



Using Blended Concessional Finance to Invest in Challenging Markets

ECONOMIC CONSIDERATIONS, TRANSPARENCY, GOVERNANCE,
AND LESSONS OF EXPERIENCE

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GOVERNANCE, AND LESSONS OF EXPERIENCE



Creating Markets, Creating Opportunities

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CONTENTS

- 7** | FOREWORD
 - 8** | EXECUTIVE SUMMARY
 - 11** | INTRODUCTION
 - 14** | Blended Concessional Finance—A Primer
-
- PART I.**
BLENDED CONCESSIONAL FINANCE—WHY AND HOW?
- 17** | CHAPTER 1: Economic Considerations in Using Blended Concessional Finance
 - 27** | CHAPTER 2: Blended Concessional Finance—Transparency, Access, and Governance
-
- PART II.**
LESSONS FROM IFC’S EXPERIENCE IMPLEMENTING BLENDED CONCESSIONAL FINANCE
- 39** | CHAPTER 3: Selecting and Structuring Infrastructure and Other Projects for Blended Concessional Finance
 - 44** | CHAPTER 4: Scaling Up Private Investment in Lower-Income Countries
 - 51** | CHAPTER 5: The Rise of Returnable Capital Contributions
- 57** | REFERENCES
 - 58** | FURTHER READING

Tables, Figures, and Boxes

TABLE P.1 Expected Leverage of Private Finance with Donor Funds	15
FIGURE 1.1 Types of Private Sector Project Impacts	17
FIGURE 1.2 Project Spectrum and Role of DFIs and Concessionality	19
FIGURE 1.3 Articulating the Rationale for Blended Concessional Finance	21
FIGURE 2.1 IFC Blended Concessional Finance Annual Commitments, FY2010–20, Total Project Volume by Funding Source (US\$ Millions)	27
FIGURE 2.2 Processes to Allocate Concessional Funds	31
FIGURE 2.3 Elements of IFC Governance for Blended Concessional Finance	34
FIGURE 4.1 Percent of Countries with Investment Grade Ratings, 2015–17	45
FIGURE 4.2 DFI Concessional New Commitments by Income Level, 2017–18 (US\$ Millions)	45
FIGURE 4.3 DFI Concessional Amounts by Region, 2017–18	45
FIGURE 4.4 IFC Concessional Amount by Income Level, FY2010–20 (US\$ Millions)	46
FIGURE 4.5 IFC Blending Concessional Funds Under Management by Thematic Focus, FY2010–20 (US\$ Million)	46
FIGURE 4.6 IFC Blended Concessional Finance Commitments by Concessional Instrument, by Project Count, FY2010–20	47
FIGURE 4.7 DFI Total Leverage of Concessional Amount, 2017–18	47
FIGURE 5.1 IFC Blending Concessional Funds Under Management by Individual Facility, FY2010–20 (US\$ Million)	52
FIGURE 5.2 DFI Blended Concessional Finance: Concessional Commitment Volume by Instrument, 2017–18 (US\$ Millions)	53
FIGURE 5.3 Blended Concessional Finance Instruments: The Donors' Perspective	53
BOX 1.1 Distortions that Underpin Additionality	22
BOX 1.2 Types of Additionality	23
BOX 1.3 Case Study of VITO Rice: Articulating the Rationale for Blended Concessional Finance	24–25
BOX 2.1 Calculating the Concessional Element in a Project	34
BOX 3.1 Blended Concessional Finance in Practice	40
BOX 3.2 Additional Examples of Blended Concessional Finance in Practice	42

Glossary and Definitions of Key Terms

BLENDED CONCESSIONAL FINANCE *“Combining concessional finance from donors or third parties alongside DFIs’ normal own-account finance and/or commercial finance from other investors, to develop private sector markets, address the Sustainable Development Goals (SDGs), and mobilize private resources.”* Definition adopted by the DFI Working Group on Blended Concessional Finance for Private Sector Projects for the private sector operations of DFIs (development finance institutions). *Source: DFI Working Group on Blended Concessional Finance for Private Sector Projects—Summary Report, October 2017, p. 3.*

COMMERCIAL FINANCING Financing at market rates (or market equivalent if there is no market rate).

CONCESSIONAL FINANCING Financing below market rates (or with maturity, grace period, security or rank offered on soft terms without being priced according to the market).

DEVELOPMENT FINANCE INSTITUTIONS (DFIs) Development institutions that finance private sector projects in developing countries.

EXTERNALITIES Costs and benefits that are not reflected in market prices.

MARKET FAILURES Market outcomes that lead to economically inefficient allocation of goods and services.

SUSTAINABLE DEVELOPMENT GOALS (SDGs) The international development goals agreed under the auspices of the United Nations for achievement by 2030.

Abbreviations and Acronyms

AIMM	Anticipated Impact Measurement and Monitoring	MSMES	Micro, small, and medium enterprises
DFI	Development Finance Institution	ODA	Official Development Assistance
CRRH	Caisse Régionale de Refinancement Hypothécaire	OECD	Organisation for Economic Co-operation and Development
ESG	Environmental, social, and governance	PRSW	GAFSP's Private Sector Window
E&S	Environmental and social	PSW	Private Sector Window
FCS	Fragile and conflict-affected situations	RAROC	Risk-adjusted return on capital
GAFSP	Global Agriculture & Food Security Program	R&D	Research and development
GNI	Gross national income	SLGP	Small Loan Guarantee Program
HIC	High-income country	SME	Small and medium enterprise
ICT	Information, communication, and technology	SDG	Sustainable Development Goal
IDA	International Development Association	SRP	Sustainable rice platform
IDA PSW	IDA-IFC-MIGA Private Sector Window	UMIC	Upper middle-income country
IFC	International Finance Corporation	UN	United Nations
IMF	International Monetary Fund	US\$	United States Dollar
IRR	Internal rate of return	WAEMU	West African Economic and Monetary Union
LIC	Low-income country	WE-FI	Women Entrepreneurs Finance Initiative
LMIC	Lower middle-income country	WEOF	Women Entrepreneurs Opportunity Facility
MENA	Middle East and North Africa	WBG	World Bank Group
MFD	Maximizing Finance for Development		
MIGA	Multilateral Investment Guarantee Agency		

Note: All dollar amounts are U.S. dollars unless otherwise indicated

FOREWORD

The UN's Sustainable Development Goals are driving innovation and new thinking about how to attract private capital to development—especially to lower-income countries and fragile situations, where it is needed most.



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There is no silver bullet in development finance. That is, no single financing instrument or strategy that will bring sustainable private investment to the most challenging environments. However, some approaches hold unique potential to mobilize development finance and de-risk projects in these markets to help bring the jobs, goods, and services that are essential to improve people's lives.

One such approach entails the blending of commercial funds from private investors and IFC or other development finance institutions (DFIs) with concessional funds from governments or philanthropic sources. We have found that this solution, known as blended concessional finance, can help attract significant private investment. This report shares IFC's experience in this area, providing guidance for practitioners on how to employ blended concessional finance effectively, efficiently, and transparently.

Central to IFC's mandate for development is the creation and ongoing support of private markets with strong development impact. The use of blended concessional finance is an important part of our efforts to create new markets and promote pioneering investments that would not happen otherwise. At this time of increased global risk from the COVID-19 pandemic, blended finance solutions are also increasingly being seen as a critical tool to provide liquidity for viable firms where finance is drying up, to bridge the crisis and preserve livelihoods, while creating a renewed private sector for the future.

Today, IFC is a large global provider of blended concessional finance for private sector operations. And with that position comes responsibility. IFC has assumed a leadership role in formulating common rules and best practices for the use of these funds. This work has led to the adoption by IFC of rigorous approaches to evaluating the need for blended concessional finance in projects, and in conjunction with other DFIs, the adoption of the DFI Enhanced Principles for Blended Concessional Finance for Private Sector Projects. The Principles provide a framework for the effective and efficient use of

blended concessional finance. They require that projects have a clearly defined economic rationale for the use of concessional funds, use only the minimum concessional needed to make a project viable, and have a clear path to commercial sustainability without concessional.

IFC has developed strong governance processes to ensure that blended concessional finance principles are applied, including independent decision-making for managing development partners' concessional resources. IFC reports the amount of concessional applied in each project to its Board of Executive Directors and publicly discloses all projects that use concessional funding. For all transactions mandated after October 1, 2019, that use blended concessional finance, IFC publicly discloses the amount of concessional (as a percentage of total project cost) applied in each transaction. This will bring a new level of transparency to the use of concessional resources to support private sector projects. IFC is committed to leading on transparency and encourages partners to follow.

As the use of blended concessional finance grows, it is increasingly important to understand how it can be leveraged for maximum efficiency and impact. And IFC, as a leader in the creation of markets in developing economies, needs to continuously expand the frontier of thinking and practice around this financing instrument. That is the goal of this report: to share with other blended concessional finance practitioners the knowledge and lessons we have gained from nearly two decades of experience managing and deploying development partners' resources in blended concessional finance solutions. We reflect on what works and what doesn't, bringing greater analytical depth and rigor to the application of this promising solution in our toolbox.

This report is the first step. We invite others to engage with us for further discussions and sharing of experiences, with the ultimate goal of mobilizing private investment where it is needed most. ■

EXECUTIVE SUMMARY

This report examines multiple ways that blended concessional finance can help bridge the pronounced gap between the scale of investment needed to meet the Sustainable Development Goals and the limited fiscal and commercial resources available to finance investments in developing countries. The lack of funding for these investments has created a new focus on innovative ways to increase available resources, including by blending public funds with private investment to provide the needed financing. This report provides guidance for practitioners on employing blended concessional finance effectively, efficiently, and transparently.

Blended Concessional Finance—Why and How?

Economic Considerations in Using Blended Concessional Finance. IFC has developed a framework for articulating the economic case for using blended concessional finance in a project. This framework is currently being used by IFC, but has potential applicability to many other DFIs. The economic case for using blended concessional finance in a project starts with a clear articulation of the contributions of the project to development. The private sector is essential for livelihoods—in most countries, an estimated 80–90 percent of employment is in the private sector.¹ The private sector also provides essential goods and services and tax revenues, and can contribute to social stability. In considering potential impacts from financing a project, it is important to look at two levels: 1) direct impacts of the project on key stakeholders (including employees, customers, suppliers, government, and the community), on the broader economy and society, and on the environment; and 2) impacts on markets, including effects on sector competitiveness, inclusiveness of employment and services, and the resilience of the market to external shocks. To support the use of blended concessional finance, these impacts need to be quite substantial.

Second, the role of IFC or other development finance institutions (DFIs) in enabling and improving the project should be described. This would cover the contributions (or additionality) of IFC or other DFIs in facilitating a high-impact project using their financial products and advisory services, including providing comfort to investors, to address market distortions hindering a successful project.

Finally, a clear articulation is needed of why the normal commercial-based support from IFC or other DFIs is insufficient to make an important project viable, what the

remaining constraints are, and how concessional funds can be used to address those constraints.

Another element of good practice in structuring blended concessional finance projects includes aligning the instrument of concessionality closely with the rationale for the use of concessional funds to ensure minimum use of concessional funds, and to maximize impact on market creation.

In summarizing the overall rationale for utilizing blended concessional finance, it is important to highlight how the use of concessional funds extends the development impact of private sector activities in the country, such as by creating new markets consistent with country development priorities, or by extending products and services to new consumers and end-users.

Transparency, Access, and Governance. IFC and other DFIs, with financial support from donors and other contributors, have recently been significantly expanding the scope and scale of blended concessional finance activities to help deliver greater development impact.

Responding to this growth and the need to maximize the impact of these additional funds, the DFIs have begun working together to share knowledge and best practices in the use of concessional funds to ensure maximum effectiveness and efficiency without market distortion.

IFC and other DFIs have, therefore, agreed to a set of operational principles and processes to manage blended concessional finance and ensure that both public policy considerations and private sector commercial issues are adequately addressed. There are five key principles: 1) a sound economic rationale for the use of concessional funds, 2) crowding-in and minimum concessionality, 3) expectation of eventual commercial sustainability, that is, that use of concessional finance will be time-bound in a sector with the goal that market players will eventually provide commercial

finance, 4) comprehensive approaches to reinforce markets, and 5) high standards with respect to governance, transparency, and environmental and social issues.

IFC works to ensure the implementation of these principles through robust transparency, access, and governance processes. For *transparency*, IFC provides details to donors and the public for each project using blended concessional finance, including the type of concessional funds used, the rationale for their use, the expected development impact of the project, the role of IFC in supporting the project, the reason that concessional funds are needed to make a project viable, and the amount of concessionality utilized, among other details. IFC, in cooperation with other DFIs, also reports on aggregate volumes of blended concessional finance used in different regions, sectors, and instruments.

With respect to *access* to blended concessional finance, a number of processes have been used by IFC to facilitate the second DFI principle of “crowding-in and minimum concessionality.” These include, when market conditions allow, competitive processes such as *tendering* and *auctions*, where many companies compete primarily on price and delivery capabilities to provide a known service (usually in infrastructure), ensuring that the best companies are funded and resources are used efficiently. Another option is *programmatically approaches that offer open access* where the development impact objective is defined *ex-ante*, and there are clear parameters for potential clients to be part of the program, such as the type of instrument and fee they pay to access funds, as well as the client’s capabilities with respect to environmental and social issues, financial strength, and delivery capacity. Relevant market players know the conditions to participate and can apply, ensuring wide participation to maximize potential project impacts.

Finally, ideas to solve strategic development challenges can also present themselves “bottom-up” through IFC’s regular pipeline origination. These bottom-up projects are often innovative, pioneering investments that can facilitate market creation and are typically in the agri-business, manufacturing, ICT (information, communication, and technology), and certain service sectors. These projects can be critical for development, yet in high-risk environments they may require temporary concessional support while not lending themselves to competitive tenders or open-access approaches. The development objective is not identified in advance by IFC, but rather IFC verifies the anticipated development impact of the project idea proposed by the sponsor.

To ensure the concessional funds are utilized efficiently and effectively, especially in this situation, IFC and other DFIs need to have sound analytical and *governance* processes to evaluate the need for concessional funds, amounts required, and the benefits expected. This can include independent decision processes, separate team structures, operating procedures that review compliance with the DFI principles, and disclosure policies that ensure transparency regarding the use of concessional resources, including the estimated amount of subsidy.

An example illustrates the impact of sound governance. IFC was considering financing the construction of one of the first solar power plants in a lower middle-income country in Latin America, which would demonstrate the feasibility of utility-scale solar projects in the country and region. However, the project was not bankable due to country risks, first-mover challenges with the technology, and limited financing from banks. Making this project viable required structuring the financing with senior loans from a donor, IFC, and commercial lenders, and a donor subordinated loan. A robust governance process enabled IFC to identify potential weaknesses in the structure and adjust the financing to better align the interests of IFC and the donor, an arrangement that allowed the project to proceed.

To advance best practice, DFIs will need to continue to share experiences with different approaches to managing blended concessional finance. Evaluation of transparency, access, and governance processes can help provide the necessary feedback loop.

Lessons from IFC’s Experience Implementing Blended Concessional Finance

Selecting and Structuring Infrastructure and Other Projects for Blended Concessional Finance. For over a decade, IFC has been using blended concessional finance selectively to fund projects. Since July 2009, the Corporation has blended \$1.6 billion in concessional investment capital to support projects that leveraged over \$13.2 billion in IFC and third-party financing. IFC has learned some key lessons from this experience. For the effective implementation of blended concessional finance, the basic structuring of a project needs to be sound, especially with respect to risk management. IFC has identified structuring techniques that can reduce a project’s risk profile. Strong project fundamentals are essential, and risks should be borne by parties most able to manage them. Risks can also be reduced by building up local currency financing options and streamlining

project preparation. Working with partners and effective execution are also critical elements of any successful blended concessional finance undertaking.

Scaling Up Private Investment in Lower-Income Countries.

Blended concessional finance can be particularly important for scaling up private investment and accelerating development efforts in lower-income countries, which often have both the greatest need for market creation and the most imposing barriers to private sector development. For example, in FY20 IFC's blended concessional finance programs supported 13 percent of IFC own-account investments overall, but 22 percent of investments in IDA and FCS countries, and 34 percent of investments in low-income IDA and FCS countries. The challenge here is to initiate groundbreaking investments that demonstrate viability and begin to attract additional private investments on commercial terms. In addition, blended concessional finance in lower-income countries differs from other contexts, having a more diversified instrument mix, higher ratios of concessional finance, and higher levels of advisory support to develop projects and markets.

In Madagascar, for example, where three-quarters of the population lives in extreme poverty and 80 percent are dependent on agriculture, IFC and the World Bank teamed up with the Global Agriculture and Food Security Program and a local agribusiness firm, BoViMa, to develop

the country's first modern feedlot and abattoir, which supported the livelihoods of some 20,000 herders and farmers. The project demonstrates the potential impact of a comprehensive approach to creating markets that includes advisory support, DFI financing, private sector sponsorship, and donor-funded concessional co-investment.

The Rise of Returnable Capital Contributions. Donors can use many different structures to provide concessional funds to DFIs for financing private sector investments. An important approach that is seeing expanded use is the "returnable capital" model, where donors receive regular reflows of interest, fees, dividends, and principal repayments. Earlier methods for contributions to DFIs were largely based on grants or contributions without regular return provisions. The returnable-capital model provides donors with control over the use of investment reflows. In many cases, the contributions are then classified as investments in government budgets rather than expenditures,² and could thus facilitate greater flows to the private sector while freeing up grant money for other uses. However, there are other repercussions of the returnable-capital model, such as changes in reported ODA levels and a possible reduction in the risk-bearing capacity of the concessional finance. All these impacts need to be fully understood by donors so they can best decide how to organize and manage their concessional funds.

IFC's experience indicates that blended concessional finance has excellent potential to help the private sector grow and deliver a high level of development impact, including by providing essential jobs and services. The application of sound transparency, access, and governance principles is critical to maximizing this potential. IFC's experience also indicates that sound structuring of projects and effective risk management is fundamental to success, blended concessional finance has an important role to play in lower-income countries and high-risk situations, and providers of blended concessional finance have a choice of funding structures that can be used to best match their funding situations. ■

INTRODUCTION

Blended Concessional Finance has been defined by Development Finance Institutions (DFIs) as “combining concessional finance from donors or third parties alongside DFIs’ normal own-account finance and/or commercial finance from other investors, to develop private sector markets, address the Sustainable Development Goals (SDGs), and mobilize private resources.”³ This type of financing can be essential in high-risk environments where pioneering private investments can bring important benefits to society—such as creating new markets and developing new technologies—but where these initial investors may need a temporary incentive to overcome the high costs and risks inherent in these markets.

Importance of Blended Concessional Finance for Development

Increasingly, the development community is focusing on private sector solutions for development. While strong government institutions and social services are essential for successful societies, the private sector is also critical, as it provides employment, goods, and services that can lift people out of poverty and put countries on a path toward shared prosperity. Private firms are also a major source of tax revenue that can support social programs. In the context of developing the SDGs and the 2030 Development Agenda, the development community has recognized that much of the investment needed to reach the SDGs will have to come from the private sector, especially in lower-income countries.

The development community is also increasing efforts in high-risk countries, where the great challenges of poverty are becoming concentrated, and on innovative technologies and business models needed to address challenges such as climate change. In these situations, private sector activity may be constrained by a poorly developed regulatory and investment environment and by high risks associated with pioneering projects and technologies. While for many projects, the financial support of IFC or other DFIs at commercial rates, along with advisory support and policy work, is sufficient to bring these projects to viability, others may require some temporary concessional finance. The COVID-19 pandemic has also significantly increased the risk of private investment in developing countries, resulting in an increased need for blended concessional finance resources to help preserve impact of the activities of private sector companies and the critical jobs, goods, and services they provide, while laying the foundation for a renewed private sector for future growth that is inclusive, green, and gender-focused. Governments post-COVID will not be able to afford to provide all the services and jobs for recovery given fiscal constraints—so private solutions will be essential.

Blended concessional finance can be used in different ways to make high-risk projects viable, for example, by reducing risk, boosting project returns, or improving affordability for low-income consumers. For instance, in many cases, blended concessional finance provided as equity or subordinated debt can reduce project risks for senior lenders by lowering the number of senior claims on assets. Alternately, in some cases, senior debt at reduced rates can reduce debt service costs and thus reduce the risk profile of a project. These improvements in project financial structure often translate into lower costs for consumers and end-users, allowing important new markets to be started and providing market access to previously excluded groups.

There are many other ways that blended concessional finance can be used to structure projects, but in all cases the financing is used to make developmentally important projects viable that otherwise could not be structured fully on commercial terms. An important principle in the use of blended concessional finance is that its use be temporary—that over time, the projects funded help stimulate strong private sector markets that can then grow without government assistance and provide critical income, services, and revenue to society.

IFC’s Experience and Governance

Because blended concessional finance combines both public and private funds, its use poses challenges that are often outside the know-how or experience of existing public or private institutions. The finance has private aspects, such as the need to identify projects that can compete in the marketplace, and public aspects, such as the need to justify the use of public funds for appropriate public benefits.

IFC and several other DFIs have been using blended concessional finance in certain high-risk situations for nearly two decades and have gained considerable experience in structuring and implementing these projects. Knowledge

of how to use blended concessional finance is continually being developed. For example, building on existing standards and previously developed frameworks, as well as consultations with government agencies and other DFIs, IFC has strengthened the framework for establishing the rationale for the use of blended concessional resources. The objective is to more effectively deploy blended concessional finance and possibly provide a framework as an example for other DFIs. The new framework provides a clear distinction between normal IFC additionality and the added value of concessional finance, and includes an explicit link to IFC's 3.0 market creation strategy and to the World Bank Group Country Partnership Framework process. This then enables a comprehensive and strategic approach to the use of concessional finance to further development in countries.

In addition, several working groups that include IFC and other DFIs, government funders, the private sector, and/or other stakeholders have begun to share knowledge to improve the efficiency and effectiveness of blended concessional finance activities. IFC and other DFIs have developed the *Enhanced Principles for Blended Concessional Finance*, which provide important guidelines to manage the use of concessional funds for high impact.

Implementation of the principles requires strong processes to clearly define why blended concessional finance is needed and to provide appropriate transparency, access, and governance with respect to the use of concessional resources. IFC has developed processes in each of these areas and continues to strive to improve them. It is a leader in governance, with separate teams and decision-makers for concessional funds, it has launched competitive processes—such as the incorporation of blended concessional finance terms as part of public bids—to ensure concessional funds are used efficiently, and it has developed transparent reporting for donors and the public with respect to the use of concessional funds both for individual projects and in aggregate.

Continuing to Improve

IFC and other DFIs and stakeholders continue to improve the use of blended concessional finance and identify good approaches to structuring projects and creating impact.



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For example, IFC has been meeting with other DFIs to share its framework for establishing the rationale and efficient use of blended concessional resources. IFC has also committed to disclosing publicly the percentage of subsidy used in each blended concessional finance transaction mandated after October 1, 2019, to provide greater transparency regarding the use of public resources. IFC will continue to work with its partners to look for ways to improve the effectiveness, efficiency, and transparency of blended concessional finance, such as by encouraging government donors and other providers of concessional resources to adopt the DFI Enhanced Principles in their agreements with implementers. IFC will also continue work to improve the information provided to donors and the public on the utilization of concessional funds.

Finally, as part of a continuous learning process, IFC needs to regularly evaluate all aspects of its blended concessional finance activities, including project selection, transparency, access, and governance, to improve approaches and ensure the greatest impact from this important tool.

Report Structure

Each chapter in this report is based on a recent note or article by IFC that focuses on various important issues for practitioners in managing blended concessional finance. These draw on IFC's experience, knowledge shared among DFIs, and academic research on concessional finance. The analyses first cover economic issues and key implementation processes for blended concessional finance (Part I. Blended Concessional Finance—Why and How?): 1) economic considerations in using blended concessional finance, and 2) important transparency, access, and governance processes for effectively managing a combination of commercial and concessional resources. Second, the report reviews some lessons from IFC's experience (Part II. Lessons from IFC's Experience Implementing Blended Concessional Finance Projects), including 1) selecting and structuring projects, 2) tailoring blended concessional finance to the issues facing lower-income countries, and 3) understanding the implications of different structures donors can use to provide concessional funds to DFIs to support the private sector. ■

ABOUT IFC AND BLENDED CONCESSIONAL FINANCE

From July 2009 to June 2020, IFC deployed \$1.6 billion of concessional donor funds to support 266 projects in over 50 countries, leveraging \$6.1 billion in IFC financing and more than \$7.1 billion from other private sources. IFC's blended concessional finance facilities cover key sectors and thematic areas that are essential components of its Creating Markets strategy.

- IFC's longest-standing blended concessional finance facilities are for climate finance, where for more than 15 years IFC has worked to pioneer climate-smart investments with support from Climate Investment Funds (CIFs), the IFC-Canada Climate Change Program, and the Global Environment Facility (GEF). In addition, several recent blended climate finance programs have been added: the Finland-IFC Blended Finance for Climate Program, the Canada-IFC Blended Climate Finance Program, the Canada-IFC Renewable Energy for Africa Program, and the UK-IFC Market Accelerator for Green Construction Program.
- The Global Agriculture and Food Security Program (GAFSP) Private Sector Window targets agricultural projects in low-income countries.
- The Global SME Finance Facility works with financial intermediaries to provide dedicated lending windows for small and medium enterprises (SMEs) and guarantees loans made to SMEs using blended finance.
- The Women Entrepreneurs Opportunity Facility is a partnership with the Goldman Sachs Foundation, which is dedicated to financing women-owned SMEs in developing countries.
- The Women Entrepreneurs Finance Facility (We-Fi) is a multi-donor collaborative partnership that aims to unlock financing for women and women-led businesses, including in fragile and low-income markets.
- The IDA-IFC-MIGA Private Sector Window (IDA PSW) includes three IFC-managed facilities—the Blended Finance Facility, the Local Currency Facility, and the Risk-Mitigation Facility—as well as the MIGA Guarantee Facility (MGF), created to help crowd-in private sector investment where it is most needed, in IDA countries and fragile and conflict-affected situations. Funding for the IDA PSW is allocated on a three-year basis in alignment with IDA replenishments*. For IDA 19, the PSW has been allocated \$2.5 billion—\$2 billion for the IFC-managed facilities and \$500 million for the MGF.
- The MENA Private Sector Development Program (MENA PSD) is a partnership with the government of the Netherlands for a \$22 million multi-sector blended concessional finance facility named *Alafaq Aljadida* (New Horizons) as well as a \$48 million advisory program in the Middle East and North Africa region to strengthen the private sector, unlock new markets, support entrepreneurship, and create jobs.

*For more information on IDA replenishments visit: <https://ida.worldbank.org/replenishments/ida19>

Blended Concessional Finance—A Primer

Blended concessional finance is growing as an important tool for creating markets and stimulating development. This primer provides basic definitions related to blended concessional finance, the main reasons for using this type of finance, and some of the primary structures employed. It provides important background for understanding the concepts and examples covered in the rest of this report.

1. What is commercial finance?

Commercial finance is defined as finance at market interest rates or market rates of return.

2. What is concessional finance?

Concessional financing is financing on terms and/or conditions that are more favorable than those available from the market. Concessional finance can be achieved through one or a combination of the following:

- Interest rates or expected returns below those available on the market
- Other terms that would not be accepted/extended by a commercial financial institution such as:
 - Longer maturity (years before principal for a loan needs to be repaid)
 - Longer grace periods (time before interest or other payments are required)
 - Reduced security (rights to claim certain company assets if the loan is not repaid)
 - Lower rank (order in which financiers are repaid by the company)
 - Longer repayment profile (amount and timing of principal repayments)

3. What is the source of concessional finance?

Concessional finance generally is sourced from governments or other development partners (for example, foundations) that require less of a return than the market.

4. What is blended concessional finance?

Blended concessional finance is the combination of concessional finance sourced from governments (or other partners) with commercial finance from the private sector and development institutions' balance sheets. Most concessional funds are structured as co-investments with a probability of reflows for future investment or other uses.

Blended concessional finance is one source of investment finance for private sector projects in developing countries. Its importance has been growing in recent years.

5. Why is blended concessional finance used for private sector projects?

Private companies are essential to a country's development as they provide most of the employment, goods, and services. They are critical to reaching many of the Sustainable Development Goals (SDGs), such as those related to employment, growth, and poverty reduction.

However, the private sector in developing countries often faces constraints related to political and regulatory uncertainty, poor infrastructure and supply chains, limited firm capabilities, and other issues related to nonexistent or immature markets. These issues can make developing private sector projects difficult, high cost, and risky, which can also limit their ability to raise finance.

Development institutions that focus on the private sector address these constraints by helping develop projects, providing finance that is often not available from the market, attracting private investors, and creating markets. However, in certain high-risk situations, such as very poor or conflict-affected countries, pioneering projects, or those reliant on new technologies, development institutions may lack the financial capacity and risk tolerance to support some projects, even those with great potential for development and impact. In these cases, blended concessional finance may provide the necessary additional finance that can make important projects viable. Blended concessional finance can use a relatively small amount of concessional donor funds to mitigate specific investment risks and help rebalance the risk-reward profile of pioneering investments.

6. What are the different types of blended concessional finance products?

The main product types in blended concessional finance include:

- Senior loans, loans with a top priority for repayment, provided at below-market interest rates or other non-commercial terms (for example, maturity, grace period, security, repayment profile)
- Subordinated loans, loans with a lower priority for repayment (or with interest or principal payments deferred in certain pre-agreed situations), and provided at below-market interest rates or with other non-commercial terms
- Guarantees or risk-sharing facilities, which transfer all or part of the financial risk of a loan or group of loans to the guarantor, with fees charged at below-market rates; this could be, for example, in the form of a first-loss protection, where the donor guarantees a portfolio of investments of a financial intermediary and pays out before the senior guarantor in case there is a payment default
- Equity, an ownership stake in a company or participation in a fund, with return expectations below what market investors would expect
- Grants, either finance with no expectation of repayment, or performance grants that are paid if a project reaches specified milestones

Leverage is the ratio of a total project's financing to the amount of concessional finance that is used to make the project viable and varies by product type. Table P.1 indicates the range of leverage that different

TABLE P.1 Expected Leverage of Private Finance with Donor Funds

		AVERAGE	RANGE
Real Sector	Debt	11X	3X–15X
	Sub-debt	22X	10X–30X
Financial Intermediaries	Debt	6X	2X–10X
	First loss	30X	15X–50X

Note: Indicative leverage ratios are based on IFC's portfolio of blended climate investments.

structures could achieve based on IFC's experience in blended concessional finance. In cases where the donor provides concessionality beyond pricing (for example, subordination), higher leverage can typically be achieved compared to a structure where only a pricing concessionality is offered. There are trade-offs between leverage, risk-taking, and ability to receive reflows under blended concessional finance structures.

Providers of blended concessional finance need to understand the project constraints and try to identify the most effective use of concessional resources to overcome them.

7. What is the benefit of blended concessional finance and how is success measured?

Blended concessional finance can help launch pioneering and other high-impact private sector projects that provide jobs, goods, and services that can help people escape poverty and improve their lives. These projects can open up markets by demonstrating the viability of investments and developing the supply chains and support structures necessary for other companies to enter the market. The benefits of projects can be measured by their impact on jobs, services, and markets, using the systems DFIs have put in place to measure the development impact of all their projects.

In addition, specifically in the case of blended concessional finance, institutions look to minimize the amounts of concessional finance, the extent of concessionality (for example, how much below market), and the amount of time concessional finance is used to promote various levels of private sector activity.

8. What are the risks of using blended concessional finance?

Overuse of blended concessional finance can reduce the potential for viable markets to develop and attract commercial finance if concessional funds are used to support inefficient or failing firms and sectors become dependent on long term subsidies. Blended concessional finance thus requires a high level of competence from development institutions to ensure the concessional funds are used appropriately and support the functioning of markets. Strong governance and implementation procedures are required to ensure effective use and to realize the potential for blended concessional finance to support critical needs in development. ■

PART I. BLENDED CONCESSIONAL FINANCE—WHY AND HOW?



Bonne Viande de Madagascar (BoViMa), Madagascar.

CHAPTER 1

Economic Considerations in Using Blended Concessional Finance

By Emelly Mutambatsere, Philip Schellekens, and Kruskaia Sierra-Escalante

Concessional funds from donors are scarce, and their use in private sector projects must be carefully focused where they are most needed to achieve high development impact. This chapter provides a framework developed by IFC to identify economic considerations for the use of blended concessional finance—why and when its use in private sector projects is most appropriate and impactful. This requires looking broadly at the role of development institutions in supporting the private sector, including 1) the role of the private sector in development, 2) how IFC or other development finance institutions can help with private sector development, and 3) when blended concessional finance can be an important part of these efforts. This framework is currently in use by IFC, but has potential applicability to many other DFIs.

I. The private sector in development

The private sector is essential for livelihoods—in most countries, 80 to 90 percent of employment is in the private sector. The private sector also provides essential goods and services, generates tax revenues, and can contribute to social stability. A vibrant private sector is essential for the type of growth needed to rapidly lift people out of poverty.

At IFC, the *development impact* of a private sector project is evaluated at both the project and market levels (Figure 1.1):

- **Project outcomes:** direct effects of a project on stakeholders (including employees, customers, suppliers, government, and the community), broader impacts on the economy and society, and impacts on the environment. This includes impacts such as increases in high-quality employment, provision of improved and less expensive goods and services, effective management of environmental and social impacts, and impacts on the wider society through, for example, increased demand and employment in local and regional businesses.

- **Market impacts:** a project’s ability to catalyze systemic changes that go beyond direct effects brought about by the project itself. This includes effects on sector competitiveness, the inclusiveness of employment and services, and the resilience of

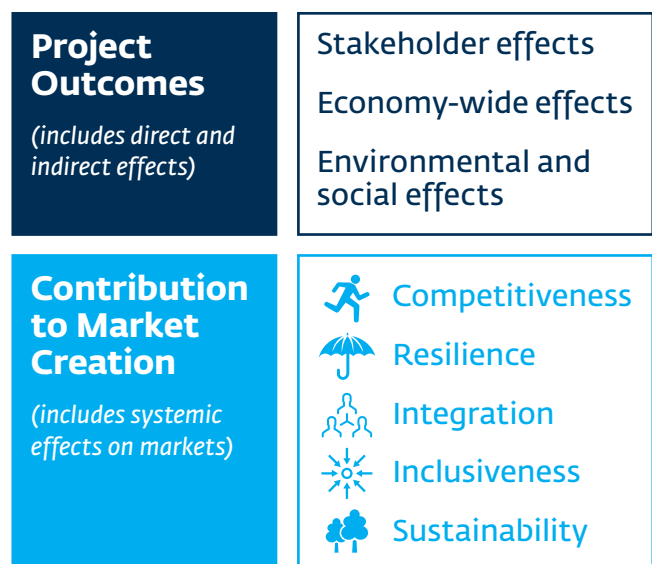


FIGURE 1.1 Types of Private Sector Project Impacts

Source: IFC.

the market to external shocks. Market outcomes can occur through various channels, such as putting in place regulatory frameworks that enable markets to function, promoting competition via innovation and improved management, providing a demonstration of new concepts that can be replicated by others, and building capacity and skills that open new markets.

Successful investments can open up a market to more domestic and foreign capital, especially when coordinated and sequenced with policy reforms that propel the government to develop smart regulations that support sustainable business and consumer markets, overcome market failures, and support strong demonstration effects. Pioneering investments can catalyze systemic market change and provide a strong signaling effect in high-risk environments, revealing the true nature of risks and showcasing the critical actions needed to make investments successful and sustainable.

II. How IFC and other DFIs help private sector development

Although many private sector projects can take place in developing countries without IFC or other DFI support, there are situations where highly developmental projects have difficulty attracting finance. For example, in many lower-income or fragile countries a weak regulatory and business environment, poor infrastructure and a lack of qualified suppliers, and limited worker skills and markets can raise the costs and risks of pioneering projects and discourage the private investment needed for robust growth and poverty reduction. Even in more well-developed markets, important innovative projects may face similar constraints.

In these circumstances, IFC or other DFIs can provide a number of financial and advisory services that can help de-risk private sector projects and increase the number of projects that are viable. The services provided by DFIs for a project beyond what is currently available in the market are called DFI *additionality*. Additionality can be in two major forms:

- **Financial additionality:** providing various financial products for a project not currently

available from the market, such as long-term loans, equity, guarantees, or hedging instruments

- **Nonfinancial additionality:** this includes the advice provided by DFIs on structuring and developing a project, addressing environmental or policy issues, strengthening the regulatory environment, and providing comfort to bring in other investors.

De-risking can happen at different levels and in different ways. For example, IFC or other DFIs can operate upstream to help strengthen the business environment in a country and/or sector. This represents a medium- to long-term de-risking intervention that can prove effective in creating the right business environment for investment to happen in a sustainable manner. In some cases, specific interventions at the transaction level are also needed to direct private investment toward achieving development objectives or overcome market failure. De-risking at the transaction level can happen in the form of risk reduction or risk transfer, and they can also happen together. In general, it is helpful to transfer risks to stakeholders that are in the best position to bear the risk and manage it.

In many cases, IFC or other DFIs can provide services not available in the market because of the mission and structure of their organizations—their mandate to help the private sector, their willingness to take on more risk than other financial institutions, their experience and knowledge in working in high-risk environments, and their relationships to governments that can help address regulatory and government capacity issues and mitigate political risk. The standard business model for IFC and most other DFIs includes the provision of the financial products at commercial rates, with some additional upstream interventions and advisory services that are often financed by donors.

III. The added value provided by concessional finance

For some projects with high expected development impact, especially in high-risk environments, the persistent market failures exacerbated by issues with the investment climate or inherent risks from innovative projects and technologies may make the projects financially non-viable, even with standard IFC or DFI

help. In these cases, finance at concessional terms via blended concessional finance structures may allow a project to proceed and provide significant development impact to the country (see the yellow area in Figure 1.2).

Blended concessional finance can reduce risk through various types of risk-sharing mechanisms, longer tenors, subordination, and guarantees. For example, there may be a need to provide local currency financing to a sponsor that will earn local currency revenues, but there is no market appetite for the related foreign exchange risk. Blended concessional finance can, in this case, provide capital or other solutions engineered to specifically offset currency exchange risks.

Through lower interest or fee charges, blended concessional finance can also reduce costs incurred by first movers that are creating positive externalities. This can bring the risk/return profile in a range where private sector companies can agree to participate. For example, a power project might not be able to sell clean energy at affordable rates to low-income

segments of society if investors funded the project solely on commercial terms. Blended concessional finance could provide an incentive to the project sponsor to adjust the size or design of the project to access a broader group of consumers. Over time, improvements in technology and reduced production and distribution costs could allow the service to be provided without concessional support.⁴

Blended concessional finance can also be used to directly incentivize project performance that maximizes development outcomes, such as by providing performance-based incentives when a financial intermediary reaches lending targets for a certain number of women entrepreneurs.

The amount of concessional support is likely to be minimized and be more effective if the blended concessional finance instrument is closely aligned with the underlying constraints. For example:

- Distortions that increase a project’s risk or risk perceptions may be best addressed through de-risking solutions (such as guarantees, first loss, subordination).
- Distortions that affect a project’s returns directly (for example, returns initially too low due to untested business models, low-income market segments, or limited scale) may benefit from instruments focused on improving a project’s internal rate of return, for example, through concessional loans or interest rate buydowns.

Concessional funds may operate on the financial aspects of these projects, but their impact translates to improved outcomes for end-users and other stakeholders. For example, without concessional support, projects that help financial intermediaries may be able to proceed but the higher fees that must be charged to borrowers would likely make the finance inaccessible to most SMEs. Similarly, without concessional support many new technology projects or pioneering market-creating investments would have to charge consumers such high prices that the project could not succeed. And when blended concessional finance is used for performance incentives, such as rewarding banks when reaching SME lending targets, the funds directly contribute to increasing services available to end-users.

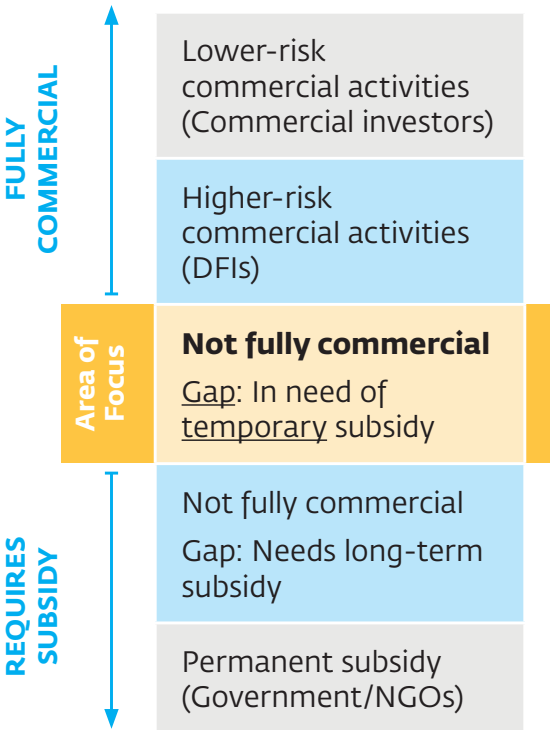


FIGURE 1.2 Project Spectrum and Role of DFIs and Concessional Support

Source: IFC.

Using the financial mechanisms described above, blended concessional finance can help make some of the projects in the “yellow” section of Figure 1.2 financially viable. Because of the scarcity of concessional funds, these should, to the extent possible, be projects with especially high levels of impact, for instance addressing underserved communities, pioneering new markets in difficult settings, or developing green technologies.

Blended concessional finance can thus be a critical component in realizing the development goals in IFC and World Bank strategies, by supporting important programs for a country’s development that would otherwise not be possible. IFC’s 3.0 strategy, which focuses on actively creating projects that can build innovative private sectors, requires a combination of strong upstream project development support and, in many cases, blended concessional finance to help launch innovative private sector projects in high-risk situations. The COVID-19 crisis is further leading to heightened risk for private investment in many countries. In this environment, blended concessional finance is providing important support for IFC’s crisis response facilities, particularly in lower income countries.

The importance of blended concessional finance is reflected in development impact metrics. At IFC, the projects with blended concessional finance have had higher expected development impact scores (as measured by IFC’s Anticipated Impact Measurement and Monitoring, or AIMM, System),⁵ implying a larger contribution to development impact than with typical projects without concessionality.

Blended concessional finance is also used in most cases where there is a clear path to phasing out the concessionality in the sector over time. This avoids creating permanent dependency on subsidies, which could hinder long-term market growth and waste resources. Concessional funds should be used to provide temporary help that facilitates the creation of a long-term sustainable market.

Despite the usefulness of blended concessional finance, de-risking private investments cannot substitute for systematically addressing public policy failures or sponsor capacity constraints. Both are needed, along with upstream interventions that IFC and other DFIs provide through technical assistance and advisory services.

IV. Steps to identify the rationale for blended concessional finance

Drawing on the above concepts of development impact, additionality, and the role of concessional finance, IFC has developed recommendations to clearly articulate the rationale for the use of blended concessional finance. This approach is currently being used by IFC but could be applicable to many other DFIs. There are three main steps (see Figure 1.3):

1. First, establish an **evidence-based development rationale**:
 - **Establish alignment of the project with the country’s development priorities, for example, as in IFC or other DFI country strategies.** At IFC, these are articulated in Country Strategy documents, which feed into World Bank Group Country Partnership Frameworks. The priorities are established following rigorous diagnostics, through Country Private Sector Diagnostics undertaken to establish the main development challenges and growth bottlenecks faced by countries in different sectors. They also reflect the views of country authorities.
 - **Clearly articulate the anticipated development impact of the project based on evidence, for example, as in the AIMM approach.** As discussed earlier, these impacts can be grouped under both project outcomes and market outcomes.
2. Next, **identify market distortions and how these are addressed via IFC or other DFI additionality**:
 - **Identify the underlying distortions in the economy impeding the project from proceeding most effectively.** A broad set of distortions—public and private—should be considered, including distortions related to the efficiency of market outcomes (such as imperfect competition, imperfect information, externalities, public goods), as well as the equity of resource allocations. These could include distortions related to insufficient supply chains, very high start-up costs, poor market information, inadequate regulatory environment, poor local skills and experience base, inability to price for public

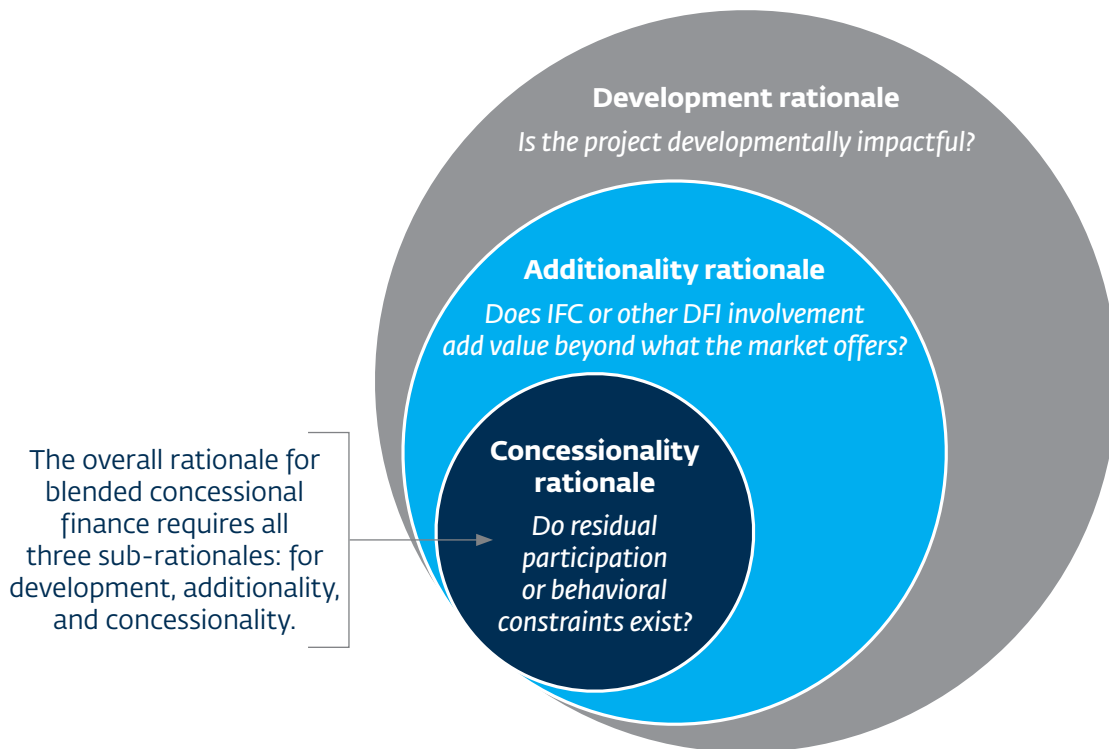


FIGURE 1.3 Articulating the Rationale for Blended Concessional Finance

Source: IFC.

goods, high market demand and off-taker risk, or inability to profitably employ or market to disadvantaged or underserved groups. (See Box 1.1 for a non-exhaustive list of distortions.)

- **Identify the additionality provided by IFC or another DFI and how it addresses the underlying distortions.** Both financial and nonfinancial additionality can be included, such as long-term financing or other financial products not readily available in the market, comfort that can crowd-in other investors, or advisory services related to the regulatory environment or client business and environmental, social, and governance (ESG) skills. (See Box 1.2 for a framework on DFI additionality.)
- 3. Finally, **identify the rationale for concessionality.** Identify remaining bottlenecks that limit projects with strong expected development impact from proceeding even with normal IFC or other DFI additionality, and that could be addressed with concessionality. Blended concessional finance may enable optimal participation (through de-

risking and return enhancement) and enhance development impact (through incentives and technical assistance):

- **Enabling Participation.** Participation constraints are barriers that prevent all parties in a contractual relationship from wanting to engage. Parties to the relationship may include IFC or another DFI, the sponsor, the co-capital provider, the developer, and the end user. IFC or another DFI, for example, may find the project's risk-adjusted return on capital (RAROC) too low, or a sponsor may require a higher internal rate of return (IRR) to participate. Concessional resources can help alter the risk-return profile, enabling investors, including the DFI, to participate.
- **Aligning Incentives.** Behavioral constraints refer to situations where there is a divergence of views among the project participants about key elements of the contractual relationship. Where distortions produce market outcomes that fail to maximize social welfare, concessionality can help realign incentives toward IFC's or another DFI's

development mandate. For example, blended concessional finance performance incentives may influence financial intermediaries to finance micro, small, and medium enterprises (MSMEs) or women entrepreneurs, or concessionality may lower end-user tariffs in a solar investment to induce energy consumers to embrace cleaner forms of energy.

The three components described above for the “overall rationale” for blended concessional finance—

1) development rationale, 2) rationale for IFC or another DFI additionality, and 3) rationale for concessionality—must all be present to justify the use of concessional resources. Box 1.3 presents a case study that illustrates how the rationale for using blended concessional finance can be articulated employing this framework.

In summarizing the overall rationale for utilizing blended concessional finance, it is important to highlight how the use of concessional finance extends the development impact of the private sector in the

BOX 1.1 Distortions that Underpin Additionality

1. Efficiency Concerns: Various distortions—of both private and public origin—may decrease or alter the efficiency of market outcomes.

- **Imperfect competition and economies of scale:** (Partial) monopoly power drives prices above and output below their efficient outcomes. DFI interventions may help improve efficiency by supporting new or existing players in the market to increase production and lower prices. Imperfect competition may arise from economies of scale in industries with large fixed costs of entry (such as large R&D investments or highly specialized capital equipment costs), in which case average production costs fall as more units are produced. Average production costs may also fall over time in the case of learning by doing that is internal to the firm—these are *dynamic economies of scale*.
- **Imperfect information:** A lack or asymmetry of critical information necessary to make informed decisions on the risk associated with a market interaction can result in issues such as problems setting correct prices for different market segments or having managers adequately represent the interests of investors. This increases transactions costs and may result in undersupply, for example, credit rationing.
- **Positive and negative externalities:** Externalities produce a misalignment of social and private incentives. Negative environmental externalities, for example, may result in overproduction relative to the social optimum. Underproduction tends to occur in the case of positive externalities that are not captured. For example, the beneficial aspects of firms clustering may not be captured, in which case there is *under-clustering* and lower productivity. Learning by doing may also produce benefits external to the firm, such as learning by exporting (Aitken and others 1997) which may produce demonstration effects that are not priced in at the level of the firm.
- **Public goods:** Goods (and services) that are available to all and are not depleted through use. Public good attributes make it difficult or costly for private firms to achieve adequate returns. As a result, public goods are typically provided by the public sector. However, there are cases when goods and services are provided by the private sector, often through public private partnerships (PPPs)—examples include street lighting and public safety infrastructure.

2. Distributional Concerns: Societies tend to hold preferences in relation to not just the efficiency but also the equity of resource allocation. Subsidies are used to achieve distribution objectives, including in cases where the market would have produced an efficient outcome. The new outcome could result in higher social welfare, or simply represent a different combination of outcomes that society considers to be more desirable from an equity perspective. This argument holds in the provision of basic goods and services (education, health, and basic infrastructure), provision of capital to underserved businesses, and inclusion, among others. In these cases, properly targeted subsidies are used to increase consumption by underserved or marginalized groups by addressing affordability concerns for these user groups or compensating producers for higher transaction costs associated with serving them.

country, such as by creating new markets in line with the development impact goals for the country, or by extending products and services to new consumers and end-users.

V. Conclusion

This chapter has discussed the role of the private sector in development, how IFC and other DFIs contribute to this role, and how concessionality can enhance the contributions of the private sector to development. A set of steps has been recommended to articulate the overall rationale for blended concessional

finance, which is being used by IFC and has potential applicability to other DFIs.

The concepts discussed in this chapter also highlight a number of issues with respect to justifying the use of concessional resources, identifying appropriate projects for blended concessional finance, using concessional resources most efficiently, and avoiding the inadequate use of concessional funds. This highlights the need for IFC and other DFIs to implement strong processes to ensure that blended concessional finance is implemented for maximum impact. These issues are discussed in the next chapter. ■

BOX 1.2 Types of Additionality

- 1. Financial additionality:** The financial value added by DFIs participating in an investment, beyond what commercial investors are able or willing to provide at reasonable costs. The main sources of financial additionality are summarized below.
 - **Financing structure:** Providing terms that are necessary for the investment but are not readily available in the market. Due to their development mandate, higher risk tolerance, and long-standing presence in emerging markets, DFIs can provide longer tenors, extended grace periods, and denomination of loans in specific currencies.
 - **Innovative financing structure and instruments:** Providing innovative financing structures or instruments that may lower the cost of capital, mitigate commercial risks, or bring other financial attributes not available from the market.
 - **Resource mobilization:** Mobilizing capital from commercial banks, institutional investors, private sources and (under certain conditions) other DFIs. Due to their syndication expertise, credit rating, convening power, and privileges, DFIs are often able to mobilize these resources more effectively and efficiently.
 - **Own-account equity:** Providing equity that addresses risk-capital gaps faced by certain types of investors, enhances financial soundness of a project, and/or credit-worthiness of the client.
- 2. Nonfinancial additionality:** This includes benefits to projects that come from mitigation of nonfinancial risks, improvements in standards, changes in design to enhance development outcomes, and strengthening regulatory and policy environments.
 - **Noncommercial risk mitigation:** Providing reassurance to clients and investors that political or regulatory risk are adequately mitigated. Noncommercial risk mitigation could be implicit (DFI lending its name and due diligence reputation to the project), or explicit (DFI providing noncommercial risk cover).
 - **Policy, institutional, regulatory change:** Triggering or supporting change in policy or regulatory frameworks to reduce sector risk or risk perceptions, improve capital flows, and enhance sector development practices.
 - **Knowledge, innovation, and capacity building:** Providing sector and market knowledge, expertise, and innovation, as well as building public and private capabilities, that are essential for project design, risk mitigation, and realization of expected development outcomes.
 - **Standard setting:** Raising environmental, social, and governance standards applied by projects and clients.

BOX 1.3 Case Study of VITO Rice: Articulating the Rationale for Blended Concessional Finance*

SUMMARY

The Project is a corporate loan to VITO Rice, a leading rice miller and exporter in Caledonia, a low-income, post-conflict country, to support the construction of a new rice mill and expand working capital. The corporate loan will help the Company increase its production capacity, increase purchases from local rice farmers in its supply chain, and extend further technical support to these farmers. VITO Rice is currently the only rice miller in Caledonia that works directly with smallholder farmers through contract farming models and co-ownership in specific activities in the value-addition process, including drying, storage, and trading. As part of the Project and through DFI-supported advisory services, the Company is also looking to increase its production of organic rice and rice certified as compliant with Sustainable Rice Platform (SRP) standards. The Project cost is \$12 million, to be financed through a loan package that includes a \$5 million DFI senior loan with a tenor of six years, a blended concessional finance subordinated loan of the same amount and tenor, and internally generated cash. Blended concessional finance is necessary for this project to go ahead at full scale, allowing the project to extend broad positive impacts to farmers, improve the efficiency and environmental sustainability of the sector, and demonstrate market viability of contract farming and sustainable practices.

THE COMPOSITE RATIONALE FOR BLENDED CONCESSIONAL FINANCE

1. The Sub-Rationale for Development Impact

Anticipated outcomes at the project level.

1) *Smallholder farmer access to markets:* The Project has positive income effects for smallholder farmers in VITO's supply chain. The Company currently sources rice from about 8,000 small farms organized around 45 agricultural cooperatives. Following the capacity expansion, farmer reach is expected to increase by about 20 percent. Through technical assistance provided by the Company as part of the Project, and stable off-take arrangements offered, smallholder farmers are expected to experience increased productivity, stabilized incomes, and improved livelihoods.

2) *Environmental and social effects:* The Project contributes to improving resource efficiency, adoption of climate-smart practices, and reduction of biodiversity risks in the rice supply chain, through adoption of SRP standards and increased production of organic rice.

Anticipated outcomes at the market level.

1) *Enhanced competitiveness of the sector:* The Project is expected to enhance the competitiveness of the sector by demonstrating the benefits of the contract farming modalities adopted in the Project, as well as superior financial business outcomes from niche product lines such as organic or SRP-certified rice that can be replicated. VITO will also offer training for relevant certification to selected cooperatives as part of its technical assistance, supporting the realization of market level effects.

2. The Sub-Rationale for Additionality

VITO provides market access to thousands of smallholders in a country where the rice sector still suffers from significant constraints despite its importance and solid growth in recent years. The sector faces environmental externalities resulting from unsustainable cropping practices and climate change effects including flooding and drought, while fragmentation and inadequate infrastructure makes it difficult for smallholders to access product and capital markets. Both the organic and SRP-certified rice markets are at nascent stages in terms of size, and are underdeveloped in terms of production practices. For these segments, market entry is restricted by lack of know-how, a small domestic market, and a lack of market information to assess risk. Finally, agriculture in Caledonia faces investment barriers resulting from underdeveloped capital markets, a high cost of debt, and unfavorable financing terms.

Financial additionality: The DFI will provide a financing package at terms not readily available in the market for agribusiness firms like VITO. Long-term financing is required to improve Project economics and allow the Project to proceed.

Nonfinancial additionality: DFI participation will provide technical know-how and access to global networks through advisory services to the sector, with the goal of improving farmers' capacity in new niche markets, as well as certifications on sustainable farming practices. DFIs also contribute to improving environmental and social impact management practices from the application of their E&S performance standards, which exceed national standards.

3. The Sub-Rationale for Concessional

Enable participation by de-risking senior lenders and providing a concessional interest rate: The concessional subordinated loan allows senior lenders to move forward with this investment and unlock the Project's envisaged development impact. Subordinated concessional debt is required to: 1) lower the cost of financing and preserve project economics given the Company's thin operating margins; 2) maintain lower senior debt leverage ratios at the corporate level; and 3) address risk from potentially insufficient collateral. Without blended concessional finance, project risk is un-bankable for senior lenders. As VITO is unlikely to find alternative sources of affordable long-term financing, blended concessional finance is necessary for the Project to go ahead at full scale, within the expected timeframe.

**The case study is a stylized case for illustrative purposes and is based on real IFC projects.*



A beneficiary of Acleda Bank (Women Entrepreneurs Opportunity Facility), Cambodia.

CHAPTER 2

Blended Concessional Finance— Transparency, Access, and Governance

By Kruskaia Sierra-Escalante, Arthur Karlin, and Morten Lykke Lauridsen

In recent years, DFIs have been expanding their use of blended concessional finance and broadening sectoral and country focus. They have also worked together to develop comprehensive policies for the most effective and efficient use of blended concessional finance as embodied in the “DFI Enhanced Principles.” To implement these principles, IFC has been developing robust transparency, access, and governance processes, which are discussed in this chapter.

DFIs and Blended Concessional Finance

Since July 2009, IFC has blended \$1.6 billion in concessional investment capital to support 266 investment projects that leveraged over \$13.2 billion in IFC and third-party financing. These investments have supported pioneering projects, including innovative energy efficiency financing in Turkey, SME finance in Central and Western Africa, and catalytic solar photovoltaic facilities in Thailand. Volumes have increased significantly in recent years (see Figure 2.1).

The DFIs as a group (covering about 25 development finance institutions that fund the private sector) now provide over \$1 billion of concessional funds each year and in 2019 supported over \$10 billion of projects.⁶ Key sectors that utilize blended concessional finance are infrastructure (particularly renewable energy), banking (much of it for supporting lending to SMEs), and other sectors, including agribusiness. Most DFI concessional finance is deployed in low-income and lower middle-income countries.

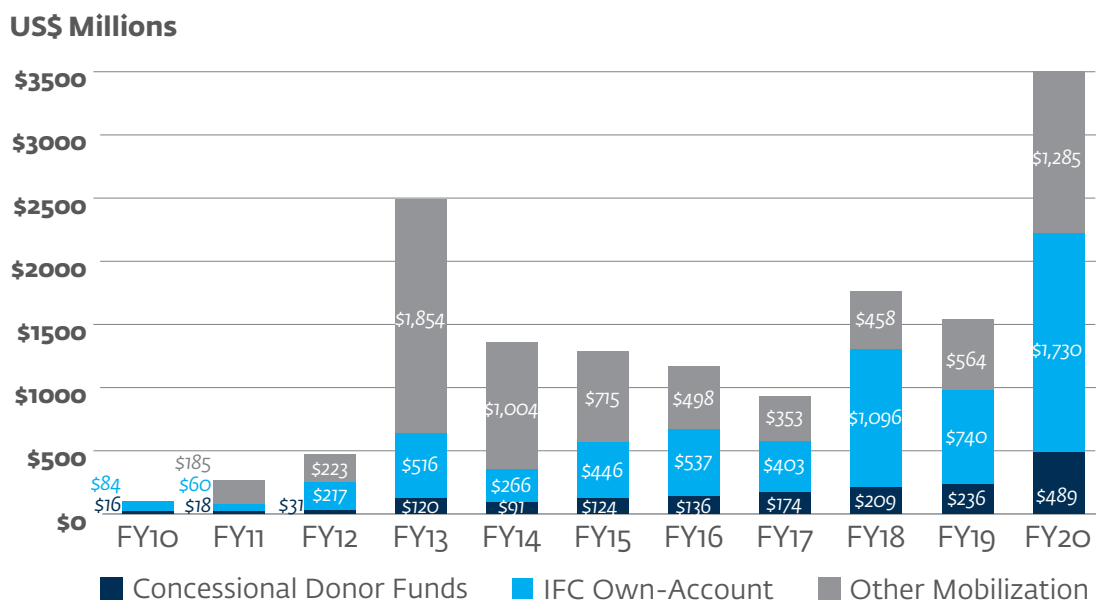


FIGURE 2.1 IFC Blended Concessional Finance Annual Commitments, FY2010–2020, Total Project Volume by Funding Source (US\$ Millions)

Source: IFC data.

Concessional support by DFIs has grown in recent years, and DFIs are significantly expanding program size and scope, especially to address high-risk countries and vulnerable groups, to increase support of green investments, and to respond to the challenges of the COVID-19 crisis.

Concessional funds used by DFIs generally come from bilateral and multilateral facilities funded by donor countries, as well as some finance provided by foundations and other third parties. The funds available have grown significantly in recent years, including some with a particular focus on lower-income countries. Historically, most funds were provided as grants or long-term contributions to concessional facilities, but in recent years there has been a trend of donors providing concessional funds as investment capital, expecting in some cases at least capital protection and in others also a certain level of regular return. This has the potential to further expand the pool of concessional funds available, as in many cases investment funds are not counted as part of a country's development budget.⁷

With this growth of blended concessional finance investments and greater availability of funds, the DFIs have been working together for several years to share knowledge and best practices to use these funds for maximum impact. Despite the growth, concessional funds remain quite scarce relative to their potential use, and thus require a clear protocol for effective deployment. One critical aspect of this is to carefully identify the right projects for concessional support and to identify what type of support is needed. This was the subject of the previous chapter.

Beyond identifying the right projects and type of support, DFIs also need to ensure that concessional funds are used as efficiently and effectively as possible. Key issues include identifying the right level of concessional funds to make a project viable without providing unnecessary subsidies to investors, avoiding distorting markets by favoring certain firms or creating dependency on subsidies, and providing appropriate advisory support to ensure that markets are reinforced and investments can succeed over the long term without continuous subsidies.

To help guide the effective and efficient use of blended concessional finance, DFIs have therefore developed a set of Enhanced Principles for using blended concessional

finance and corresponding processes to implement the principles. The next section discusses the DFI Principles, and the rest of this chapter will cover related processes to implement them.

Operating Principles for Blended Concessional Finance

DFIs that invest in the private sector have agreed to a strong set of operational principles (the DFI Enhanced Principles) that specifically address the issues discussed above.⁸

These principles include:

- **Economic Rationale for Using Blended Concessional Finance.** Concessional finance should be used for projects that contribute significantly to market development and where the concessional funds are required beyond DFIs' normal additionality to make projects viable. This generally means that the financing will help overcome market failures and provide benefits to society beyond the investors' returns. By facilitating and pioneering private sector projects, significant improvements can be achieved in the enabling environment, and private markets can then become open to additional companies that can operate without concessional support.
- **Crowding-in and Minimum Concessionality.** Since concessional funds are scarce, they should be used to the minimum extent possible to make projects viable and attract as much private commercial finance as possible.
- **Commercial Sustainability.** Projects and sectors need to become commercially sustainable over time to contribute to market development. Investments should thus have a clear path to sustainability, with a plan for how concessional support in the sector can be phased out over time.
- **Reinforcing Markets.** Concessional funds should create and reinforce markets. Markets started with concessional funds can become dependent on subsidies, preventing commercial players from engaging. To avoid this, attention should be given to all aspects of the market that are preventing the viability of commercial projects, such as issues related to regulations, suppliers, and skills. Supplementary advisory services and capacity-building interventions

may be required to address these issues. Furthermore, it is critical that the specific instrument used for blended concessional finance—whether it is debt, equity, a risk-sharing facility, a guarantee product, or a performance-based incentive structure—is clearly designed to meet the development challenge at hand. No single solution will fit all situations. To assess whether blended concessional finance is needed and how it can be effectively structured, it is essential to understand the restrictions and market failures and the sectoral and country context, and to articulate how blended concessional finance is supporting the creation of markets or is helping them move toward commercial sustainability.

- **Promoting High Standards.** All development projects should have high standards for environmental, social, and other issues, but those with concessional finance have a particularly high burden because of the direct public contributions. The use of concessional finance also requires strong governance and transparency processes to ensure that all the above principles are implemented.

Overall, in deploying blended concessional finance based on the DFI Enhanced Principles, it is essential to apply analytical rigor and transparency in assessing market failures, determine the size of temporary subsidies that may be needed, and evaluate the potential for market creation and development impact from providing concessional support.

The following sections discuss many of the processes that IFC has developed to implement the DFI Principles. The first section covers transparency in the use of concessional funds, which is central to clear accountability to shareholders and the public. The next section on “access” discusses the different ways that concessional funds are made available to private firms to ensure a wide level of availability to market participants, that strong players with high potential for development impact are funded, and that the appropriate level of funds are allocated. The final part of this chapter covers the internal governance structures used to manage concessional funds within IFC, to provide for effective and efficient use of funds and to manage any potential conflicts of interest that can arise when funding from different sources is managed within the same organization.

Transparency

Transparency is very important in the management of concessional funds. It allows donors, DFI management, Board members, and the public to see how public funds are being used, and that they are being used for maximum development impact, consistent with the above principles. Transparency also allows for the assessment of the role of blended concessional finance in the context of other development finance and instruments.

At the project level, there are four key areas of transparency identified by IFC that can help stakeholders track the appropriate use of concessional funds:

- **Economic rationale for blended concessional finance.** A description of the key market failures and analyses that support the use of concessional funds (see Chapter 1), including the expected development impact, the additionality provided by IFC, and the additional constraints to the project that are overcome through the use of concessional funds.
- **Evidence of minimum concessionality and crowding-in.** This could include, for example, the use of competitive processes or open access approaches to determine concessional levels or crowd-in private finance (see next section), or data on the level of concessionality relative to benchmarks to indicate that concessional levels are in a typical range.
- **Instrument mix and relevance toward identified market distortions.** The specific concessional instrument used (such as subordinated loans or performance incentives) and how this addresses underlying market distortions.
- **Adherence to the DFI Enhanced Principles.** How blended concessional finance is used in a way that adheres to the five DFI Enhanced Principles.

Additional items are relevant at the aggregate level. Information on **overall volumes** of blended concessional finance used in different sectors and geographies can aid the understanding of how concessional funds support development in different contexts. Data on **results** for blended concessional finance projects can help determine the effectiveness and impact of blended concessional finance.

At IFC, reporting is provided to contributors and Board members on all the above topics, and the key elements are also provided to the public.

Reports to contributors generally include projects funded, expected impact, and rationale for blended concessional finance, as well as details on the concessional co-investment. **Board reports** for each project include a section discussing the economic rationale for blended concessional finance and other blended concessional finance principles and how they apply to the project. Board reports also include the project structure and the role and amounts of concessional finance, including the level of concessional finance as a percent of the total project cost. For measuring impact, all IFC projects are evaluated using the AIMM framework that measures project contributions to market creation along the dimensions of competitiveness, integration, resilience, inclusion, and sustainability.⁹

Public documents regarding IFC's blended concessional finance transactions include pre-board disclosure that blended concessional finance will be used, the instruments employed, financing amount, and the rationale for the use of concessional finance (including expected development impact, additionality, and the reason for the use of concessional funds). And recently, to improve transparency with respect to blended concessional finance, **IFC began to release the estimated subsidy¹⁰ of every blended concessional finance transaction publicly as a percent of total project cost or project value.**

Additional public information is provided at an **aggregate level**. If requested by contributors, public reports can be prepared that show funded projects and expected impact. Overall levels of blended concessional finance used by IFC, and the resources mobilized, are released in public documents, including the annual report. Since 2017 (and comprising blended concessional finance data starting in 2014), the DFI Working group on Blended Concessional Finance has also been reporting on blended finance activities across 23 institutions, including leverage, breakdowns of volumes by instrument, and more recently, volumes by country income level. In addition, the World Bank Group's Independent Evaluation Group periodically reviews IFC blended concessional finance activities, including coverage of financial and developmental results.

Access to Blended Concessional Finance Solutions

One of the critical challenges in managing blended concessional finance is to address the “crowding-in and minimum concessionality” principle—to identify the right amount of concessional funds to make an important project successful and achieve high impacts, without overspending or allowing private participants to realize profits beyond those needed to make an investment viable. It is also important that all market players have an opportunity to have access to concessional funds to ensure the best projects move forward and that the DFIs thereby reinforce markets and do not unfairly support certain firms or “pick winners.” A number of processes have been utilized by IFC to achieve crowding-in and minimum concessionality. These include various types of competitive or open-access processes, such as competitive tendering/auctions or programmatic approaches, as well as project-specific negotiation procedures under very strong governance procedures in the case of demand-driven market-based opportunities. Each of these is discussed below (see Figure 2.2).

Competitive Tendering and Auctions

Some projects originate from a competitive tendering or an auction process. Auctions are increasingly being used throughout the world to procure energy and other infrastructure and have led to increased competition and reduced prices. In some cases, these projects have involved the use of blended concessional finance. An example is the World Bank Group's Scaling Solar program, under which blended concessional finance has been offered to all bidders through the bid documentation in a tender process. The Scaling Solar program provides a “one-stop shop” offering a package of relevant World Bank Group services with the aim of delivering competitively priced solar energy from private Independent Power Producers (IPPs) in a period of as little as two years. The package of services includes components related to project preparation, tendering, and indicative financing, including risk mitigation products and concessional finance. The program has proven effective at stimulating competition and reducing prices to consumers and has brought projects to financial close in Zambia and Senegal.

	Fully competitive tendering processes	Programmatic approaches	Demand-driven market-based opportunities
Development impact objective	Stated in advance, and potential clients can decide to participate in the initiative knowing its development impact objective	Stated in advance, and potential clients can decide to participate in the initiative knowing its development impact objective	Verified as the idea is proposed by the client to IFC
Competitive process for allocation of concessionality	Public tender	Predefined standardized parameters to access the program that is publicly advertised	Internal review and governance to simulate a competitive process that guarantees a fair outcome, based on pricing and benchmark assessments
Choice of client/ implementer of development impact	Fully transparent process with pre-set parameters in a tender	Internal review and verification of compliance with IFC standards, once a client proposes itself to participate in the program	Internal review and verification of compliance with IFC standards and client's ability to implement an impactful project through a proprietary idea

FIGURE 2.2 Processes to Allocate Concessional Funds

Source: IFC.

This approach works well for public services that can be tendered (for example, energy, health, or water). The mechanism effectively uses market dynamics to allocate concessionality. The development impact objective is defined ex-ante (for example, offer clean energy in a country at affordable tariffs), the process to access the subsidy is available to all relevant players in the market, and the choice of the player accessing the subsidy is part of a transparent process, as selection criteria are pre-defined. Thus, the process can encourage competition to find the best firms at the lowest costs and is used by IFC wherever possible. However, this method requires a number of specialized project characteristics: 1) a fairly standardized and known product output, allowing qualified companies to compete primarily on price, 2) a single buyer, usually a government off-taker for services like infrastructure, that can guarantee demand for the entire project output, and 3) a number of companies in the market that are capable of competing for the business. In tenders, concessional fund amounts can either be predetermined, so that competition is on price to the end user, or the amount can be determined as an outcome to the bidding process. Predetermined concessional

funds can be effective in high-risk contexts where the prepackaging of all elements of the tender is a key success factor for attracting a sufficient number of high-quality bidders. Determining concessional amounts as part of the bidding process may be more uncertain for bidders, but also may lead to less need for concessional funds, consistent with the minimum concessionality principle. Both processes ensure that private companies receive the minimum profits needed to make the project viable. The choice of approach will depend on the specific country and sector context.

Programmatic Approaches with Open Access

Many businesses and sectors lack the characteristics required for auctions—there are often many buyers in the market buying a wide range of products and services, under changing conditions with respect to demand and competition. For these situations, IFC is developing programmatic approaches with open access, for clients to access concessional funds. These approaches also benefit from market processes. IFC defines ex-ante the development impact objective expected and sets clear parameters for the clients to access the program, such

as the type of instrument offered and the fee they pay to access funds. Players know the conditions to participate and can apply, as the program is publicized. Clients chosen for a program must pass IFC's normal strict due diligence process to ensure project effectiveness, including respecting environmental, social, and governance standards.

One example of such a programmatic approach is IFC's Small Loan Guarantee Program (SLGP), a \$120 million allocation of the IDA Private Sector Window (PSW) to support Financial Intermediaries' expansion into the small and medium enterprise (SME) segment, providing a pooled first-loss guarantee at a standard fee range. The use of concessional finance from the IDA PSW allows the fee to be set at a range that makes supporting SMEs affordable for the financial intermediaries. SLGP has demonstrated the value of standardized products and programmatic approaches to efficiently scale up the impact of concessional finance. The program has had good uptake in countries such as Haiti, Cambodia, and eight African countries. It synchronizes with broader World Bank Group efforts to improve the enabling environment for SMEs to access finance, and incentivizes banks to do more lending to higher-impact projects and entrepreneurs.

Programmatic approaches such as the SLGP provide a mechanism for interested companies/financial intermediaries to access the program and can help ensure that the funds support projects with high impacts. The structure does, however, still require a well-known type of project or intervention, and one that can be replicated by many firms, so that the rationale for concessional funds, the program structure, and the fees can be determined in advance. Sectors such as SME finance, microfinance, and some well-established agribusiness, manufacturing, or service sectors may lend themselves well to this approach. Commodity businesses and provision of local currency risk mitigation products may also be good candidates for this approach.

Negotiations for Demand-Driven Market-Based Opportunities

Ideas to solve strategic development challenges (consistent with country strategies) can also present themselves "bottom-up" through IFC's regular pipeline origination. These bottom-up projects are often innovative, pioneering

investments that can facilitate market creation, and are typically in the agri-business, manufacturing and ICT (information, communication, and technology), and certain service sectors, where project sponsors put forward proprietary investment ideas.

These projects can be critical to development and raising standards of living, for example by providing new products and services tailored to local populations, or creating new competitive domestic and export sectors that can create jobs and raise wages. The products and processes and organizational structures may be unique or proprietary and not lend themselves to competitive or open-access processes where many of the project parameters need to be known in advance and applicable to many companies.

Yet in high-risk environments, these high-impact but pioneering projects may be especially difficult to finance due to high implementation risks and first-mover costs, and may need temporary concessional support to overcome constraints. To achieve the benefits of these projects with blended concessional finance, very strong governance and analytical processes are needed. The development objective is not stated in advance, but rather IFC verifies the anticipated development impact of the project idea proposed by the sponsor. To ensure that concessional funds are utilized efficiently and effectively, IFC needs to evaluate the need for concessional funds, amounts required, and the benefits expected (see below). Benchmarks may be useful, such as the amount of concessional funds needed for projects in similar countries and sectors, or the required internal rate of return for companies in similar circumstances. In certain cases, project benefits can be calculated (for example, emissions reductions) and compared to the amount of concessional funds utilized.

Governance

The presence of concessional funds can affect the profitability and risk profile of an investment project and the expected returns and risks for other investors in the project. There can thus be a conflict of interest between the providers of concessional funds and DFIs or other suppliers of funds on commercial terms. This is particularly a risk in cases where some of the competitive mechanisms discussed above (such as tenders) or open

access programmatic approaches are not available. Without strong discipline, DFIs may seek to employ concessional financing beyond what is required to make projects viable in an attempt to improve their own financial returns or to improve the financial returns of project sponsors or other investors beyond what is necessary to allow a project to proceed. As financial institutions, DFIs may also have volume targets in certain sectors that lead them to focus on getting deals done even when there is no clear path to commercial sustainability. Or, to meet targets, DFIs may seek to use concessional funds to merely compete with other DFIs. Governance structures are therefore needed to manage these potential conflicts and ensure the maximum impact of scarce concessional funds.

Implementing the DFI Enhanced Principles also introduces important requirements for analysis outside of the normal governance processes of DFI operations, such as identifying the economic rationale for concessional finance, assessing minimum concessionality, and considering whether it will be feasible to phase out concessional finance over time. Clear processes and experience are required to make these assessments, although care should be taken to ensure these added processes do not unnecessarily slow down project execution.

Demand for special governance arrangements where there are potential conflicts of interest is by no means new in the financial sector or among DFIs, and methods for dealing with the requirements for blended concessional finance have been sought in similar situations. For example, within DFIs, a common issue is the potential for conflicts between providing advice to governments and investing directly in projects affected by that advice. Managing these situations usually involves the separation of investment and advisory teams, clear rules about what data can be shared between teams, and disclosure to all parties involved about the potential for conflicts of interest and the processes employed to manage those conflicts.

Conflict-of-interest issues are also common in the financial industry. For example, in private equity funds, there can be different interests between general partners who receive fees and manage several funds, and limited partners who invest in the funds. These conflicts are

managed through agreed decision rules regarding different investment situations, and in many cases, the use of limited partner investment advisory committees that review transactions where there is a potential conflict. Another example is in commercial banking, where there may be a need to ensure that loan officers with volume targets maintain high credit standards. A separate, independent credit department can be employed to approve all loan decisions to provide the needed checks on investment departments.

Thus, although approaches to managing conflicts of interest vary greatly depending upon the situation, approaches can include transparency of decision making, independent decision reviews or separate decision-making bodies, restrictions on certain information sharing, and detailed processes to ensure rules are observed and appropriate analyses are done. These lessons should be employed to find the best possible solutions for handling potential conflicts of interest in DFIs and others engaging in the use of blended concessional finance.

IFC's Governance for Blended Concessional Finance

Drawing on some of the experiences and ideas highlighted above and the DFI Enhanced Principles, IFC has been developing, in accordance with its policies and procedures, structures and processes to ensure strong governance when using blended concessional finance. The major structures and processes are highlighted in Figure 2.3 and are discussed below.

Team Structures

IFC has established a dedicated team to handle concessional finance investments, separate from the investment teams and management that manage IFC's own funds. The team shares information on the project and works in partnership with IFC's operational teams. However, the concessional finance team represents the interests and monitors the engagement requirements of the concessional finance providers in the transaction, both at the investment stage and during portfolio supervision. This ensures that the contributors' development requirements and financial interests are strongly represented and that concessional finance principles are observed. Sector economists support the

IFC Management/ Decision Structures	IFC Processes	Analytics	Project Structures
<ul style="list-style-type: none"> • Separate concessional fund team • Independent decision making through Blended Finance Committee or the Blended Finance Department Director 	<ul style="list-style-type: none"> • Blended concessional finance principles addressed throughout the project cycle • Same policies as IFC • Presentations to Blended Finance and Investment Committees • Training/Guidelines 	<ul style="list-style-type: none"> • Concessional element benchmarks • Analysis of Expected Rate of Return • IFC's strategy processes 	<ul style="list-style-type: none"> • Co-investment model (IFC own-account investment together with the concessional co-investment) • Sponsor investment in the project • Performance incentives

FIGURE 2.3 Elements of IFC Governance for Blended Concessional Finance

Source: IFC.

blended finance team in the identification of market barriers and analysis of the economic rationale for providing concessionality.

Decision Processes

IFC uses a senior level decision-making process for blended concessional finance, which is independent from investment decisions for IFC's own account, including through a special committee called the Blended Finance Committee. This committee is chaired by an IFC vice president and comprises other vice presidents and directors who are not involved in the project and do not oversee the IFC own-account investment being discussed. If any potential conflicts of interest are identified, the committee members may recuse themselves from the decision. The committee or the Blended Finance Director reviews and approves the use, structure, and terms of concessional donor funds at both project concept and approval stages and is also involved in important decisions with respect to any significant portfolio events, including restructurings. The team managing the concessional funds leads the presentation of each project to the Blended Finance Director or the Committee, and most blended finance contributors delegate full decision-making for the use of their concessional funds to IFC.

Embedding Concessional Finance Principles and Analytics

IFC teams managing concessional funds participate throughout the project cycle and are responsible for

applying IFC's principles with respect to concessional finance, drawing from the DFI Enhanced Principles. IFC policies require teams to use the same standard of care for donor funds as they would with IFC's own funds. This includes the use of qualified staff and the application of relevant policies and procedures, including environmental and social performance standards and integrity due diligence with respect to lead investors and project managers. Specific discussion of concessional finance principles is required at early endorsement and final approval stages of projects and in project Board documents.

Special analyses are often required to ensure adherence to concessional finance principles. For example, to help assess and justify minimum use of concessional funds, a quantification of the concessional element in a project is required (see Box 2.1), including, when relevant, a comparison to the level of concessionality in

BOX 2.1 Calculating the Concessional Element in a Project

The level of concessionality provided by a blended concessional finance co-investment is estimated based on the difference between 1) a "reference price" (either a market price, if available; the price calculated using IFC's pricing model, which comprises three main elements: risk, cost and net profit; or a negotiated price), and 2) the "concessional price" being charged by the blended concessional finance co-investment.

similar projects.¹¹ Minimum concessionality may also be determined by examining expected returns on the project, with a comparison to appropriate benchmarks.

Blended concessional finance projects also go through the normal IFC decision processes, which, under IFC's *Creating Markets* strategy, provide a holistic focus on all elements, public and private, that are necessary to create and reinforce markets. This includes extensive diagnostics of key private sector constraints with the World Bank, a private sector development strategy in each country, the *Cascade* approach (see Chapter 4) to ensure public and private actions are used in an appropriate mix to open markets, and the application of technical assistance to help open markets where needed. In addition, staff managing blended concessional finance projects must articulate how the projects are reinforcing markets, presenting this information to the Blended Finance Director or the Committee and in Board documents.

Staff Guidelines, Training, Internal Promotion

IFC offers internal training programs for investment officers on adherence to concessional finance principles. Joint sessions have also been held between blended finance investment staff and IFC sector economists to refine the techniques for understanding and articulating the economic rationale for blended finance. Approval templates and Board and Blended Finance Director/Committee documentation include discussions on adherence to concessional finance principles. Training on blended finance and concessional finance principles is included for all new staff at the induction course for IFC.

Project Structures

IFC generally requires certain structural features for investments to provide appropriate incentives for all parties involved to strive to achieve commercial sustainability. For example, IFC's approach to blended finance requires an own-account investment in all blended concessional finance projects and requires that sponsors are directly invested in the project. These are important elements to align interests across relevant stakeholders. For financial institution projects targeting small and medium enterprises, concessional funds are often provided in

the form of performance-based grants to incentivize the achievement of development targets.

IFC Blended Finance Governance Systems in Action

An example illustrates how the IFC Blended Concessional Governance structures can improve projects.

IFC was considering financing the construction of one of the first solar power plants in a lower middle-income country in Latin America, which would demonstrate the feasibility of utility-scale solar projects in the country and region. Due to country risks, first-mover challenges with the new technology, and limited financing from international and local banks, the project was not bankable on commercial terms.

Making this project viable required a combination of concessional and DFI senior loans to improve the cash flow, and concessional subordinated debt to improve the risk profile for senior lenders. Initially, the project was structured with donor, IFC, and commercial senior loans and a donor-supported concessional subordinated loan.

However, lessons from previous investments indicated that sometimes subordination of blended finance investments to senior lenders can be difficult to manage, as conflicts regarding losses and payments can arise between IFC and other senior lenders and sub-lenders when there are financial issues. The IFC Blended Finance Committee, therefore, conditioned the larger donor sub loan on IFC investing a small amount in the form of a sub loan (in that case priced commercially), to align interests between IFC and the donor. Thus, in case of a restructuring, IFC would have a similar interest to the donor in negotiating the possible levels of compensation for holders of the subordinated debt. While this is not always possible, particularly in the context of low-income countries and fragile situations where there are no markets, strong governance structures can help assess when this alignment of interests is desirable or possible.

Different Approaches to Handle Conflicts of Interest

In addition to IFC, many DFIs have been making significant progress in implementing concessional finance principles, including strengthening their

decision-making and governance processes and internal capabilities.¹² Many institutions have prioritized having strong operating guidelines that specifically draw on the Enhanced Principles, as well as transparency regarding concessional funds use. DFIs are also putting in place various types of checks and balances on the use of concessional funds. Although there are many variations of these checks and balances, some of the main approaches include:

- **Team structures** range from 1) use of regular operational staff for structuring both the concessional finance and any DFI own-account finance, but with special detailed policies and guidelines for the use of the concessional funds, and with independent internal reviews; 2) use of dedicated and independent concessional finance staff, working with regular investment units, representing blended concessional finance issues in approval committees; and 3) independent concessional finance teams reporting to management outside of the investment departments.
- **Decision committees** also vary. Some DFIs have a separate blended concessional finance committee, while others use the regular approval committees but rely on the specialized and independent concessional finance staff or teams to represent the donor viewpoints. A third approach is to use the regular approval committees for decision-making, but with the advice and review of an independent technical level committee, which can be composed of in-house experts not connected with operations and may also include outside experts and peers.

The type of structures for checks and balances used by DFIs are driven by several factors:

- **Level of interaction with donors.** Some donors approve each project, providing a strong level of oversight that reduces the need for checks and balances within the DFI. Other donors delegate decision-making on individual projects to the DFI, placing a stronger requirement for independent decision structures within the institution.
- **Volume of blended concessional finance operations.** Separate concessional finance units and decision-making committees require a large volume of activity to support overhead costs but

may be justified over time. For example, at IFC, the governance structures evolved in stages as blended concessional finance grew over almost two decades.

- **The need for processing speed.** Separate decision committees introduce an additional decision layer in investment processing and can slow processing down. One way some DFIs address this issue is to use blended concessional finance committees on an exception basis—that is, only in cases with special issues—and delegate decision-making for other projects to lower levels.

Going Forward—Key Issues

Effective management of concessional funds requires sound processes to implement the DFI Enhanced Blended Concessional Finance Principles and to ensure funds are used effectively and efficiently without market distortions. As demonstrated in this chapter, there is a range of processes in the key areas of transparency, access, and governance that IFC employs to manage concessional funds. The use of specific processes by IFC or other DFIs will depend on many factors, including the project and country context, as well as the DFI or other blended concessional finance implementer's specific circumstances.

Going forward, three issues are key for progress:

First, DFIs and other implementers need to continue to share experiences with different approaches to managing blended concessional finance in order to make improvements that ensure that concessional funds are used effectively and efficiently, with maximum impact on market creation. Models for access and governance should evolve based on their effectiveness, with a joint vision of learning from each other. DFIs will need to provide rigorous evaluation of the effectiveness of their transparency, access, and governance processes to provide the necessary feedback loop.

Second, the incentives of the different actors involved in blended finance transactions need to be understood at the start of any transaction, as the motives of a financial intermediary might be different from those of donors. Blended concessional finance management processes should focus on managing potential

conflicts of interest, including between DFIs, and on implementing strong principles for the use of concessional finance, based on the DFI Enhanced Principles. This is even more crucial as concessional finance is entrusted to private sector actors that may not have experience in managing public resources or providing concessionality to private sector operations. Donors can play an important role in enhancing good governance by ensuring adherence to the DFI Enhanced Principles in agreements with implementers of their blended concessional finance programs.

Third, any management process for the use of blended concessional finance should be based on transparency, both for private and public actors involved in investments. Disclosure of information on concessionality is essential to providing the required trust among all actors and should be a key element of DFI cooperation. DFIs should also encourage wide access of qualified firms to concessional funds to strengthen markets and avoid “picking winners,” and share evaluations and monitoring of results from the use of concessional funds. ■

PART II. LESSONS FROM IFC'S EXPERIENCE IMPLEMENTING BLENDED CONCESSIONAL FINANCE

A photograph of a man wearing a straw hat and a light-colored shirt, smiling as he pours a large amount of grain from a woven basket. The background shows a clear blue sky and some green trees. The man is wearing a silver bracelet on his left wrist.

Bonne Viande de Madagascar (BoViMa), Madagascar.

CHAPTER 3

Selecting and Structuring Infrastructure and Other Projects for Blended Concessional Finance

By Neil Gregory and Kruskaia Sierra-Escalante

For over a decade, IFC has been using blended concessional finance selectively to fund projects and has learned some key lessons from this experience. Successful implementation starts with a sound project design that reduces and appropriately allocates risk to different parties, and targets blended concessional finance where additional risk reduction is warranted. Streamlined project preparation can reduce costs and risks and bring more projects to financial viability. Further, deployment of blended concessional finance requires focused resources for effective execution.

There are many shapes and forms in which commercial and concessional funds can be combined—or “blended”—within the scope of one project. When applied indiscriminately, blended concessional finance can subject projects and sectors to numerous pitfalls, including market distortion and inappropriate risk allocation.

The proper deployment of concessional blended finance requires a careful understanding and navigation of these potential pitfalls. But the payoff is worth it: When done well, blended concessional finance has proved to be a highly effective catalyst for jump-starting high-risk, nascent markets in developing countries.

Below are four key lessons from IFC’s experience with blended concessional finance: 1) a disciplined approach to project selection and design, 2) effective management of project risks, 3) streamlined project preparation, and 4) effective execution.

A Disciplined Approach to Project Selection and Design

Approaches to deploying blended concessional finance should not be attempted lightly. There are not enough bankers, lawyers, and donor officials to run every investment through a complex blended concessional

finance structure, and the incorrect application of blended concessional finance can waste significant resources on dead-end projects while sending false market signals. Discipline and strategic deployment are crucial.

Before choosing to use blended concessional finance to increase funding in a priority area, several questions must be addressed. First, are the fundamentals in place to produce financeable transactions? Blended concessional finance will not make a financially unsustainable activity sustainable. Nor will it render unaffordable infrastructure suddenly affordable. In such cases, blended concessional finance could make subsidies opaque and quite likely suboptimal.

As noted by Michael Klein, power tariffs in emerging markets, on average, cover 80 percent of cost, while water tariffs cover 30 percent.¹³ Private investment will not flow into power and water assets on this basis—these are simply not viable investments. Governments can either transparently address these viability gaps by closing them (by raising prices and/or cutting costs) or by filling them with subsidies. Either method is transparent and provides a basis for attracting private investment so long as the solution is sustainable. Concessional finance can sometimes be helpful to tip the balance in marginally profitable, risky projects

toward attracting commercial investment, but it cannot alter the fundamental economics of an industry. To scale up finance, we need to build an investment climate and regulatory framework that generates robust project structures on a replicable basis. Blended concessional finance can help critical investments proceed but should be seen as a stepping stone to more comprehensive reforms.

Effective Management of Project Risks

Where the fundamentals of project economics and investment climate are in place, blended concessional finance can make the difference in moving a project forward. To do so, it is important to think carefully about how to mitigate project risk. Note that risk transfer is not the same as risk mitigation. While it is possible to use concessional public money for guarantees, mezzanine tranches, and other structures to buy down part of the project risk, that approach does not make a project less risky; it merely transfers the risk to the public sector contributor. In the long term, it is preferable to pursue risk-allocation structures that align risk exposure to the ability to

manage that risk—thus providing incentives to reduce the risk. Private investors do not mind taking risks as long as they can diversify and hedge them, but they will want to be compensated for the risks they are taking—resulting in more costly, less affordable infrastructure. In contrast, structuring to reduce risk strengthens the economic fundamentals and makes infrastructure more affordable.

Good project structuring allocates risk to parties best able to manage it, hence reducing overall project risk. Public institutions with a relationship with the government, such as multilateral development banks, are better placed to manage political risk than are private investors. For example, the Multilateral Investment Guarantee Agency (MIGA) is able to offer affordable political risk insurance in even the highest risk environments because of its unique relationship with host governments and status as a member of the World Bank Group. Good risk allocation also considers the different risk appetites of various parties. A key value addition of blending public and private finance is that it brings different risk appetites and time horizons into the transaction.

BOX 3.1 Blended Concessional Finance in Practice

GLOBAL AGRICULTURE & FOOD SECURITY PROGRAM (GAFSP)

GAFSP's Private Sector Window (PrSW) is managed by IFC and provides innovative financing to enhance the commercial potential of smallholder farmers and small and medium enterprises. Among its approaches is a blended concessional finance mechanism to crowd-in private sector investment funding by enhancing the risk and return profiles of projects that might not otherwise attract commercial funding. GAFSP funding is co-invested alongside IFC funding, with concessional funds allowing investments to target market failures and invest in early-stage, risky projects with sound business plans and a high degree of development impact. Every one dollar of PrSW funding leverages four dollars of private sector funding, and since 2013 this has seen the deployment of \$305 million in funding to support 66 investment projects with a total size of \$1.5 billion.

BLENDED CONCESSIONAL FINANCE FOR CLIMATE CHANGE MITIGATION AND ADAPTATION

IFC has roughly \$1.4 billion in concessional donor funds under management, which have been used or will be deployed in conjunction with IFC's commercial funds, to catalyze climate-smart investments with high development impact that would not occur under normal market conditions. Using concessional financial instruments such as soft senior or mezzanine loans, direct equity investments or private equity funds investments, and guarantees, IFC addresses market barriers to facilitate pioneering projects that combat climate change and provide powerful demonstration effects. Since 2010, IFC has committed \$624 million in donor finance for climate change to mobilize \$1.7 billion in IFC financing and \$5.1 billion in private sector investment.

This approach offers opportunities for blending public and private finance on commercial terms in ways that structure assets to meet private sector risk and time profiles. For example, public money may have a longer time horizon, and so can offer longer tenors or deferral features, allowing private investors to take shorter-term risk. Or the public sector can take the construction risk (which it may be better able to monitor and manage) and then sell down assets to private investors post-construction when those risks have passed. Before using subsidies, donors can consider what could be achieved simply through patient capital.

Risk appetites are constrained by the size of balance sheets. Investors decide how much capital they want to put at risk for different risk exposures. Hence, a constraint to financing large investments is that the ticket size for investors may exceed their risk thresholds, either for specific deals or for their total investment portfolios of that asset type. Financial intermediaries can help by distributing assets across multiple investors to reduce the risk exposure of each investor, as in syndicated loan programs. But at the portfolio level, investors may soon fill their appetites for certain risks (for example, small countries and fragile states) while many investment needs remain unmet.

Blended concessional finance can play an important role in expanding the risk appetite of private investors by partially guaranteeing their exposure or by helping rebalance their risk-reward expectations. At its simplest, a 50:50 risk-sharing arrangement can double the exposure that an investor is willing to take in a particular type of investment. But it can do more than that: By introducing investors to new classes of risk they have not had previous exposure to, blended concessional finance can help calibrate their risk perceptions. As their perception of risk falls, the share of risk or the incentive support that concessional finance needs to take (or provide) may also decline.

Most investments, especially in infrastructure, generate revenues in local currencies related to the performance of the local economy. Financing these investments from local banks and capital markets can be a good way to remove currency risk. Governments and development finance institutions should look at ways to mobilize domestic savings pools—which are

increasing as populations age and more people save for retirement, and as growing middle classes save more and purchase more insurance.

These savings can be intermediated through domestic bond markets, domestic financial institutions, and domestic corporates that finance infrastructure and other investments on-balance sheet through corporate finance. Of course, this approach works better in larger emerging markets where financial institutions and capital markets are big enough to intermediate significant capital flows. For smaller countries, regional financial institutions and capital markets can play a similar role, but unless the region shares a common currency, some currency risk will remain.

Streamlining Project Preparation

One-off deals are often too costly to appraise and offer too much risk concentration. Aggregating assets allows for risk diversification and can create large enough ticket sizes to attract developed market pension funds, insurance companies, sovereign wealth funds, and endowments. Public finance can have a bigger impact by participating in structured finance transactions for portfolios of assets rather than project-by-project financing. In smaller, frontier markets, donors are interested in supporting “capacity building,” but more attention should be given to streamlining origination—making it simpler to assemble projects rather than support complex processes. This approach emphasizes standardization of deal terms and instruments, common appraisal standards, and de-bottlenecking governmental and regulatory approvals.¹⁴

The Importance of Effective Execution

Over the past decade, following the successful deployment of pilot projects, IFC has created a dedicated blended concessional finance product offering. This has enabled IFC to build a track record as a disciplined investor of concessional donor funds, employing well-defined procedures that encompass all stages of the project cycle, from project due diligence and approval to monitoring and evaluation. This approach has made donors comfortable with delegating authority to IFC for project approvals, which maximizes efficiency in support of impactful projects.¹⁵

BOX 3.2 Additional Examples of Blended Concessional Finance in Practice

GLOBAL SME FINANCE FACILITY

Small and medium enterprises (SMEs) in emerging markets face a trillion-dollar financing gap. While banks in some markets are beginning to move into SME lending, there are segments that remain almost totally underserved. These include SMEs in fragile and conflict-affected markets, women-owned businesses, education and healthcare SMEs, and firms in rural markets. This facility helps increase access to finance for such SMEs by providing financial intermediaries with dedicated SME lending windows and guaranteeing loans made to SMEs using blended concessional finance. The facility also shares best SME lending practices and provides advice to enhance banks' SME operations in areas such as product development and risk management. This approach alleviates the real or perceived risks that prevent commercial financing of projects in a sector.

BLENDED FINANCE FOR GENDER IMPACT

Blended concessional finance investment solutions capitalize on partnerships among diverse actors, including international organizations, development cooperation agencies, and private enterprise. An example of such a partnership is the Women Entrepreneurs Opportunity Facility (WEOF), launched in March 2014 by IFC and Goldman Sachs 10,000 Women. This is a first-of-its-kind global facility dedicated to expanding access to capital for women-owned small and medium enterprises. It also aims to signal the relevance of this asset class to the broader investor market. The funding for the facility includes \$50 million of blended concessional finance from Goldman Sachs 10,000 Women to create performance incentives for financial institutions to boost their lending to this segment, and to support capacity building among financial institutions and women borrowers. WEOF in its first five years (2014–19), with \$20.8 million in performance-based incentives, has directed \$1.4 billion of IFC's and other commercial investors' financing to 53,000 female entrepreneurs and SMEs across 33 countries.

Similarly, a newer facility, the Women Entrepreneurs Finance Initiative (We-Fi), is a multi-donor initiative to address barriers to financial access to women entrepreneurs and women-led SMEs, and provide related services that address public and private sector constraints to these women and firms across the developing world, thereby promoting jobs and boosting economic growth. The funding for the facility includes \$49 million of blended concessional finance from We-Fi. To date, We-Fi has provided \$733,000 in performance-based incentives that has directed \$136 million of IFC and commercial investor financing to women-owned SMEs.

Key Findings

Blended concessional finance is not a silver bullet and should be used only as part of a broader strategy that includes regulatory and pricing reforms. Overall, however, this type of finance has proved to be an effective element of the development finance toolkit and will continue to be going forward.

Blended concessional finance investment solutions

capitalize on partnerships among a multitude of development and private sector partners: international organizations, donor agencies, and private enterprise. For this multi-stakeholder partnership to have the desired development impact, public institutional expertise and emerging-market knowledge are essential to identify and structure projects that can demonstrate market and sector sustainability in the long run. ■



A beneficiary of YES Bank (Women Entrepreneurs Opportunity Facility), India.

CHAPTER 4

Scaling Up Private Investment in Lower-Income Countries

By Kruskaia Sierra-Escalante, Arthur Karlin, and Morten Lykke Lauridsen

Blending funds from private investors with concessional funds from donors and philanthropic sources has the potential to scale up investment in lower-income countries and accelerate development. The use of blended concessional finance is already weighted toward lower-income countries; over 70 percent of IFC's blended finance commitments are in lower-income countries. Recent strategies from the World Bank Group indicate that the relative share of lower-income countries in IFC's global mix of blended concessional finance will increase further. Scaling up engagements in lower-income countries requires solutions tailored to local contexts, as well as the deployment of the whole spectrum of development finance tools, including advisory work, regulatory dialogue and reform, and a mix of blending instruments encompassing both pricing and risk mitigation features.

Recognizing the Needs

In lower-income¹⁶ and fragile countries, access to private financing is often scarce due to both real and perceived market risks, including regulatory constraints, poorly developed investment climates, inadequately educated and trained workers, and a pronounced infrastructure gap. Comprehensive solutions and strong domestic leadership are required to tackle these issues, and blended concessional finance can help by unlocking untapped investments for sustainable development.

Blended concessional finance is needed given the difficulties inherent in financing private businesses in lower-income countries. As illustrated in Figure 4.1, only a fraction of lower-income countries today have investment-grade ratings. Yet many private investors have a preference—or even a regulatory requirement—for investment-grade products in their core investment strategies. More than 80 percent of lower-income markets remain below investment grade, which significantly restricts the amount of private funding available in these countries and underscores the need for blended concessional finance to initiate transactions and demonstrate their long-term commercial viability.

The challenge for crowding in private investments in lower-income countries is often to initiate first-of-their-kind investments that can showcase commercial viability in the longer run, and thereby attract subsequent private investments on commercial terms. To address common market failures in lower-income countries, the World Bank Group has developed the “Cascade” approach. This entails prioritizing private sector solutions, when possible, to promote the judicious use of scarce public resources. Where markets are not conducive to private investment, the World Bank Group focuses on reforms that address market failures and constraints to private sector solutions at the country and sector level. Where risks remain high, the priority will be to apply de-risking instruments such as guarantees and risk-sharing instruments. In these situations, blending concessional funds from public or philanthropic sources with funds on commercial terms from private sector sponsors, banks, development finance institutions (DFIs), and other participants has significant potential as part of a comprehensive solution.¹⁷

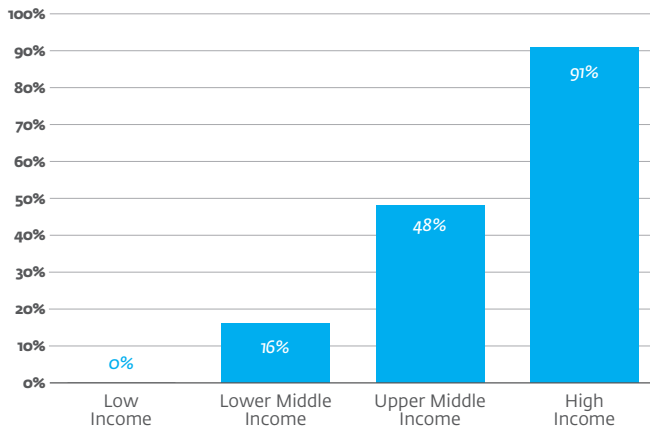


FIGURE 4.1 Percent of Countries with Investment Grade Ratings, 2015–17

Source: IFC calculations based on Fitch Sovereign Ratings. World Bank income classification is based on GNI per capita: Low-income countries (LIC) \$995 or less; lower middle-income countries (LMIC) \$996 to \$3,895; upper middle-income countries (UMIC) \$3,896 to \$12,055; high-income countries (HIC) \$12,056 or greater.

Applying the DFI Enhanced Principles, which provide agreed rules across DFIs to use concessional funds effectively and minimize market distortions (see Chapter 2), also becomes even more important in lower-income countries where benchmarks for commercial terms are often less clear, and where perceived market risks are often greater. Avoiding potential pitfalls and ensuring concessional funds are used appropriately by implementing the joint DFI Enhanced Principles can help to effectively scale up private sector engagements in lower-income countries.¹⁹

Blended Concessional Finance Utilization in Lower-Income Countries

Blended concessional finance by DFIs is already focused on lower-income countries, and, for IFC, the share is expected to increase as fund availability and donor interest increase. In lower-income countries, there is often a need to offer products that go beyond senior debt, and it is important to use multiple instruments in a coherent approach that may in some instances involve higher levels of concessionality.

Figures 4.2 and 4.3 show data from the 2017 and 2018 surveys of DFIs’ use of blended concessional finance undertaken by the DFI Working Group on Blended Concessional Finance in Private Sector Projects.²⁰

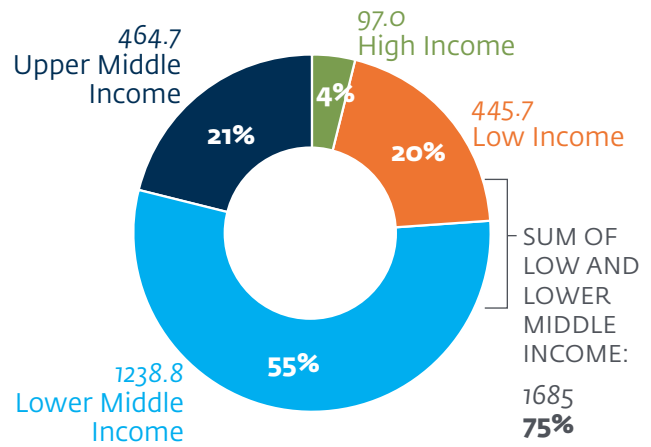


FIGURE 4.2 DFI Concessional New Commitments by Income Level, 2017–18 (US\$ Millions)

Source: IFC calculations based on DFI self-reported data.

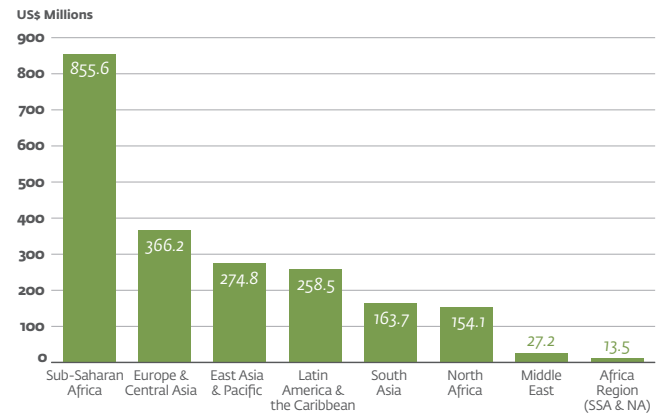


FIGURE 4.3 DFI Concessional Amounts by Region, 2017–18

Source: IFC calculations based on DFI self-reported data.

Figure 4.4 shows the concessional amounts by income level specifically from IFC. As illustrated, blended concessional finance is particularly prevalent in lower-middle-income countries and in Sub-Saharan Africa.

Recent IFC strategies and new concessional resources indicate that the relative importance of lower-income countries in its blended concessional finance mix is likely to increase in the future. IFC has established a target to increase its share of new commitments in IDA countries—largely low- and lower middle-income countries—from about 25 percent today to 40 percent by 2030, and increase its share in low-income and fragile countries from about 10 percent to 15 to 20 percent over the same period.²¹

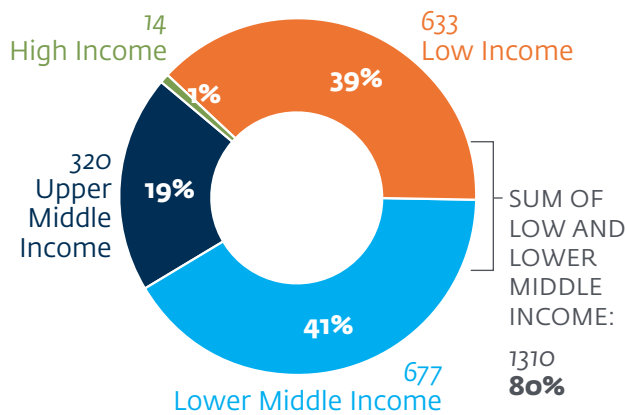


FIGURE 4.4 IFC Concessional Amount by Income Level, FY2010–20 (US\$ Millions)

Source: IFC data. Based on World Bank country classifications in year of commitment.

New concessional resources from the IDA-IFC-MIGA Private Sector Window (IDA PSW) are specifically targeted toward lower-income countries and are becoming an important component of IFC resources available for blended concessional finance. Figure 4.5 illustrates the significance of IDA PSW for allocations to lower-income countries. The IDA PSW primarily targets the poorer IDA countries (specifically IDA-only countries) as well as IDA-eligible fragile countries, and it also increasingly enables deals that include other

DFIs. It also expands IFC’s blending capabilities to include new sectors (e.g., in manufacturing) and new instruments (e.g., local currency hedging and off-taker risk mitigation). IFC is also increasing advisory services in lower-income countries via its new Creating Markets Advisory Window.

Instruments and Concessional

The blended finance instruments used by IFC in lower-income countries have several differences from those used in higher-income countries (Figure 4.6). Lower-income countries tend to have a greater variety of instruments beyond senior debt, with a combination of cost and risk bearing through pricing, incentives, subordination, or use of equity or guarantees.

Advisory services are also used more extensively in lower-income countries to help create the capacity and conditions for effective private sector operations. This reflects the combination of constraints often found in lower-income countries that are related to risk parameters, costs, capacity, and regulatory issues.

The amount of concessionality required in lower-income country projects also tends to be greater. This can be inferred from DFI data in Figure 4.7, which compares total project cost and concessional financing amounts, and indicates a relatively higher share of concessional

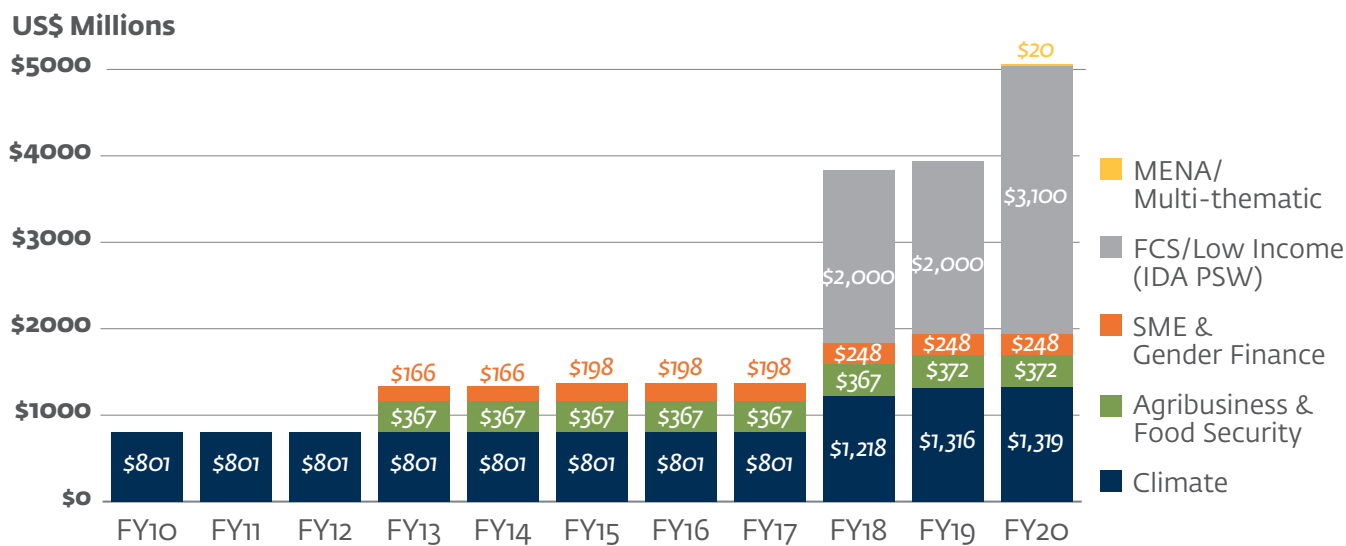


FIGURE 4.5 IFC Blending Concessional Funds Under Management by Thematic Focus, FY2010–20 (US\$ Million)

Source: IFC data.

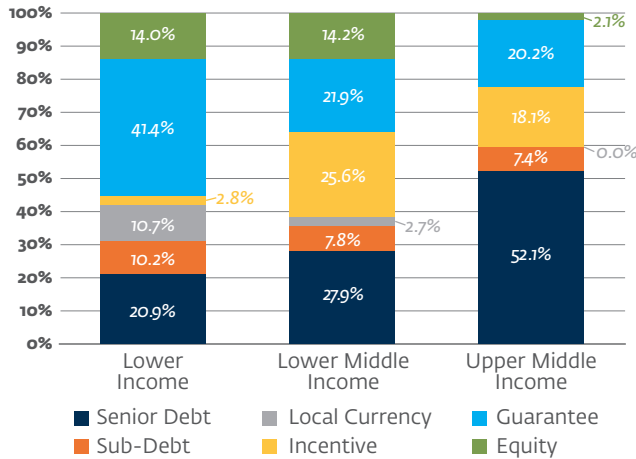


FIGURE 4.6 IFC Blended Concessional Finance Commitments by Concessional Instrument, by Project Count, FY2010–20

Source: IFC data. Based on World Bank country classifications in year of commitment.

finance for projects in lower-income countries than in upper middle-income countries.²²

IFC’s experience with blended concessional finance confirms that this observed level of concessionality—or embedded subsidy as a percentage of total project cost—tends to be higher in lower-income countries.

The Importance of Blended Concessional Finance to Lower-Income Countries: Case Study Examples

Blended concessional finance has significant potential in lower-income countries, especially when the blending is part of a comprehensive approach supporting local capacity development and policy change to create new markets. The three case studies below provide examples of some of the characteristics of blended concessional finance in lower-income countries and how they relate to advisory services and the prevalence of risk-bearing instruments. These examples also illustrate the Cascade approach of the World Bank Group.

Helping Farmers and Agribusiness in Madagascar

Three-quarters of Madagascar’s population lives in extreme poverty, and 80 percent are dependent on agriculture. Although Madagascar has excellent conditions for cattle and goat production, inadequate

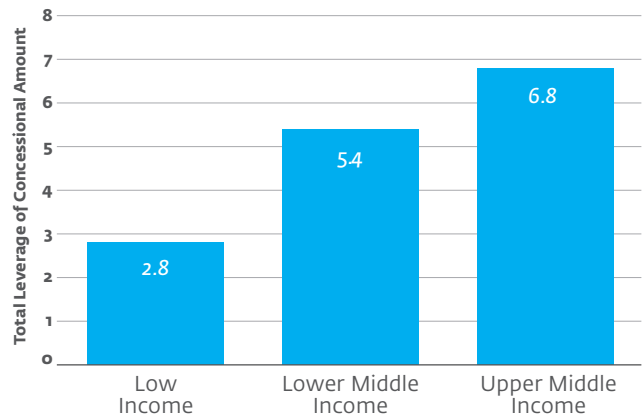


FIGURE 4.7 DFI Total Leverage of Concessional Amount, 2017–18

Source: IFC calculations based on DFI self-reported data. Concessional amounts include concessional contributions from sources beyond the DFI reporting group.

veterinary services and infrastructure limit economic opportunities and exports. The government of Madagascar, with World Bank support, has been helping rural herders and farmers improve incomes by expanding veterinary services, developing new road infrastructure, addressing agriculture value chain policy and governance issues, and building related technical capacity.

IFC is complementing these activities with support for a local agribusiness firm, BoViMa, which is developing the country’s first modern feedlot and abattoir. With support from the Global Agriculture and Food Security Program (GAFSP), advisory services are provided to help BoViMa improve animal husbandry and strengthen the company’s supply chain for both breeders and local farmers who produce animal feed. IFC and GAFSP are also providing a \$7 million subordinated debt investment in the company to make the project viable and crowd-in other investors.²³ The blended concessional finance will allow the BoViMa project to help support the livelihoods and operations of more than 20,000 local herders and farmers.

This project illustrates how a comprehensive approach involving advice to government and suppliers, development institution financing, private sector sponsorship, and donor-funded concessional

co-investment can help create markets. The project required extensive effort to develop but could revive the country's former export market for beef and goat meat. The project also illustrates the importance of higher risk-bearing instruments such as subordinated loans in high-risk environments.

Housing Finance in West Africa

Less than 7 percent of households in the countries of the West African Economic and Monetary Union (WAEMU) can afford to buy a home, partly due to a lack of financing. The region's mortgage market is quite limited, with short tenors that average less than eight years. Banks generally have short-term liabilities that limit their ability to lend long-term, and they have difficulty obtaining external long-term funds in local currencies due to poorly developed local capital markets. The World Bank and other DFIs are supporting a comprehensive housing development program in the region that includes the development of effective regulations and government planning with respect to the many areas that affect housing.

To support this overall program, IFC is providing financing to CRRH, a mortgage finance company serving the eight countries of WAEMU. IFC is helping to scale a market in bonds supporting housing finance by purchasing local currency bonds issued by CRRH at longer maturities than the company been able to issue in recent years. This is starting with 12-year tenors, but eventually is expected to reach 20 years. The project is important to help pioneer these long-maturity bonds and over time establish the viability of the long-maturity housing bond market for the region.

The IFC financial package used concessional funds from the IDA Private Sector Window (PSW) to assume risks associated with providing local-currency financing, which is essential for a project based on local-currency revenues. Over time, the long-term bond market should become viable with local-currency funds coming from local investors, including institutional investors. The risk mitigation provided by the PSW will allow for greater access to long-tenor mortgages and thereby help increase the affordability and availability of housing as well as contribute to economic growth and job creation.

This project illustrates the importance of a holistic approach, with a combination of government regulatory reform, private investment, DFI involvement, and donor support to help create long-term impact and new markets. An innovative financing instrument was also used—the PSW Local Currency Facility provided risk guarantees that allowed IFC to obtain the domestic currency funds and thereby fulfill its role of strengthening the emerging long-term housing finance market.

Distributed Generation in the West Bank and Gaza

Gaza's only power plant suffers from a lack of fuel, aging feeding lines, and damage caused by ongoing conflict. Outages range from 12 to 16 hours per day, with annual supply at less than 50 percent of average demand. The Palestinian Authority is working with the World Bank Group and international partners on an energy reform agenda, including reforms to enhance financial discipline, help public institutions improve the efficiency of electricity distribution, and pilot new business models for solar energy in Gaza.

Contributing to this program, IFC, MIGA, and the World Bank, with donor support, are financing a \$12 million, 7-megawatt rooftop solar project in Gaza—the first privately financed energy project in more than a decade. This will provide critical energy to 32 factories in Gaza's only industrial park—the Gaza Industrial Estate—at a price 10 percent cheaper than current grid-provided power and up to 50 percent below the cost of diesel-based generation. Project financing will include up to \$4 million in loans each from IFC and the IFC-Canada Climate Change Program, a blended concessional finance program supported by the Government of Canada. MIGA is providing critical political risk insurance from two trust funds supported by government contributions.²⁴ Thanks to the reliable and cheaper electricity that will be available to factories inside the park, the project is expected to create approximately 800 direct and indirect jobs.

Donor financing was critical to achieving the financing structure that will support the extensive job creation. The project demonstrates the importance in lower-income countries of anchoring blended concessional finance in an overall sector development strategy. It also illustrates how the use of a combination of

instruments—concessional, risk guarantees, and grants or “ultra-blending”—may be necessary in lower-income countries.

The Journey Ahead

The data presented in this chapter illustrate a strong focus on lower-income countries among development finance institutions. This trend is likely to continue through innovative mechanisms with an explicit focus on lower-income and fragile countries such as those targeted by the IDA-IFC-MIGA Private Sector Window.

The cases presented in this chapter illustrate three important lessons for the journey ahead on how to scale concessional finance to lower-income countries.

The first lesson is that DFIs must prioritize working in difficult environments—and be willing to take risks in doing so. Multiple instruments will be required to tackle different market barriers and have sufficient risk absorption capacity in lower-income markets. Innovative models are needed that can be adjusted to local circumstances, as are exit strategies to avoid creating long-term dependence on concessional finance.

A second lesson is the importance of comprehensive approaches where the use of blended concessional finance should never be seen in isolation from other efforts. In lower-income countries, it is important to view the use of concessional finance as part of a transformative process that involves actions at many levels to maximize long-term development finance. Operatively, this approach implies a close link between blended concessional finance, advisory services, upstream efforts, sector plans, and regulatory reforms to maximize development finance.

The third lesson is the crucial importance of stronger cooperation between development banks with respect to strategies and approaches to blended concessional finance in lower-income country contexts. The latest data from the DFI working group on blended concessional finance shows that more than 70 percent of new commitments were to lower-income countries. With increasing engagements in lower-income countries, it also follows that DFIs have the opportunity to coordinate and share experiences to support sustainable development and new private markets. Continued interactions among DFIs will further enhance the overall effectiveness and discipline of blended concessional finance. ■



The Upper Trishuli-1 Hydropower Project, Nepal.

CHAPTER 5

The Rise of Returnable Capital Contributions

By Arthur Karlin and Kruskaia Sierra-Escalante

A relatively new approach for the provision of concessional capital for use by development finance institutions in their blended concessional finance programs is emerging—the “returnable-capital” model. With this new model, principal, interest, and other amounts are repaid to the original provider of funds (usually a government) on a regular basis. Because this can reduce the impact on donor government budgets, more government funds could become available for collaboration with the private sector. This chapter explores the effects of this new model on incentives, accounting, resource management, and reporting.

The Rise of Returnable Capital Contributions

Until recently, the concessional funds used by development finance institutions (DFIs) in blended concessional finance projects came mostly from government grants or long-term contributions to dedicated facilities. These facilities then invested the funds in private sector projects on concessional terms, alongside DFI and other commercial finance. This “grant/long-term contribution model” was the financing modality generally used by IFC for donors’ contributions to the climate facilities before fiscal year 2010, as well as for newer facilities that finance small and medium enterprises (SMEs) and agribusinesses (see Figure 5.1).²⁵ Starting in FY10, with climate funds from Canada, and continuing in FY18, with new funds from Canada as well as from Finland and the IDA-IFC-MIGA Private Sector Window (PSW), more funding became available to IFC based on a different model—the “returnable capital” model. With this model, there is an explicit up-front agreement that reflows (interest, fees, dividends, and repayment of principal) are regularly returned to the original providers of the concessional funds. While IFC used a similar approach with some earlier multilateral donor facilities, the desire of funders to receive periodic reflows has become explicit, and has grown in recent years. IFC expects that this returnable-capital model for funding blended concessional finance will become even more important in the future.

The returnable-capital model can appeal to governments because they regularly receive the reflows and can redeploy the funds for other programs or priorities. However, choosing between a “grant/long-term contribution” model and a returnable-capital model involves some important considerations related to incentives, accounting, resource management, and reporting. Thus, to help DFIs and other providers of blended concessional finance make the best decision when choosing between the two models, the rest of this chapter addresses the differences between the two approaches.

Blended Concessional Finance Instruments: The Clients’ Perspective

The choice between the grant/long-term contribution model and the returnable-capital model primarily concerns the providers of concessional funds to DFIs, rather than the private sector firms that ultimately receive the funds. However, the decision can affect the instruments as well as the level of concessionality and risk appetite available for use in private sector projects. Thus, these impacts are important considerations in deciding how to structure blended concessional finance facilities.

In 2017 and 2018, the DFI Working Group on Blended Concessional Finance surveyed DFIs to gather information on the different instruments they use to provide concessional funds to private sector clients.

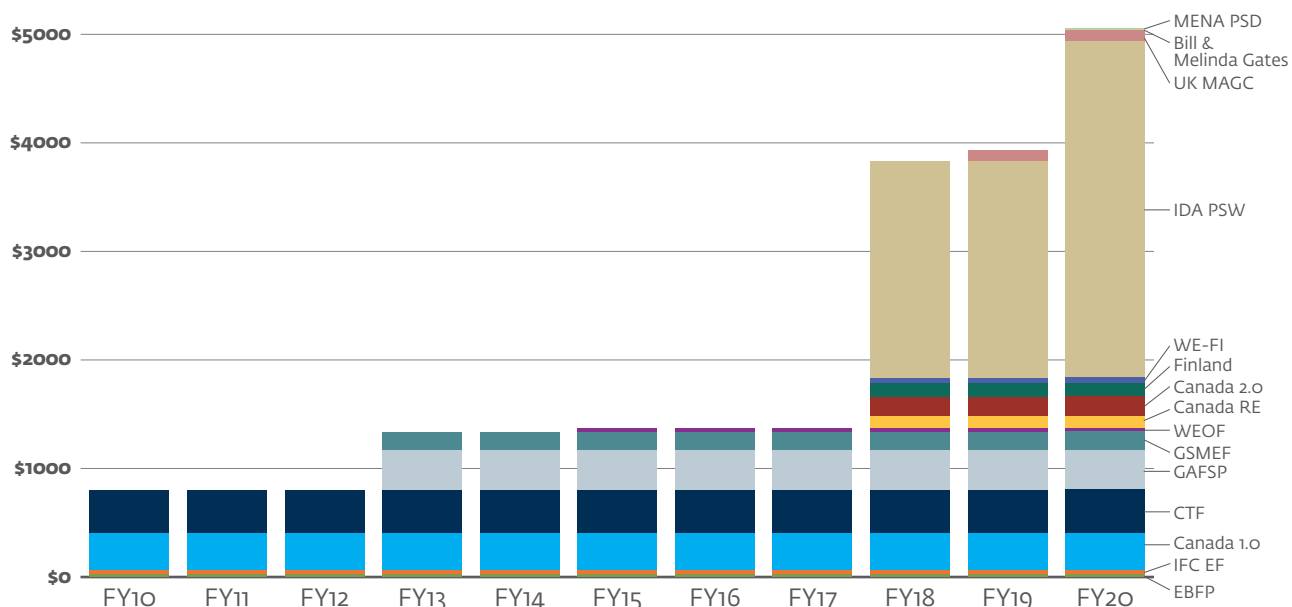


FIGURE 5.1 IFC Blending Concessional Funds Under Management by Individual Facility, FY2010-20 (US\$ Million)

Source: IFC.

Note: IFC EF=IFC-GEF Earth Fund Program; EBFP=IFC-GEF Environmental Business Finance Program; CTF=Clean Technology Fund (Climate Investment Funds); GAFSP=Global Agriculture and Food Security Program; GSMEF=Global SME Finance Facility; WEOF=Women Entrepreneurs Opportunity Facility; WE-FI=Women Entrepreneurs Finance Initiative; IDA PSW=IDA Private Sector Window (including allocations under IDA 18 and IDA 19); Finland=Finland-IFC Blended Finance for Climate Program; Canada 1.0/2.0=Canada-IFC Blended Climate Finance Program (phase 1, phase 2 respectively); Canada RE=Canada IFC Renewable Energy Program for Africa; MAGC=UK-IFC Market Accelerator for Green Construction Program; Bill and Melinda Gates=Leveraging Technologies for Agriculture; MENA PSD = MENA Private Sector Development Program. A description of, and links to, further information on the various funds can be found on the IFC website under Blended Finance.

Figure 5.2 shows the results, which indicate that DFIs use a wide range of instruments for concessional finance, including various types of debt, equity, guarantees, and grants. Although the reasons for using the different instruments reflect many project variables regarding risk, costs, timing, and investor characteristics, the 2017 review identified some common themes:²⁶

- **Senior debt**, when concessional, can address cost issues, for example, the high start-up costs for pioneering technologies, or the high costs of providing loans to SMEs.
- **Sub debt and equity** mitigate senior debt risk by improving coverage ratios (the expected cash flows compared to the required senior debt interest payments).
- **Grants** can address high initial capital or start-up costs that occur with new technologies or markets.

- **Performance grants** can provide incentives to encourage project sponsors to meet development goals.
- **Guarantees and risk-sharing facilities**, especially when on-lending through financial intermediaries to riskier segments such as smallholder farmers' cooperatives or SMEs, can address underlying portfolio risks. Typically, these are used when liquidity is either not a problem, or to indirectly address the cost of local currency funding.

In addition to finance, advisory services (technical assistance) are often provided by the DFIs to help develop projects, create markets, and address supply chain issues. In many cases, the funding comes from the same facilities (or parallel funding pockets) that are used for blended concessional finance.

Of the two models for providing concessional finance from donors, the grant/long-term contribution approach is the more flexible. Once funds are provided to a facility, depending upon the agreement

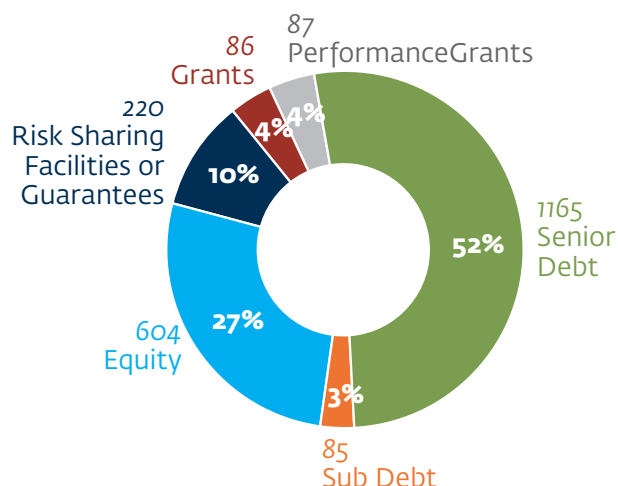


FIGURE 5.2 DFI Blended Concessional Finance: Concessional Commitment Volume by Instrument, 2017–18 (US\$ Millions)

Source: DFI Working Group on Blended Concessional Finance for Private Sector Projects, Joint Reports, October 2018 and October 2019.

with donors, the funds can be used for various types of debt, equity, guarantees, and grants, and in many cases, also for advice and/or capacity building. Returnable-capital models, however, require a regular reflow of funds, which generally means that providing grants and performance-based incentives to clients and funding advisory services is not feasible, as such instruments “consume” the original capital, with no potential for reflows.

Blended Concessional Finance Instruments: The Donors’ Perspective

From the perspective of the providers of concessional resources (usually governments), the grant/long-term contribution and returnable-capital models vary with regard to cash flows, budgets, credits for official development assistance (ODA), and the instruments available to the ultimate private sector clients (see Figure 5.3).

Reflows

As discussed, the most obvious difference between the two models is the difference in reflows. With the grant/long-term contribution model, principal, interest, fees, and dividends from clients regularly flow back to

Grants/Long-term Contributions to Private Sector Facilities	Returnable Capital
<ul style="list-style-type: none"> No reflows except, in some cases, at the facility’s close On budget Counts as ODA Allows for grants to private clients Uses existing facility governance and management 	<ul style="list-style-type: none"> Regular reflows May be off budget ODA count but different timing/amount (“net”) No grants to private clients May require new partners and vehicles

FIGURE 5.3 Blended Concessional Finance Instruments: The Donors’ Perspective

Source: IFC.

the facility, not the donor. Depending on the facility’s agreement, these reflows may be used for advisory services or additional private sector investment. In some cases, there may be provisions for eventually returning any remaining capital to the original donor.

In the returnable-capital model, principal, interest, dividends, fees, and other reflows are paid back on a regular basis to the original contributor of the concessional finance. The original contributor can then reinvest the funds in various ways—for example, back into the same concessional finance facility, into alternative investments, or used for domestic finance.

Budget

Depending on the rules in the country providing concessional finance, the two concessional finance models can have significantly different impacts on government budgets. Grants or long-term contributions to facilities may be viewed as on-budget expenses. Contributions for returnable capital may be viewed as investments, and thus, for the most part, off budget in terms of government expenditures.²⁷ This can be a strong incentive to provide funds to facilities as returnable capital rather than as grants or long-term contributions. Returnable capital can be viewed as an

addition to regular ODA, beyond the current budget resources. Also, it can provide new ways of increasing development outcomes through the private sector via investments and leveraging private capital.

The returnable-capital model seems consistent with the *Billions to Trillions*²⁸ concept of leveraging targeted support from governments to increase private sector engagement in achieving the SDGs. The overall result of the difference in impact on government budgets could be that substantially more resources become available to the private sector under the returnable-capital model. Also, if shifting private sector programs from grants to returnable capital takes the private finance off budget, more ODA grant resources could become available for purposes that are not generally suitable for returnable-capital financing—for example, most human-capital investments.

Official Development Assistance (ODA)

The rules used by the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC) for counting private sector support in Official Development Assistance (ODA) are currently under review.²⁹ One of the methods being piloted (the “institutional approach”) includes, as ODA, government contributions to a private sector investment facility, net of any reflows of principal from the facility back to the government. This could discourage governments from using the returnable-capital model for concessional finance, as it could lead to a reduction in ODA credits due to the reflows (that is, if the funds come out of the ODA budget and are not reinvested in other ODA uses). An alternative method being piloted by the OECD for calculating ODA for private projects (the “instrument-specific approach”) would likely not have this issue. In this case, the ODA calculations would be based on net flows (outflows minus reflows) between the facility and the private sector client (rather than from the government to the facility), and thus, under the returnable-capital model, ODA would not change.

Impacts on Private Sector Clients

As discussed above, investment grants, performance grants, and advisory services to support the private

sector can be important parts of DFI programs. However, these instrument options would generally not be available with a returnable-capital model. Therefore, the providers of concessional finance will need to consider the importance of these different instruments in the context of their development goals.

For example, advisory services are an essential complement in high-risk countries to create markets, while performance grants can be important in aligning incentives among various stakeholders, and in achieving the development outcomes that otherwise would not be obtained. One alternative could be to use returnable capital for investments and use separate facility grant agreements for investment grants, performance incentives, and/or advisory services. Another alternative would be to structure the facility as partially returnable capital—allowing for a percentage to be “consumed” through some of these grant-based instruments.

An additional impact of the returnable-capital model on private sector clients could be changes in the allowable risk profile for investments, pricing flexibility, and corresponding levels of concessionality. With returnable capital, the provider of concessional finance is directly affected by the performance of the private investments and the price charged for taking such risks. For donors looking for a basic level of return, this might lead them to put greater restrictions on the risk levels of the projects being undertaken, the pricing, or the level of concessionality. For highly risky segments such as smallholder agribusiness, it may be important to be more flexible regarding the minimum return requirements.

The returnable-capital model is also limited due to its potential inability to provide support to important development projects that may not have a clear investment return—for example, social programs or disaster recovery programs.

Investment Management

In many cases, the establishment of returnable-capital models for providing concessional finance to the private sector will require new partnerships between the providers of concessional finance and the institutions that have the capacity and experience to effectively

deploy the finance to private sector projects via non-grant instruments. Providers of concessional finance will have to consider how much management can be undertaken in-house versus delegating investment decisions to a partner. Investment partners should have deep experience in assessing and structuring investments in developing countries, especially with projects in higher-risk environments that are more likely to require blending. Investment partners should also have strong governance, fiduciary, and reporting capabilities; high environmental and social standards; an understanding and commitment to development; and the ability to measure different types of investment impact. In addition, alignment of the interests and perspectives on development of both the providers of capital, and the implementing partners, is essential.

Outlook and Recommendations

Based on feedback from the providers of concessional funds, use of the returnable-capital model is likely to grow. Providers of concessional funds who are considering the returnable-capital model should carefully examine four major issues:

1. The importance of regular reflows for the overall management of development programs
2. The specific impacts on budgets and ODA
3. The impacts on the types of funding instruments available to the private sector, and assessment of the possible trade-offs between development impact and the required return on investments
4. Management of the funds and the selection of partners

Returnable-capital approaches for providing concessional funds to the private sector could have important benefits for the providers of concessional funds, particularly through the availability of reflows, and less impact on budgets. This could mean that far more resources might become available to the private sector. Other impacts may also be important, though, as the reported ODA could potentially become more uneven, and the instruments available to clients, such as grants and advisory services, could become more limited. The specific circumstances for providers of concessional funds with regard to their development goals, country accounting rules, ODA rules, and details of the agreements for funding facilities, will all affect the attractiveness of the two different options. ■



Solar power reboots Gaza's business potential.

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- ¹ World Development Report. 2005. “An Investment Climate for Everyone,” p. 1; World Bank Group Strategy for Fragility, Conflict, and Violence (FCV) 2020–2025, p. 36.
- ² There may still be some impact on budgets depending on how governments account for the funds. For example, if the interest rates are fixed, but below government funding costs, a “grant element” may be on budget, but the rest of the contribution counts as an investment.
- ³ DFI Working Group on Blended Concessional Finance for Private Sector Projects – Summary Report, October 2017, p. 3.
- ⁴ In general, programs that require a permanent subsidy are not good candidates for blended concessional finance, but would be better addressed by other means, such as ongoing government subsidies.
- ⁵ For more information on IFC’s AIMM framework see: https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/development+impact/areas+of+work/sa_aimm.
- ⁶ DFI Working Group on Blended Concessional Finance for Private Sector Projects, Joint Report, November 2020 Update (forthcoming).
- ⁷ See Chapter 5 for a fuller discussion of returnable capital.
- ⁸ See DFI Working Group on Blended Concessional Finance for Private Sector Projects. 2017. “Report on Phase 2 Activities,” October, pp. 5-8.
- ⁹ For more information on IFC’s AIMM framework see: https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/development+impact/areas+of+work/sa_aimm.
- ¹⁰ For projects mandated after October 1, 2019.
- ¹¹ The “concessional element” is the grant equivalent of any concessional finance instrument. For instance, the “concessional element” of a grant is 100 percent, while the concessional element of a low interest rate loan might range from 5 to 25+ percent.
- ¹² DFI Working Group on Blended Concessional Finance for Private Sector Projects. 2018. “Joint Report, October 2018 Update.”
- ¹³ Michael Klein. 2015. “Public-Private Partnerships: Promise and Hype.” World Bank Group Policy Research Working Paper, No. 7340, June. For additional information on cost recovery in the power sector, see Vivien Foster and Anshul Rana. 2020. “Rethinking Power Sector Reform in the Developing World.” World Bank, Chapter 8.
- ¹⁴ The programmatic approaches, such as the IFC SLGP discussed in Chapter 2, are examples of project origination processes that incorporate some of these ideas.
- ¹⁵ See Chapter 2 for additional discussion of IFC governance processes.
- ¹⁶ In this chapter, lower-income countries refers to low-income countries and lower-middle-income countries.
- ¹⁷ For more information on the World Bank Group’s Cascade and MFD approach refer to <http://www.worldbank.org/en/about/partners/maximizing-finance-for-development>.
- ¹⁸ DFI Working Group on Blended Concessional Finance for Private Sector Projects. 2017. “Report on Phase 2 Activities,” October 2017, pp. 5–8.
- ¹⁹ For more information on the DFI Enhanced Principles see Chapter 2.
- ²⁰ DFI Working Group on Blended Concessional Finance for Private Sector Projects. “Joint Report, October 2018 Update,” p. 14, p. 16., and “Joint Report, October 2019 Update,” p.11, p.14.
- ²¹ Development Committee of the World Bank and IMF. 2018. “Sustainable Financing for Sustainable Development.” World Bank Group, International Monetary Fund.
- ²² This discussion excludes DFI data in high-income countries because of the small sample. If a high-income category were included in Figure 3.7 with the existing DFI data, the leverage shown for high-income countries would have been 3.0.
- ²³ See: <https://disclosures.ifc.org/#/projectDetail/SII/38036>.
- ²⁴ MIGA. 2017. “PRICO Operations Rooftop Solar—Project Description.” <https://www.miga.org/node/1874>.
- ²⁵ This discussion reflects general trends and does not apply to all donors, for example, one of the donors to the Global Agriculture Food Security Program has always taken back reflows.
- ²⁶ See DFI Working Group on Blended Concessional Finance for Private Sector Projects. 2017. “Report on Phase 2 Activities,” October 2017, pp. 13–14.
- ²⁷ The exact impact on budgets depends on the details of the donor contract, and on the rules of the different governments. For example, if interest rates are fixed, but below government funding costs, a “grant element” may be on budget, but the rest of the contribution counts as an investment.
- ²⁸ World Bank and International Monetary Fund. 2015. “From Billions to Trillions: Transforming Development Finance Post-2015—Financing for Development: Multilateral Development Finance,” April 2.
- ²⁹ OECD. 2018. “Reporting Methods for Private Sector Instruments,” December 12.

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Additional reports about investing in challenging markets as well as a list of EM Compass Notes published by IFC Thought Leadership: [ifc.org/thoughtleadership](https://www.ifc.org/thoughtleadership)



DFI Working Group on Blended Concessional Finance for Private Sector Projects

Joint Report, October 2019 Update—46 pages

Blended concessional finance can be used to unlock untapped investment into sustainable development, especially from the private sector, in support of the “Billions to Trillions” agenda. The increasing use of concessional funds blended with Development Finance Institutions’ (DFIs’) own financing and that of others on commercial terms has brought the DFIs together to develop common standards and principles for implementation of blended concessional finance projects, provide comprehensive data on blended concessional finance activities, and review existing approaches and practices. This report provides an update on the core outcomes of this work conducted in 2019.



DFI Working Group on Blended Concessional Finance for Private Sector Projects

Joint Report, October 2018 Update—43 pages

This report aims to provide an update on the core outcomes of the DFI working group activities in 2018. During the year, members of the group began to translate the DFI Enhanced Principles into governance arrangements within their institutions, develop relevant data, and share knowledge. This document reports on these activities, including information on the different blended concessional finance governance practices among the DFIs and updates on DFI blended concessional finance data.



DFI Working Group on Blended Concessional Finance for Private Sector Projects

October 2017—16 pages

Blended concessional finance for private sector projects is one of the significant tools that multilateral development banks (MDBs) and development finance institutions (DFIs) can use, in cooperation with donors and other development partners, to increase finance for important private sector activities, help address the Sustainable Development Goals (SDGs), and mobilize private capital.

To help ensure the effective and efficient use of concessional resources in private sector projects, and avoid market distortion or crowding out private capital, the MDB Heads at their October 2016 meeting called for efforts to build on and further strengthen the principles for the use of concessional finance in private sector operations agreed by the DFIs in October 2013.

This paper summarizes the results of the work over 2017 of the DFI working group.

Additional EM Compass Notes

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Note 80a: IFC Technology Code of Conduct—Progression Matrix—Public Draft—Addendum to Note 80

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