Importance of Blended Finance in the National Planning Process

In 2015, the international community agreed to a set of 17 SDGs that outline a broad range of objectives needed to help end extreme poverty, fight inequality and injustice and address climate change. One of the largest opportunities to address a number of the SDGs is through the development of sustainable infrastructure, which can contribute to a range of environmental, social and economic outcomes. However, the financing gap for the infrastructure needs in developing countries exceeds \$1 trillion a year, far beyond the combined financing capacity of governments, aid agencies and multilateral development banks.⁸ Meanwhile, market inefficiencies that are exacerbated by weak regulatory frameworks and country risks, both real and perceived, have led to a lack of foreign and domestic capital being made available to support critical projects.

The use of Blended Finance in the national planning process requires a new

perspective on the role that private capital has traditionally played in mobilizing the funding needed to implement priority public sector projects. Certain institutional steps are needed to help ensure that the right financial and risk structures can be put in place to attract capital from the private sector and to help ensure appropriate risk-return ratios can be realized for the private sector relative to their alternative options.

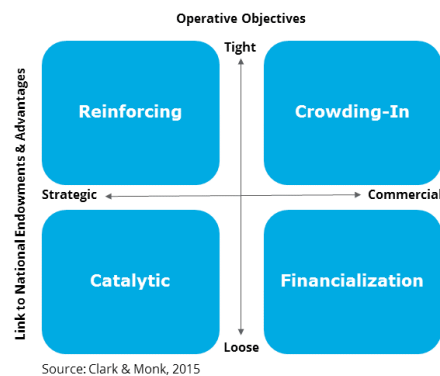
Subsequently, Blended Finance needs to be integrated into national planning processes to be successful and play a meaningful role in providing the capital for investments that can enhance development impacts.

Facilitating Blended Finance in National Planning

Even with the increasing interest of private capital providers in developing countries, national governments still have an important role to play in establishing an enabling environment for Blended Finance. To harness the significant potential of this approach for critical investment projects, the appropriate regulatory framework needs to be put in place.

To achieve this objective, governments must take the necessary steps to enable Blended Finance by establishing a process that can focus on driving towards “bankable” projects. First, this approach involves a firm understanding of what “bankability” means in the context of the private sector, including the depth and breadth of project preparation required with the national needs of the project. Second, public sector processes must align with private capital incentives, particularly in terms of process and procedures. Third, once a Blended Finance approach has been adopted as a strategy at a national level, an assessment must take place to benchmark the respective gaps in the process for project approvals and development to help ensure capacity can be built and the appropriate skills can be adopted. Finally, a strategy to fully integrate a collaborative approach with the private sector investment must be adopted to help ensure that projects can be structured to deliver both positive development outcomes being sought by governments and the financial outcomes and risk mitigation being sought by the private sector. A framework outlining the process to integrate these steps can be found

Categorization of Strategic Development Funds



in A How-To Guide for Blended Finance published by the World Economic Forum in 2015.⁹

The benefits to governments of facilitating Blended Finance can also be categorized by better understanding its operative objectives and links to national processes (see Categorization of Strategic Development Funds)¹⁰:

- Increase and accelerate investment for critical national development priorities:** Blended Finance can increase private sector investment in bankable projects and help ensure that public funds and ODA remain available for critical development objectives related to health, education and other social projects where commercial investment may not be feasible.
- Access to expertise and experience:** Blended Finance can provide the necessary resources to help deliver projects by utilizing private sector expertise to improve and accelerate project execution, mobilizing local capital markets for investment in projects that reduce hard currency exposure, and accessing a broad range of products that can be incorporated into project capital structures that reduce risks and enhance returns.
- Crowd-in new sources of capital:** Blended Finance can increase the investment attractiveness of projects by leveraging the public sector’s long track record and balance sheet, providing local knowledge and experience to reduce lead times and transaction costs. Public co-investment can act as a signal for the quality of an opportunity and can reduce perceived risk for investors, increasing the pool of projects that can attract private capital.

- Catalyse and accelerate regulatory reform:** Blended Finance requires regulatory reform to effectively scale. As transactions are proven out, best practices and lessons learned can catalyse and accelerate regulatory reform to support this activity, leading to more rapid advancement of projects.

FONSIS

FONSIS, the Senegalese Strategic Investment Fund, is one example of an expanding network of state-sponsored strategic investment funds (SIFs) that have emerged in developing countries to help facilitate private sector investment.

FONSIS has built an organization with significant financial and transactional experience. It has taken several steps to demonstrate alignment with the private sector, enabling it to act as a financial intermediary that provides market credibility, access to a network of international investors and capacity to structure, negotiate and transact deals:

- FONSIS has instituted targets that are aligned with commercial interests, requiring a minimum rate of return on its investments (hurdle rate) of 12%.**
- A target multiplier of \$12 for every \$1 committed by FONSIS.**
- The investment criteria for FONSIS have been shared publicly to ensure transparency with the private sector and mitigate pressures to undertake projects that do not fit these criteria.**
- If necessary, FONSIS can provide return enhancements or risk mitigation to attract external capital to high-priority projects.**
- FONSIS is actively involved at all points of the development process, engaging with technical and financial partners, from project origination to financial close.**

www.fonsis.org/en

How can National Governments Incentivize Blended Finance?

Given the positive impact that Blended Finance can contribute to emerging markets, processes that facilitate the engagement of private capital and the collaborative use of public funds should be developed to enable this approach at a country level to help ensure the sustainability and scalability of this approach. Specific programmes can be pursued that support:

- **Institutional coordination:** Provide a mandate for dedicated units (such as public-private partnership units) to serve as a conduit for private sector capital. Key institutional champions need to be identified that are empowered to lead domestic efforts and have sufficient stature to guide government agencies on best practices for structuring these transactions and help ensure this change management process can be implemented.
- **Capacity building:** Help to ensure that the appropriate skill sets are available to work with the private sector across the project development process so that transactions are properly structured. Investment in recruitment and training of staff that are able to properly prepare projects, with experience across a range of financial instruments, may be required.
- **Regulatory environment:** Assess the barriers to investment and work to modify the regulatory environment where appropriate to enable Blended Finance and catalyse investment. Specific policy instruments that could improve the enabling environment for Blended Finance include reducing capital controls, streamlining company registration requirements, creating fiscal incentives (particularly for large investors such as pension funds) and streamlining bureaucracy and red tape (including removing unnecessary barriers).

A number of immediate actions can also be taken to advance these objectives, including:

- **Align** public processes and objectives with the needs of investors early in the project preparation process to help ensure design parameters are consistent with expectations.
- **Engage** with donors and development finance institutions to understand and facilitate access to existing instruments such as guarantees and concessional financing that can give greater comfort to investors.
- **Strengthen** existing dedicated units to help coordinate between government agencies and the private sectors to act as a focal point.
- **Leverage** multi-stakeholder initiatives and platforms that facilitate public-private finance, such as the Sustainable Development Investment Partnership (SDIP).

Sustainable Development Investment Partnership (SDIP)

The Sustainable Development Investment Partnership (SDIP), co-led by the World Economic Forum and the OECD, is a coalition of public and private entities implementing Blended Finance to scale sustainable infrastructure (including climate-resilient infrastructure) investments in developing countries. By providing an open and neutral platform, SDIP connects projects with capital and brings sustainable infrastructure projects to bankability, helping to close the financing gap required to achieve the SDGs by enabling the scaling and replication of efforts to enable broader systemic change.

SDIP activities include:

- **Project Investment Review Group**
Presenting live project opportunities to the members that require some form of blended finance to become commercially viable
- **Pooling Resources**
Supporting models that address financing challenges by leveraging the combined resources of the membership
- **Policy & Regulation**
Developing guidance based on member insights and transaction experiences
- **Regional & National Acceleration**
Building regional hubs to accelerate local and regional solutions

www.sdiponline.org

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End notes:

1. Sachs, J and Schmidt-Traub, G. (2014). 'Financing Sustainable Development: Implementing the SDGs through Effective Investment Strategies and Partnerships'. Unedited draft for public consultation, and UNCTAD. 2014. 'World Investment Report 2014. Investing in the SDGs: An Action Plan'. UNCTAD: Geneva; accessed at <http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=937>
2. Sachs et al 2014 op cit, UNCTAD 2014 op cit
3. Blended Finance in the Private Sector Context, World Economic Forum, 2015
4. Risk Mitigation Instruments in Infrastructure: Gap Assessment, July 2016
5. Blended Finance Vol. 1: A Primer for Development Finance and Philanthropic Funders, September 2015
6. Understanding the challenges for infrastructure finance Prospects for new sources of private sector finance, BIS Working Papers, September 2015
7. Ibid
8. Risk Mitigation Instruments in Infrastructure: Gap Assessment, July 2016
9. A How-to Guide for Blended Finance, World Economic Forum, September 2015
10. Strategic Investment Funds, Opportunities and Challenges, the World Bank, October 2016

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