SUMMARY OF KNOWLEDGE EXCHANGE AND LEARNING SESSION ON BLENDED FINANCE

31st JAN - 1st FEB 2017, PARIS, FRANCE

EXECUTIVE SUMMARY

The 30 countries that make up the Organization for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC) spent $142.6 billion in Official Development Assistance (ODA) in 2016. A small percentage of this amount was allocated to blended finance with 17 member countries claiming that they engage in blended finance activity. These countries are at different stages in terms of the range of instruments used and how blending is carried out. Therefore, in an attempt to institutionalize, standardize and scale blended finance, the OECD-DAC approved *Principles for Unlocking Commercial Finance for the SDGs* in late 2017.

To facilitate the move from principles to practice, Convergence and the OECD developed and organized a Knowledge Exchange on Blended Finance, primarily for the benefit of DAC members and partner countries. The 2-day agenda was designed to (1) expose participants to the OECD Blended Finance Principles (2) discuss in depth principles and practices of blended finance to mobilise private sector commercial finance and (3) profile and analyze practical blended finance cases & examples.

The first day focused on building the case for blended finance and discussing various ways in which these transactions are structured and deployed to attract private sector financing to achieve the SDGs. The modules identified a $2.5 trillion annual funding gap to achieving the SDGs, with blended finance having the potential to narrow this gap by attracting private sector investment to developing countries. They also provided an overview of the different segments of private sector investors and their investment criteria when considering how and where to invest the $200-300 trillion of assets in global capital and financial markets. DAC and partner countries can attract parts of these pools of capital towards their development priorities by understanding the mandates/constraints of private sector investors and by partnering to design blended finance structures that meet those needs. The critical roles of MDBs and DFIs were also discussed with consensus around leveraging their comparative advantages of (i) originating and arranging financing transactions in developing countries and (ii) mobilizing higher levels of private sector financing to developing countries.

Day two focused on the development impact of blended finance, the design of best-practice transactions and implementation models that DAC and partner countries can adopt within their own organizations. Key learnings from this day include (1) Focus resources of measuring development impact of the underlying flows mobilized by blended finance (2) DAC and partner countries should collaborate and coordinate their blended finance activities to achieve scale and to share learnings

OECD-DAC members are already engaged in blended finance and are committed to adopting and scaling this approach, with the OECD and Convergence dedicated to coordinating efforts across stakeholders to maximize the impact of these solutions towards the SDGs.

SYNOPSIS

Participants: Around 65 officials from 25 DAC and partner countries and 50 development finance and blended finance practitioners. Public sector participants ranged from foreign ministries, development aid agencies, and ministries of finance. Practitioners ranged from national development finance institutions, multilateral development banks, the private sector, philanthropic foundations and think-tanks. Over 35 experts participated in the formal agenda, including representatives from the European Commission, Citigroup, The Bill & Melinda Gates Foundation, UN Financing for Development, The Abraaj Group, European Investment Bank, African Guarantee Fund, World Economic Forum amongst others.

Format & Approach: Delivered over seven core modules ranging from context to practice and leveraged case studies and third-party expertise. Discussions included various themes:

- Importance of blended finance in filling the SDG funding gap
- Key components and mechanics of a blended finance transaction
- The critical role of MBD's and DFI's in mobilizing higher amounts of financing to developing countries through blended finance
- Best practice blended finance approaches employed by government agencies and development finance institutions
- Increasing role of the philanthropic sector in blended finance.

SUMMARY OF DISCUSSION

BUILDING THE CASE FOR BLENDED FINANCE TO PLAY A SIGNIFICANT ROLE IN ACHIEVING THE SDGs

The objective was to provide participants with

- An understanding of the capacity and importance of blended finance to attract private sector investment to developing countries to achieve the SDG's

Presentations were made by OECD, UN Financing for Development and UN Sustainable Solutions Network. Takeaways included:

- The Addis Ababa Action Agenda identifies the importance of the private sector in developing countries and developed countries to achieve the SDGs, with commercial finance in developed countries critically important to finance development in developing countries
- Blended finance can help bridge the $2.5 trillion annual SDG investment gap, but requires a common framework
- Blended finance solutions serve to lower and/or reallocate investment-specific risks and incentivize additional private sector finance to projects across key development sectors
- It is estimated that incremental annual investment needs amount to around 15% of annual global savings, 3% of global GDP and 1% of global financial assets; well within global savings
- Infrastructure is considered to be the most readily investable sector currently with significant potential for private co-financing
- Blended finance is not a panacea, there are many SDG financing needs that do not generate cashflows to repay commercial investors in blended finance structures. Many of these SDGs cannot (and should not) be financed by development finance, and are best funded by grants or sovereign loans
- An OECD survey found DAC and partner countries established 167 dedicated blended finance facilities, with a large percentage of the capital mobilized to middle-income countries
- To scale blended finance, it is important to (1) Attract coomercial finance (2) Develop a common frameowkr & understanding of blended finance (3) Collect data on consistent estimates of blended finance (4) Evaluate Development Impact

PRACTICES & MECHANICS OF BLENDED FINANCE

The objective was to provide participants with:

- Solid, intermediate level understanding of the principles and practices of best-practice blended finance solutions
- Examples of blended finance archetypes and instruments

Presentations were made by Convergence and the OECD. Takeaways included:

- Significant supply of private capital to narrow the annual $2.5 trillion SDG funding gap
- A small percentage of annual ODA funding allocated to blended finance has the potential to leverage significant amounts of private capital.
- Convergence calculates that if 10% of the $142 billion in ODA were allocated to blended finance, and those concessional funds achieved a leverage of 7x, then an additional $ 100 billion of private sector financing to developing countries could be mobilized. This amount is around 3 x the aggregate level of MDB financing to the private sector in developing countries.
- Signature markings of a blended finance transaction include leverage, impact and return
- According to Convergence, the four main archetypes and instruments for blended finance transactions include (1) Concessional debt or equity (2) Guarantee of risk insurance (3) Design or Preparation Funding (4) Technical Assistance
- Expected loss is a driver of private sector investment decisions; this is function of probability of default and loss given default. A majority of private sector borrowers in most ODA-eligible countries are deep non-investment grade (e.g. speculative grade) which translates into a high probability of default and expected loss.
- Risk-return profiles acceptable to private sector can be created through (1) Portfolio approaches that create diversification and reduce risk (2) Subordination of development funds in the capital structure
- A 2017 OECD survey showed that between 2012-15, $ 81.1 billion of private sector financing was mobilized by official development finance interventions; 30% went to Africa followed by Asia with 26%
- OECD's 5 Blended Finance Principles (1) Anchor use to a development rationale (2) Design structures to increase the mobilization of commercial finance (3) Tailor to local context (4) Focus on effective partnering (5) Monitor for transparency & results

PRINCIPLES & PRACTICES OF PRIVATE SECTOR INVESTMENT

The objective was to provide participants with:
- A solid understanding of investment criteria, mandates and requirements of commercial/fiduciary investors
- Deepen understanding of how to partner with the private sector to invest in developing countries

Citi presented followed by a panel. Takeaways included:
- There appears to be a mispricing of risk due to lack of robust data on probability of default in ODA countries; therefore the GEMS database (default and loss database for the emerging markets business of MDBs/DFIs) needs to be made open and available
- FX risk is a major consideration for investors as a large majority of financing to developing countries continues to be in hard currency
- There is a big opportunity to finance SME's that are part of the "missing middle", they are chronically underserved by financial institutions
- A portfolio approach to blended finance is attractive to institutional investors since they are interested in deals with a minimum ticket size (i.e. >$ 30 million)
- Some recent regulations impede commercial investors ability to invest in developing countries - such as Basel III which call for commercial banks to allocate higher levels of capital when lending to high risk jurisdictions will result in a reduction a cross border banking flows to emerging markets, and IFRS 9 which calls for booking a loss in the initial year for loans with high probabilities of default.
- Attracting private sector investment is one side of the equation, domestic resource mobilization (e.g. commercial bank and institutional investor funds) is equally important as it helps to improve the fiscal profile of a country
- Blended finance structures should target creating capital market instruments that provide private investors sufficient liquidity and exit opportunities
- Local institutional capital is important piece of the resource mobilization puzzle and represents a significant untapped opportunity for blended finance

THE IMPORTANCE OF THE PHILANTHROPIC SECTOR IN BLENDED FINANCE

The objective was to provide participants with:
- A strong understanding of the interest and needs of philanthropic sector participants in blended finance

Panel discussion with the Bill & Melinda Gates Foundation and Rockefeller Foundation. Key takeaways included:
- One estimate is that there is $30-35 billion of philanthropic capital allocated annually to developing countries
- Philanthropic capital has a strong development impact objectives with high tolerance for risk, and can be considered as complementary to public and private sector capital
- Philanthropic capital flows to projects that are aligned with their key areas of focus/priority
- Program Related Investments allow philanthropic foundations to make investments that involve the potential return of capital within an established time frame; this is a source of opportunity for the public sector to use as a basis of partnership

THE CRITICAL ROLE OF MDBs & DFIs IN CATALYZING PRIVATE SECTOR INVESTMENT TO THE SDGs

The objective was to provide participants with:
- An advanced understanding of the different financing alternatives deployed by MDBs and DFIs to mobilize higher levels of private sector financing

The Blended Finance Taskforce presented, followed by a panel. Key takeaways included:
- In 2016, MDBs claim they mobilized $160 billion of private capital for $200 billion on balance sheet investment, achieving an aggregate mobilization ratio of < 1:1
- Relative to the private sector, MDBs have a large comparative advantage in originating and arranging projects in developing countries
- MDBs & DFIs should target mobilizing private capital as a significant part of their mission; this would drive changes to incentive structures, product standardization and asset pooling
- Many expressed the view MDB's must move beyond originating and holding projects on their balance sheet through traditional pari-passu commercial activities (e.g. A-B loan programs) and move towards a portfolio blended finance approach (e.g. IFC-Sida MCPP Infrastructure)
- MDBs & DFIs should share their GEMS database and information on historical performance of blended finance vehicles; since the data and information demonstrate lower actual losses relative to conventional risk models' forecasts

BLENDED FINANCE & DEVELOPMENT IMPACT

The objective was to provide participants:

- With an overview of the development impact delivered by the underlying financial flows catalyzed through blended finance

A presentation by the European Commission was followed by a panel discussion. Key takeaways included:

- Key aspects of an impactful blended finance program include (1) focusing strongly on the additionality of the blending grant (2) sharpening alignment of the blending project with national policies (3) achieving greater development impact by focusing on poverty alleviation
- There is a nuanced difference between results and impact; results include outputs & outcomes for beneficiaries while impact includes benefits beyond those captured by direct beneficiaries
- Partnerships are at the core of blended finance, hence attribution is challenge
- From a developmental impact perspective, not everything that we would like can be measured
- Additionality is also hard to measure and pinpoint as blending is a concept that is becoming more fluid
- Blending has worked best in middle-income countries; as we learn from the success/failure of past projects, we will see more blending in low-income countries
- Development impact indicators should be embedded into transaction/instrument design

BEST PRACTICES AND MODELS OF IMPLEMENTING BLENDED FINANCE SOLUTIONS & STRATEGIES

The objective was to provide participants with:

- Exposure to various models and best practices of developing and integrating blended finance strategies within their respective organizations

Presentations were made by DFID, Sida and European Commission followed by a panel. Key takeaways include:

- The European Commission's External Investment Plan was profiled as a significant new source of development agency funding available for blended finance over the next four years
- Sida presented its guarantee program which includes the principle that the risk must always be shared with the actor who provides the loan
- DFID announced that it had recently provided CDC with a capital increase of £703 p.a. over 5 years to support CDC in demonstrating that market rate returns can be generated in the hardest to reach places
- DFID is developing a three-stage approach to determine need and form of concessional (1) Market Level (2) Meso Level (3) Investment Level

CASE STUDIES

The objective was to provide participants with:

- A solid understanding of best practice blended finance solutions through presentation and Q&A, allowing participants to gain hands-on, practical exposure to actual blended finance mechanisms

During these sessions; presentations were made by

- The Global Health Investment Fund, The Currency Exchange, African Guarantee Fund, Alina Vision and Sarana Multi Infrastruktur

KEY INSIGHTS

- Whilst transactional approaches have merit, a portfolio approach to blended finance has better potential to leverage higher amounts of financing due to diversification to reduce risk and small deal size of many finaicng/investment projects in ODA countries
- Private sector borrower sin ODA countries have high risk, with blended fiannce being an excellent tool to intermediate financing to these businesses/ Most "good" private sector borrowers would be 1-2 notches lower than sovereign, making the risk profile of private sector borrowers in ODA countries well below investment grade level
- Projects and businesses in ODA eligible countries require higher use of blended finance structures – median sovereign rating is B+ (65 countries are not even rated), most "good" private sector borrowers would be 1-3 notches lower than sovereign which is too weak for most private sector investors
- MDBs should leverage their comparative advantage of originating and arranging financial transactions that would allow private sector investors to invest in those assets
- Participants agreed that skills and knowledge gaps on the mechanics of blended finance acts a barrier towards increasing their support for blended finance
- Convergence & OECD will investigate the benefit of convening follow-on learning events that focus on (1) case studies highlighting innovative blended finance

transactions and 2) optimizing blended finance for specific sectors

ABOUT CONVERGENCE

Convergence is the global network for blended finance. We generate blended finance data, intelligence, and deal flow to increase private sector investment in emerging markets.

www.convergence.finance

OECD'S WORK ON BLENDED FINANCE

Blended finance is part of the OECD Development Assistance Committee's wider work on Private Financing for Sustainable Development. The overarching objective of this work is to mobilise additional resources to address the most pressing environmental and social challenges in developing countries.

OECD/blended