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Is blended finance trending in the LDCs? Perspectives from the ground

Debapriya Bhattacharya
Sarah Sabin Khan

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Sarah Sabin Khan

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Preface

Southern Voice is a network of 50 think tanks from Africa, Asia and Latin America. Since its inception in 2012, it has served as an open platform to provide structured inputs from the global South into the negotiations on the post-2015 development agenda, with a view to address the 'knowledge asymmetry' and 'participation deficit' that usually afflict such global discussions.

In 2017, *Southern Voice*, in collaboration with the United Nations Capital Development Fund UNCDF and the United Nations Foundation, joint efforts to explore the use of blended finance as part of the strategies to finance the 2030 Agenda in Least Developed Countries (LDCs). In these context, four country case studies were carried out in Bangladesh, Nepal, Senegal and Uganda, along with a synthesis paper. These were inputs also for the UNCDF's report "Blended Finance in the Least Developed Countries," published in November 2018.

The present paper constitutes the synthesis of the aforementioned four country studies. Drawing from individual country experiences, the synthesis seeks to articulate generalised implications of pertinent issues related to blended finance for LDCs. The paper concludes with concrete and actionable recommendations for LDCs so as to take advantage of this new and innovative instrument.

Hoping this paper will be a useful resource to understand the implications of the use of blended finance in LDCs.

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Abstract

Blended finance is picking up as a new source of finance to meet the funding gap in implementing SDGs. However, country perspectives reveal that the concept it is yet to gain full momentum in LDCs. Lack of awareness as well as absence of consensus regarding its definition has held back the instrument from being mainstreamed into the policy discourse. Institutional and regulatory challenges and capacity deficits have also impeded its widespread adaptation. The closest manifestation of blended operations in LDCs have been in the form of public-private partnerships which are still largely confined to infrastructure projects. Nonetheless, instruments of blending have been used for the purpose of managing diverse risks in LDCs for a while. Examples of leveraging blended finance to crowd-in private capital through demonstration effects and by addressing different market barriers are also found in plenty. Nevertheless, existing blended operations are yet to internalize any systematic mechanisms towards monitoring and evaluation of project, assessment of impact or dissemination of knowledge. Operationalization of blended finance is also subject to risks that cannot be overlooked. The amalgamation of these issues, stemming from country experiences, inform certain policy perspectives for LDCs to harness the potentials of, and avoid the curses of, this currently "trending" phenomenon of blending in the development finance architecture.

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Acronyms

aBi	Agricultural Business Initiative
ADB	Asian Development Bank
AFD	Agence Française de Développement
AfDB	African Development Bank
BIFFL	Bangladesh Infrastructure Finance Fund Limited
BPDB	Bangladesh Power Development Board
CNAPP	Public-Private Partnership National Committee in Senegal
DEG	German Investment Corporation
DFI	Development finance institution
DFID	Department for International Development
EDF	European Development Fund
EIB	European Investment Bank
FDI	Foreign Direct Investment
FMO	Netherlands Development Finance Company
FONSIS	Senegal Strategic Investment Fund
GDP	Gross Domestic Product
GPEDC	Global Partnership for Effective Development Co-operation
IBN	Investment Board Nepal
ICT	Information and Communication Technology
IDB	Islamic Development Bank
IDCOL	Infrastructure Development Company Limited
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IPFF	Investment Promotion and Financing Facility
JICA	Japan International Cooperation Agency

KfW	German Development Bank
LDC	Least Developed Country
M&E	Monitoring and Evaluation
MIGA	Multilateral Investment Guarantee Agency
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PPA	Power Purchase Agreement
PPP	Public-Private Partnership
SDG	Sustainable Development Goal
SIDA	Swedish International Development Cooperation Agency
SME	Small and Medium Enterprise
SONES	National Society of Exploitation of the Waters of Senegal
TCX	The Currency Exchange Fund
TDF	Town Development Fund
UECCC	Uganda Energy Credit Capitalisation Company
UNCDF	United Nations Capital Development Fund
UNF	United Nations Foundation
USAID	United States Agency for International Development
USD	United States Dollar

Is blended finance trending in the LDCs? Perspectives from the ground

Debapriya Bhattacharya &
Sarah Sabin Khan

About the Study

This paper is a synthesis of the findings obtained through four scoping studies carried out in selected least developed countries (LDCs), viz. Bangladesh, Nepal, Senegal and Uganda to assess the state of affairs concerning blended finance in this group of countries¹. These studies are the first to have undertaken specific research on blended finance in LDCs. Besides reviewing secondary official and independent sources, the scoping studies articulated their findings based on information gathered through interviews of relevant actors from public and private sectors, as well as domestic and international financial institutions. The country studies explored the following conceptual and operational dimensions of blended finance: a) understanding of the concept; b) relevant policy, regulatory and

 **These studies are the first to have undertaken specific research on blended finance in LDCs.**

¹ Unless indicated otherwise, country experiences throughout the paper were drawn from the following scoping studies:

Kasirye, I. (2018). *Blended Finance in Uganda: Opportunities, challenges, and risks* (Southern Voice Occasional Paper No. 45). Dhaka: Southern Voice.

Rahman, M.; Khan, T. I.; & Farin, S. M. (2018). *Blended Finance in Bangladesh: A scoping paper* (Southern Voice Occasional Paper No. 46). Dhaka: Southern Voice.

Sene, S. (2018). *Blended Finance in the National Planning Process and the SDGs in Least Developed Countries: Evidence from Senegal* (Southern Voice Occasional Paper No. 47). Dhaka: Southern Voice.

Wagle, A. (2018). *Nepal's Potential for Blended Finance: A Country-level Study* (Southern Voice Occasional Paper No. 48). Dhaka: Southern Voice.

institutional set-ups; c) major relevant actors; d) instruments deployed; e) prominent receiving sectors; f) barriers to private investment; g) development impact, monitoring and evaluation, and h) policy implications. The studies have been carried out to inform the broader research undertaking administered by the United Nations Capital Development Fund (UNCDF) on the role of and scope for of blended finance in LDCs (UNCDF, 2018). The country studies have been supported by the United Nations Foundation (UNF).

It needs to be pointed out that although all the sample countries belong to the group of LDCs, they remain very different in terms of their resource endowments, developmental needs and priorities, dependence on external support, and level of institutional maturity. Two of the four countries studied, namely Bangladesh and Nepal, are set to graduate from the LDC group.

Bangladesh will likely graduate as early as 2024 by recording threshold level achievements in the areas of gross national income per capita, human assets and reduction of economic vulnerability. Nepal will do so in the latter two. While Bangladesh has recently entered the lower middle-income country group, the three other countries i.e. Nepal, Senegal and Uganda are low-income countries and they are also significantly smaller in terms of their population and size of economy. These and other differences are bound to translate into differentiated country experiences as far as the potential scope and actual deployment of blended finance are concerned.



Two of the four countries studied, namely Bangladesh and Nepal, are set to graduate from the LDC group.

Thus, taking note of the above, the current synthesis aims to consolidate the findings under the areas of focus mentioned earlier. It seeks to highlight some discernible trends - common and differentiated - that are emerging from the country studies. It is reckoned that consolidated findings presented in the synthesis will allow the national and international policy actors to have a more informed view regarding the use of blended finance in LDCs.

Looking through the issues

Is blending indeed trending in LDCs?

The “blending is trending” narrative (see e.g. Moreira da Silva, 2017) at best gives a mixed picture of the realities on the ground as far as LDCs are concerned. Whatever limited statistics are available related to blended finance, it indicates that blending is less prevalent in LDCs than in middle-income countries. According to the OECD, between 2012 and 2015, only 7 % of global private finance mobilised by official development assistance (ODA) was in LDCs (Benn, Sangaré, & Hos, 2017). Senegal was the second largest mobiliser of private funds among LDCs (about USD 682 million), closely followed by Bangladesh in the fourth position (USD 415 million) between 2012 and 2015. Uganda and Nepal mobilised USD 127 and USD 92 million respectively for the same period². The relatively subdued picture of the use of blended finance in LDCs is largely corroborated by the lack of conversation on blended finance in the policy circles of the sampled LDCs, even in those that are attracting relatively more capital. Nevertheless, a sense of appreciation and enthusiasm regarding blended finance was observed during interviews with relevant interlocutors. In fact, the interest in exploring blended finance as an additional source of resource in implementing SDGs may be gaining momentum in LDCs as we speak.

The need for additional resources in meeting national development priorities, particularly given the challenge of delivering the Sustainable Development Goals (SDGs), is ubiquitously felt in LDCs. Furthermore, in order to shore up the revenue collection, the national governments acknowledge the role of the private sector as integral to the development process³. The potential catalytic role that public resources can play to

2 The country studies could not verify the figures due to the scope of their work.

3 This is reflected in the the Seventh Five Year Plan, SDGs Financing Strategy: Bangladesh Perspective in Bangladesh, The Ugandan Vision 2040 and The National Development Plan II (2015-2020) in Uganda, Development Finance Assessment Final Report (November 2017) and Nepal's Sustainable Development Goals Status and Roadmap (SDGsSR): 2016-2030 (December 2017) in Nepal and Senegalese Emerging Plan (PSE) in Senegal.

attract private investments has gained a lot of traction in the last decade mostly in the form of public-private partnerships (PPPs). The evolution of institutional and regulatory frameworks surrounding PPP projects are testaments to that. In fact, PPPs are often considered as a manifestation of blended finance by the local actors.

What do LDCs understand by blended finance?

Not only is a universally accepted definition of blended finance yet to be established, but the concept is also yet to be understood uniformly by actors even within a single country. Various forms of blending at the project level have existed for years in almost all LDCs, even though the term "blended finance" may have been unheard of. The essence of the concept is also perceived from varying vantage points depending on the contextual differences of these LDCs. For example, in Bangladesh blended finance is mostly seen in the framework of development cooperation and it is often associated with external concessional resources in mobilising private capital for development. In Senegal, it is seen as an essential mechanism that can demonstrate better functioning markets and attract private capital in implementing SDGs through improved risk-return profiles. In Uganda, blending is mostly seen as the public sector's incentive to the private sector to invest in specific sectors – usually manifested in the form of PPPs, concessional loans, grants, guarantees and technical assistance. In Nepal, it is seen as a model of development finance that can be harnessed to bridge the prevalent financing gap in implementing SDGs, albeit in targeted areas.

Keeping aside the varying points of departure, the overwhelming understanding of the concept at the country level would invariably seem as rather oversimplified, specifically when compared to the underlying principles of blended finance championed by the OECD (OECD, 2018). Blending is essentially understood in LDCs as a collaboration between the public and private sectors towards achieving national development priorities enabled by a favourable risk-return profile for the latter.

Concepts like additionality⁴, minimal concessionality, the risk of over-subsidising the private sector, pro-poor agenda, and eventual commercial sustainability of projects are yet to be fully internalised in the policy and operational conversations.

Can regulatory and institutional frameworks in LDCs evolve to accommodate effective blending?

Given the newness of the concept promoted by the international financial institutions, dedicated legal, institutional and regulatory frameworks are yet to develop for blended operations in LDCs. There is hardly any reference to the concept of blended finance in the concerned policy documents in this group of countries, and thus, its operational dimensions are defined by specific country contexts. In Bangladesh, the National Policy on Development Cooperation does mention blended finance, but basically as the use of public resources mobilising private and philanthropic capital for development, which may take the form of, *inter alia*, PPPs and technology transfers. Research conducted in Uganda shows that domestic development finance institutions (DFIs) have hardly any national framework to purposefully integrate blended finance in their activities. The studies from Nepal and Senegal have highlighted the need for proper legislation and laws around the use of blended finance. Although, the most recent national annual budget of Nepal has made specific mentions of utilising blended solutions to meet the financing gap of mainly large infrastructure and hydropower projects.

The institutions and regulations that are currently in place to accommodate the leveraging of private capital towards national development priorities are usually in the context of PPPs. PPPs are also the most relevant to blended finance operations in the absence of a dedicated framework. In Bangladesh, Nepal, and Uganda, national policies or laws specifically targeting PPPs have been operational since 2015.

4 According to the OECD DAC blended finance principles, to effectively increase total financing for development, blended finance needs to ensure additionality, by being deployed only for uses where commercial financing is not currently available for deployment towards development outcomes, especially if it involves concessionality (OECD, 2018).

Senegal has also put in place a legal framework guiding PPPs. These policies spell out principles such as transparency and accountability, among others. For instance, the Nepalese policy mandates competitive bidding processes in awarding contracts and global bidding processes for projects over USD 10 million.

PPP policies usually identify target sectors that are aligned with national development plans. However, it is evident that PPPs in LDCs have been largely focused on infrastructure development and similar large-scale investment projects. The PPPs related legal provisions and policy parameters in LDCs also provide for specific institutional arrangements to facilitate PPPs, e.g. PPPs Authority in Bangladesh, PPPs cell in the National Planning Commission in Nepal, PPPs National Committee in Senegal (CNAPP), and PPP Unit in Uganda. These entities are responsible for ensuring project alignment with national development priorities, and also for endorsing and overseeing PPPs deals and undertaking preliminary performance assessment.

Both public and private actors have questioned the adequacy of the existing frameworks in effectively facilitating blended operations. Lack of transparency, information asymmetry, capacity constraints, and accountability deficit are identified as some of the main concerns in this regard. For instance, in Uganda the Auditor General's Value for Money Audit Report on the Agricultural Credit Facility programme exposed illegal transfer of funds from the project account but there was not much done to enforce any accountability measures against such misconduct. The technical ability of government bodies to protect the interests of LDCs while negotiating PPP deals has also been doubted because of time overruns of projects caused by technical complications.

In the absence of a proper regulatory framework, specifically catering to the nuances and subtleties of blended finance deals, projects get delayed in being approved since authorities are averse to taking risks by going beyond the traditional practices. It is also recognised that overregulation can translate into delayed take-offs of the projects.


Who are the main players facilitating blended operations in LDCs?

The development finance architecture in LDCs in the context of blended finance involves a wide array of agents from the public and private sector, multilateral and bilateral, as well as domestic DFIs. The nature and role of these major actors in fostering financial blending vary across the analysed LDCs. Yet, common patterns have been identified.

Usually, the Ministry of Finance along with other relevant entities (e.g. Planning Commission, Central Bank, etc.) tend to be involved at the strategic level in fostering blended finance. The "core ministries" are supported by different enabling government institutions, e.g. investment promotion authorities, revenue collection boards, exchange commissions and PPP units that scrutinise, assess, implement, and oversee blended finance operations. Actors from the private sector mostly comprise local commercial banks, private equity funds, credit institutions, micro-deposit taking institutions, pension funds, and cooperatives.

The World Bank Group, particularly the International Finance Corporation (IFC) is the most prominent international development partner supporting blending operations in these LDCs. Other top international development partners involved in blending include international DFIs like the CDC Group, the European Investment Bank (EIB), the German Investment Corporation (DEG), the Islamic Development Bank (IDB), the Multilateral Investment Guarantee Agency (MIGA),

UNCDF; regional DFIs such as the African Development Bank (AfDB), the Asian



The World Bank Group is the most prominent international development partner supporting blending operations.

Development Bank (ADB), and the European Development Fund (EDF); bilateral partners like the Department for International Development (DFID), the French Development Agency (AFD), the German Development Bank (KfW), the Japan International Cooperation Agency (JICA), the Netherlands Development Finance Company (FMO), the Swedish International Development Agency (SIDA), the United States Agency for International Development (USAID); and vertical funds like Global Fund and International Fund for Agricultural Development (IFAD).

Among the domestic DFIs in Africa, the Senegal Strategic Investment Fund (FONSIS), and the Uganda Development Bank have been instrumental in facilitating various blended deals in their respective countries. FONSIS in Senegal also acts as a channel through which the government engages with other DFIs. FONSIS also provides technical support and expertise to the government in dealing with PPPs.

The engagement of domestic DFIs in blended operations in Bangladesh and Nepal could not be substantiated through the evidence provided by the country studies. Nepal's financial architecture lacks domestic DFIs altogether. Town Development Fund (TDF) and the Hydro Electricity Investment and Development Company Limited (a special purpose vehicle to address country's energy crisis) are among the very few that are relevant. TDF has a small portfolio with experience in mobilising private equity and providing support for technical assistance. However, new institutions like Investment Board Nepal (IBN) are functioning as bridge between the private investors and regulatory institutions for the projects of large ticket size. In Bangladesh, Infrastructure Development Company Limited (IDCOL), Bangladesh Infrastructure Finance Fund Limited



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(BIFFL), and Investment Promotion and Financing Facility II (IPFF II) are among the DFIs that have potential to be major players in promoting private sector investment.

What are the most prominent sectors for blended operations in LDCs and where do small and medium enterprises (SMEs) fit in?

The susceptibility of sectors in an economy towards public-private collaborative investment models is very contextual, as evident from the diversity of experiences in the country studies. As mentioned before, as the sampled LDCs vary in their circumstances and development trajectories, a country-wise exploration of prominent sectors utilising blended finance is likely to make more sense.

In Bangladesh, infrastructure, particularly energy and power, is the dominant sector with the most incidences of blended-like deal structures. Infrastructure development is still one of the top priorities of the country and experiences a huge funding gap of USD 9 billion per year to meet the desired development targets. As such, the sector is probably the most prioritised and financially cushioned by the national development plans and by the public sector. Three out of the four blended finance examples in the Bangladesh study were from the energy sector. The remaining one relates to improving access to financial services. Other potential sectors indicated by the country study include high-tech parks, logistical support facilities, and export-oriented thrust sectors including leather and footwear, pharmaceuticals, information and communication technology (ICT), plastic, and light engineering.

Given the size of the economy, population and scale of demand, ticket sizes of development projects in Bangladesh usually exceed the USD 1 million mark by a large margin. Moreover, foreign providers tend to be inclined towards collaborating with established private sector actors on big budget projects. Thus, SMEs have been sidelined from the existing modalities of blended opportunities. As identified by the research conducted in Bangladesh, SMEs are also potential entities where blended finance may be fruitfully utilised.

The PPP projects in Nepal, perceived as a form of blending in the country study, have been mostly in hydropower development, followed by transport services and infrastructure related to tourism. Equity participation in privately funded and managed hydropower projects by public entities in tourism infrastructures were deemed examples of blending in larger projects. Another version of blended finance – the Sector Wide Approach Model – in the public sector has been prevalent in the education and health sectors. Impact Funds in Nepal have been instrumental in providing concessional finance to micro and small commercial enterprises, as well as marginalised groups and segments of the society. However, these are mostly confined to small businesses and livelihood support schemes, which miss out on servicing the medium sized enterprises.

Some of the areas prioritised by the 2016 PPP Policy of Nepal include physical infrastructure and transport, power sector, ICT, urban environment sector, infrastructure related to education, health and tourism, services and facilities. Given Nepal's recent transition to a more federal structure of governance, decentralised urban service delivery and capacity enhancement of local governments are also potential areas for leveraging private investments.

The prominent sectors in Senegal experiencing blended finance type of deals were found to include the urban water sector, health, energy infrastructure, and transportation and communication infrastructure. Moreover, FONSIS, the financial intermediary in Senegal responsible for approving public-private collaborative projects, has recently approved six more projects aligned with Senegal's national plan including exploitation of the developed lands of the valley, solar energy, medical imaging, and the restructuring of some Senegalese SMEs. The other targeted sectors mentioned include agriculture and industries, energy and mining, services (hotels, tourism, health), ICT, and real estate. Small business enterprises are also one of the target sectors and dedicated funds to SMEs exist in the Senegalese development finance landscape.

In Uganda, blended projects in agriculture and the energy subsector comprise about an estimated 75 % of the total deals. Other sub-sectors where blending is taking place include telecommunications, youth and SMEs, water and construction. Indeed, agriculture is considered as a key growth sector which observes high incidences of blending. For example, the Agricultural Business Initiative (aBi) Trust, a multi-donor blended facility was set up in 2010 with the aim of supporting agri-business development in the private sector with a focus on SMEs by providing financial and technical support in selected agricultural value chains. It provides guarantees covering a maximum of 50% loss of principal outstanding, and a maximum loan amount of about USD 140,000. Infrastructure projects, due to the capital-intensive nature of their investments, are targeted by large ticket sized blended facilities.

It was noted that most of the available blended facilities in Uganda are targeting middle-income groups but leaving out the poorest of the poor. Uganda's private sector is 71% SMEs, of which 63% are small enterprises with annual sales/assets not exceeding USD 2,700. Whereas, blended facilities mostly target established enterprises with ticket sizes mostly above USD 2,500.

What instruments are most prevalent in blended projects in LDCs?

The most common concessional tools for commercial investors in blended finance deals in LDCs include grants, guarantees (equity and loan, sovereign and corporate) against different types of risks, credit lines, long-term loans, equity investment, syndicated financing, and technical assistance in an array of areas. Examples of the above listed instruments are found in the country case studies. As highlighted by the study conducted in Uganda, deployment of specific instruments is often informed by sector-specific risks as well as the preference of international development partners.

In Uganda, a common practice is "pooling of finances" where the domestic banks mix relatively expensive financing sources with outsourced low-cost financing such as

grants and loans from bilateral providers and international development institutions. Such blended finance mechanism is then lent out to targeted development causes, which are usually identified by the grant partner. For example, the Centenary Bank in Uganda implemented a solar re-finance facility where the bank mixed over one billion shillings of grants from Uganda (approximately USD 265,000) Energy Credit Capitalization Company (UECCC), with its own relatively expensive commercial finance (interest rate of above 20%) to underwrite solar projects at a lower fixed interest rate of 8.15% per annum.

Providing seed capital under different financing models and funds to encourage innovative entrepreneurial efforts among marginalised groups seems to be a common mechanism deployed for development in Nepal. For instance, the Rural Self-Reliance Fund provides wholesale seed capital credit to targeted groups. The Poverty Alleviation Fund delivers seed fund to encourage beneficiaries to form community organisations among the poorest of the poor. The Challenge Fund supports innovative and entrepreneurial youths through seed capital.

Unlike in most LDCs, guarantees are not common in Bangladesh as exclusive instruments offered by providers but rather as supplementary to other concessional tools within a deal. For example, the Shirajganj Power project by Sembcorp Northwest Power Company, benefits from political risk guarantee provided by MIGA besides the syndicated concessional funds involved in the deal. Another common instrument employed in blended operations in the energy sector of Bangladesh is the quasi-sovereign guarantee enforced by a Power Purchase Agreement (PPA) provided by Bangladesh Power Development Board (BPDB), a state-owned enterprise. The BPDB is bound to buy the electricity produced in the power plants at commercial rates and to be repaid in the earmarked currency (usually USD denominated).

Technical assistance is yet another crucial instrument in LDCs which often go unaccounted for in financial terms. As highlighted by the study conducted in Uganda, there is hardly any framework that takes stock of the flow of technical assistance to

Uganda, even though it is widely utilised in development projects in view of the technical inadequacies and capacity constraints afflicting the local counterparts. In Senegal, with to the purpose of assisting innovative private sector companies, the EIB engages in blended operations by providing financing facilities for upstream technical assistance, national and regional studies, and targeted risk capital operations. The TDF in Nepal provides support to local municipalities in strengthening their technical, managerial and financial capability to help them identify, implement and evaluate urban development projects.

As evident from the country studies, the least common in LDCs, albeit important, would be that of hedging mechanisms. A lot of these LDCs lack sophisticated currency swap or hedging facilities to protect against exchange rate shocks. For countries like Bangladesh, where foreign exchange regulations prohibit investment in local currency by foreign investors, the need for hedging mechanisms is even stronger.

Addressing the market barriers – can blended finance be a solution in LDCs?

Much of the barriers to private investment in LDCs are intrinsic and entwined systemic concerns that adversely affect the enabling national environment for doing business. Indeed, private investment in LDCs –both domestic and foreign– had been anything but encouraging in the last few years. As indicated by the country studies, private investment as a share of GDP has been marginally increasing in Nepal (between 2008-2009 and 2017-2018), stagnant in Bangladesh in recent years, and falling in Uganda (between 2011-2012 and 2015-2016). Many internal factors in LDCs contribute to such grim investment scenarios and might have adversely influenced mobilisation of private finance by leveraging ODA.

Weak regulatory and institutional frameworks, governance challenges, widespread corruption, inadequate infrastructure, underdeveloped equity markets, and transparency concerns are among the factors that weaken the enabling business environment in

these LDCs. These weaknesses, in turn, expose investments to an array of challenges including political, currency, policy, transfers, and security risks, breach of contract, expropriation of properties, violent conflict and civil disturbances. The high cost of capital, financial exclusion, informality of business operations, information asymmetry, technical inadequacy and inefficiency, capacity constraints are also indirect consequences of weak enabling business environments. Capacity constraints of local actors and institutions – both economy-wide and at the project level – have been brought forth as an endemic concern in all the four sample LDCs. While systemic concerns require a much broader overhaul to effectively boost private investment in an economy, instruments of blended finance and deals that are blended in nature have been able to address some of the barriers, as evident from the country studies.

Bridging the funding gap

In order to achieve the SDGs by 2030, Bangladesh would need an additional USD 66.32 billion per annum between 2017 and 2030. In Nepal, the annual financing requirement is about USD 17.70 billion per year, which amounts to an estimated 50% of the country's GDP for the period 2018-2030, with the highest funding gap being in the infrastructure sector. The financing gap for infrastructure development in Uganda, for example, has been estimated around USD 1.4 billion (about 6 per cent of GDP) per annum. All the financial need assessment studies maintain that the resource gap cannot be met by public expenditures and external development finance alone.

Limited access to formal financial services, including credit, also remains an issue of serious concern. Even though Nepal federates into seven states (provinces) and 753 local governments, the distribution of major bank branches is highly skewed towards big cities. Only 9% of Nepal's adults have access to credit from banks and cooperatives combined. Limited access to financing has been regularly identified among the top six problematic factors in Bangladesh by the Global Competitiveness Report of 2017. The equity and bond markets are also grossly underdeveloped in most of these LDCs.

Regarding the requirement of additionality, blended finance has the potential to mobilise significant amounts of additional finance. Bkash, a venture promoting financial inclusion in Bangladesh, is a good example of how effective blending of different instruments can ameliorate funding gaps and access issues. By blending a small amount of seed money by a foreign investor, with a grant financing technical support by the Bill and Melinda Gates Foundation, and a minority equity share by IFC, the project mobilised substantial amount of private resources from a domestic private bank namely, BRAC Bank, and eventually crowded-in a foreign private investor, i.e. Alipay Singapore Ltd. Moreover, the nature of the venture had significant impact on improving overall access to financial services.



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The AfDB led a blended finance deal structure in the Dakar-Diamniadio toll highway complex project in Senegal and was able to unlock a large pool of resources on relatively tight terms. On the surface, the project would appear to have mobilised a small amount of private funds (USD 48 million), leveraged by a large amount of public fund (USD 230 million). However, a closer look into the deal revealed that the publicly backed portion had both concessional as well as non-concessional components, which align with the principle of not over subsidising profit motives of the private sector. Effiage, a French multinational private company responsible for operating and collecting tolls, was able to secure a loan from AfDB's non-concessional window using Senegal's "blended classification". It had to do so by opening an escrow account with a local commercial bank. The Senegalese government, on the other hand, received a concessional loan from AfDB to compensate local population affected by the project. The project was further able to crowd-in additional non-concessional resources from both private entities and DFIs.

Addressing High Cost of Capital

Given the weak enabling business environment and high level of perceived risks relating to investment, the cost of capital tends to be exorbitant in LDCs. The cost of domestic funds in commercial lending has been stuck at more than 20% in Nepal and Uganda. Most credit institutions are unwilling to provide loans with repayment periods that are longer than 5-7 years. In Bangladesh, accessing long-term loans without collateral is also nearly impossible. The cost of external funds, in view of the changing terms and conditions including interest rate has been on the rise in Bangladesh over the years. Indeed, Bangladesh must access foreign funds at a higher cost as the country has moved into the lower middle-income group and has become eligible to graduate from the LDC group.

Concessionality of financial flows – determined by, *inter alia*, share of grant elements, lower interest rates, longer grace period and repayment period is, thus, an important feature in any deal that seeks to get the private sector on board to invest in sectors prioritised by the government. Besides, financial intermediaries have also been known to use pooling strategies to blend the concessional funds received from bilateral and multilateral development agencies with expensive capital procured from other sources to offer relatively affordable credit to attract private investment in targeted sectors. An example is how the Uganda Development Bank mixes the inexpensive fund it receives from the AfDB at 1% interest with costlier funds to sway investment towards development causes at reasonable rates.

The TDF Fund in Nepal lent out the grant money it received from the ADB and the Global Environment Facility as a concessional loan to support the implementation of the Kathmandu Sustainable Urban Transport project. The private company implementing the project had an equity investment worth 15% of project cost and received the remaining 85% at concessional terms from TDF and the government of Nepal. From the perspective of blended finance, the project would appear to have mobilised relatively little private

resources with substantial concessional funds. However, TDF will use the repaid loan money to set up a revolving fund which will subsequently mobilise more private funds towards urban transport projects.

The risk of over subsidising the private sector or in other words, using public money to fund private gains is one of the concerns of using concessional finance to attract private investment. As expressed by private actors in most of these LDCs, concessionality on local terms of finance may eventually lead to distortionary effects in the local market. For instance, in Bangladesh, some of the international DFIs have specific organisational terms of reference that may not allow lending to a private actor at interest rates lower than the prevailing local market rate to avoid the distortionary effects on the private commercial banks interest rates, of as this may lead to inefficient allocation of resources.

Managing risks

Investment risks –both real and perceived– are widely prevalent in all the sampled LDCs. Bangladesh ranked 177th among 190 economies in the World Bank's latest "Doing Business Report". Uganda's corruption perception ranking rose to an all-time high of 151 in 2018. Nepal is yet to be part of a sovereign credit rating mechanism. Such assessments about the country negatively shape investors' perceptions and thus, affect the prospect of foreign and domestic investments. Risk management instruments, such as guarantees and insurance, are widely used to reduce investors' exposure to the various risks and improve the risk-return profiles of investments. These instruments are effective in building investors' confidence, which improves the flow of private investment in otherwise risky or low yielding sectors and projects.

As pointed out by the Uganda study, the risks need to be largely covered depending on the nature of the sector. For example, in the energy sector in Uganda – characterised by policy instability, loan default and breach of contract – equity guarantees are more relevant. On one hand, risks covered in the agricultural sector include transfer restrictions,

expropriation, war and civil disturbances, as well as weather-related and environmental shocks. MIGA has been providing equity and loan guarantees in the power, manufacturing and agriculture sector projects. In the Bujagali Hydro Power project, MIGA guaranteed an additional USD 10 million equity cover besides the USD 330 million equity cover to protect against the breach of contract risk. In Bangladesh, the PPA in the power sector ensures guaranteed sales and also protects against exchange rate risks. Indeed, concerning blended finance operations, PPA played an instrumental role in securing concessional and commercial resources from potential financiers in the country.

Addressing capacity constraints

Institutional capacity constraints and deficit of technical expertise and efficiency are pervasive bottlenecks in LDCs, which affect a project's lifecycle –starting from conception, feasibility exercise, resource mobilisation, implementation, operation and sustainability. In Senegal, there is a lack of well-prepared, bankable and ready to be implemented projects in the pipeline. As pointed out by the study conducted in Uganda, financial institutions are often short of qualified personnel to conduct proper due diligence and proper valuation of firms. Furthermore, many private sector-led development projects have been demerged due to technical inefficiencies of the implementers and project beneficiaries. Implementation gaps usually result in an increase in project cost and delays in delivery schedule.

Blending instruments in the form of technical assistance or capacity development support are applied at different stages of an investment value chain. TDF in Nepal provides technical, managerial and financial capacity building support to local governments and municipalities to identify, implement and evaluate urban development projects as well as promote institutions working for urban development. In Senegal, both FONSIS and the Priority Investments Guarantee Fund provide multi-level financing for preparatory studies that are required for technical structuring, financial and legal set-ups concerning PPPs. AfDB, via the Sustainable Energy Fund for Africa, has financing windows for project

preparation. KfW in Uganda has been very visible in technical support for projects that take part in the agriculture and power sectors.

In Bangladesh, international DFIs have provided technical support to projects to improve their compliance assurance capacity. For instance, the power plant projects in the country had in-built technical assistance that helped the project implementers adhere to technological parameters of environment-friendly production thereby reducing social and environmental impacts of the projects.

Besides direct technical assistance, blending operations also provide access to knowledge and experience of partners with significant value-additions. For example, the projects in Uganda that are funded by bilateral and international development partners usually have inbuilt monitoring and evaluation plans. As these projects are implemented in partnership with the government, they have had positive spill-over effects on the monitoring and evaluation capacity of government employees.

Demonstration Effects.

Blended deals, through their demonstration effects, have the potential to crowd-in commercial investment in a new project, sector or market simply by building investors' confidence. For instance, bKash's success in Bangladesh was in attracting other commercial investors in the mobile financial services, a previously untapped industry in the country. The market now comprises 18 different companies with around 60 million registered clients. The Bangladesh study has also noted that the private entrepreneurs were able to mobilise additional funds because of their track records concerning participation in blended finance deals.

In Uganda, blended finance was found to attract private capital for development in areas where some of the private investors did not venture before. For instance, according to an official of Post Bank Uganda Limited, the bank would not have invested in the solar

loan project without the memorandum of understanding with the Electricity Regulatory Authority.

In Senegal, a USD 500 million urban water sector blended finance deal involved equity investment by the National Society of Exploitation of the Waters of Senegal (SONES), funds from multilateral and bilateral development agencies, fiscal transfers from the government of Senegal, private players and local commercial banks. The commercial banks initiated two loans, one of which included a USD 20 million loan from a risk pooling strategy which diversified risk and increased confidence shared among the players. According to the World Bank, SONES did not have to use the entire loan from Citibank because the project secured much better investment from other sources than anticipated. This gave the local banks confidence to renew the experience in the northern part of Senegal through a design-built-finance of a construction of a new water treatment plant.

How is development impact tracked in blended projects in LDCs?

From the country studies, it is evident that although blended finance deals are motivated by development outcomes intended by a project, systematic attempts to track or estimate the impact on changes in welfare at the project level remain feeble. Ex-ante assessments of the projects are often limited to pre-feasibility studies (e.g. energy projects in Uganda) and environmental and social impact assessments to avoid negative spillovers. For example, in Senegal, the second phase of the Dakar-Diamniadio Toll Highway complex finance project included an ex-ante assessment of the environmental and social impact assessment of the project to ensure compliance to a code of Senegal's main environmental management instrument. However, no example could be located readily of ex-ante assessments on potential development additionality or impact on achieving SDGs. The findings of the studies conducted in Bangladesh, Nepal and Uganda did not identify the availability of proper *a priori* assessments of potential development impact in the project designs of blended operations, except for the mandatory mentions

of intended impact in project proposals without any guidance regarding how it will be measured.

Ex-post evaluations are also non-existent in the case of the projects that have been completed in the sample LDCs. It is, however, recognised that impact might not be an immediate outcome that can be estimated and that a proper assessment of the development impact may take time. Most of the sample projects with blended finance that have been considered in the country studies are still at a phase where ex-post evaluation is not feasible. Nonetheless, none of the case studies indicated that an ex-post assessment was mandatory within the project design.

Preference for financial viability supersedes potential development additionality in many instances. For example, under aBi trust in Uganda, larger financial institutions are found to approve projects based on the strength of the projected cash flow without explicitly assessing full or partial additionality. On the other hand, interviews with potential financiers in Bangladesh indicated that besides financial viability, projects with innovation and high development impact were the most considered.

Although not much was revealed on the monitoring and evaluation (M&E) frameworks of individual projects from the blended finance examples explored in the country studies, the importance of M&E seems to be recognised by major actors. Providers of concessional finance had been particularly pushing for integration of effective monitoring and evaluation mechanisms. In Uganda, the government has also been actively integrating M&E in tracking the impact of its policies and programmes since 2003. Most of the foreign-funded projects in Uganda have M&E plans in their design. The relative increase in the number of job openings related to M&E in public, private and non-governmental organisations also indicate the escalating significance of M&E within the country. However, implementation gaps exist, and it cannot be reassured if M&E is adequately carried out in all blended projects .

In Senegal, FONSIS sometimes intervenes in PPP projects by monitoring its execution. However, no clear indication was found from the government's side on monitoring and evaluation of blended finance projects regarding SDG targets and impact on vulnerable communities. A look into the Dakar Diamniadio Turnpike projects' documents by the Senegal study found that even though the objectives of the projects integrate the needs and concerns of both the bottom section and upper section of the economy, the presence of structured and thorough monitoring and evaluation plans were not apparent.

Financial and technical capacity constraints usually exacerbate implementation gaps in M&E. The human resource capacities that are built in these areas through positive technical knowledge spill-overs are often limited and hard to retain. Moreover, lessons learned and knowledge gained through project evaluation and impact assessment seldom shared with the stakeholders. National governments often do not disseminate results of their evaluation of policies and programmes which inhibits the public from holding governments accountable. Confidentiality maintained in sharing project information also impedes the understanding of processes and learning from the experience. Both the Senegal and Bangladesh studies point to the difficulty in accessing data and information on projects especially when deals have been closed. Such practices not only raise questions on transparency and accountability concerns but also hinder objective assessment of overall development impact at both aggregate and disaggregated levels.

Policy Outlook


The analysed LDCs are apparently attracted to the concept of blended finance as they strive to generate additional resources from the private sector by leveraging concessional external flows. This motivation became more compelling as this group of countries faced an enhanced development finance shortfall, predicated by the demand for revenues for the delivery of SDGs by 2030. Recognisably, countries would more effectively tap into private investments to meet this yawning shortfall. Moreover, since a number of LDCs are going to lose their access to ODA as they graduate from the LDC and/or LIC group(s),

there is an expressed attempt to more effectively leverage concessional finance (as long as it is available) and to generate additional resources. Furthermore, the selected LDCs were ready to explore blended finance to overcome their traditional barriers to private investment.

At the same time, it transpires that the LDCs are gradually becoming more cognisant about the risks that underpin the operationalisation of blended finance deals. Such pitfalls include information asymmetry, capacity constraints, efficiency concerns, implementation gaps, subsidisation of the private sector, distortionary effects in the money market, crowding-out investments elsewhere and lack of inclusivity of outcomes.

As mentioned before, this paper seeks to synthesise the insights of four LDC studies concerning the use of blended finance. The following are some recommendations that resulted from this exercise.

- *Let the definition evolve.* The apparent pluralism of the definition, prevalent within and across countries, stems from the variation in contexts that drive the different perspectives from which blended finance is looked at. Often, the definition is rooted in the purpose that most suits the need of each faction. Trying to fit in a universal definition of blended finance, conceptualised in the developed part of the world, across developing countries like LDCs would be both, idea-wise and operationally inappropriate. Concepts, structures and practices of blended finance demand to be contextualised at the national level. The LDCs need to evolve and develop the principles of

 **The definition of blended finance is rooted in the purpose that most suits the need of each faction.**

blended finance as per specific needs and requirement of the country-based on substantive country ownership of the process.

- *Mainstream blended finance at the national level.* Mainstreaming the concept of blended finance across actors within an LDC is essential to mitigate information asymmetries, prevent coordination failures and exploit scale and scope of opportunities in a well-informed manner. Understandably, the mainstreaming efforts should follow a participatory process including the sharing of knowledge and experiences of all relevant stakeholders. This process should be informed by best practices of blended finance available globally.
- *Anchor blended finance in existing frameworks.* Completely new structures and resources dedicated to the cause of standardising the practice of blended finance would be redundant. Existing frameworks should be harnessed and upgraded to accommodate the nuances of blending. To facilitate the process, issues related to transparency and disclosure, management deficit and capacity shortfall, poor monitoring and accountability should be tackled. Investments in capacity enhancements of institutions and human resources will be essential for effectively adapting the existing frameworks to the needs of blended finance.
- *PPPs should be the entry point.* Blended finance in LDCs is overwhelmingly manifested in the form of PPPs, which already has institutional and regulatory frameworks. The Ministry of Finance can anchor the process with support from other relevant government agencies (e.g. investment promotion authority) and the Central Bank. The process will take time and a proper review mechanism with provisions for regular reform should be allowed.
- *Scale-down not up.* PPPs are still largely focused on infrastructure and large-scale projects. For blending to be inclusive, broadening the scope and coverage of the blended finance operations is very much desirable. There is a need to venture on

other priority sectors, e.g. health and education as well as other target groups, e.g. small and medium entrepreneurs. Such investments will also be necessary for ingraining the underlying prudent principles in the national systems and among relevant stakeholders.

- *Diversify the instruments deployed.* There is a need for diversification and innovation from the instruments traditionally deployed in LDCs. For instance, guarantees and instruments that allow hedging against currency shocks need to be facilitated more often. Furthermore, instruments that transfer knowledge and help develop capacities may be more effective in the long term.
- *Have a sectoral approach to design instruments.* The design of specific features of blended finance instruments needs to be determined at the sector level and in cognisance of their effect on the market. Such sectoral tuned instruments provide better protection from both national and global shocks.
- *Strengthen domestic intuitional capacities.* Predictions about the development trajectory of LDCs suggest that as these countries graduate from the group, domestic revenue and foreign direct investments (FDIs) will play a bigger role in supporting national development processes. Thus, there is a need to strengthen institutions involved in managing the new mix of development resources and beyond and also develop an array of customised financial products to attract additional investment. National development banks, domestic DFIs, sovereign wealth funds, impact funds, private equity funds, and national commercial banks should ideally dominate the blended finance scenario in future. Depending on the context, establishing dedicated and autonomous institutions to bridge between private and public perspectives may help countries manoeuvre through the realms of blended finance more effectively.

- *Strengthen the role of domestic actors.* This will imply that the trade bodies and entrepreneurs' associations would have endowed themselves with knowledge and skills to make the best use of the opportunities offered by blended finance. This is a special area that needs to be covered by the Global Partnership for Effective Development Cooperation (GPEDC).
- *Leveraging international development partners.* International development partners have had and will continue to have significant roles in national landscapes of development finance in LDCs. Within the purview of the Busan principles agreed by the GPEDC, development partners are the crucial channels through which innovative global solutions can effectively transpire at the national level. International development partners have been vital in leveraging commercial resources in unconventional sectors including SMEs. National governments need to engage with development partners in harnessing potentials of blended finance as well as in discouraging them regarding bureaucratisation and over-regulation.
- *Track Progress through SDG lens.* Blended operations in LDCs have so far failed to accentuate the importance of capturing development impact and monitoring outcomes. There need to be provisions for ex-ante and ex-post assessments, as well as well-structured monitoring and evaluation mechanisms embedded in the project design. A systemic and behavioural change is required towards these issues – something which can transpire through efforts and practices of development partners. Furthermore, sensitivity towards SDG goals and targets through a disaggregated lens needs to be deployed at all levels. The success of blended finance must be captured in terms of attainment of the breadth and depth of intended outcomes.
- *Too soon to recognise blending as a solution.* The systemic concerns impeding investment in these LDCs are too substantive for the small scale of blended ..

finance operations to have any concrete effect on. The barriers are structural and blended finance at its current incipient stage cannot effectively address them.

Blended finance is a concept that is still in an incipient stage in LDCs. It is evolving within a backdrop of diverse contexts and realities. There are both opportunities and risks involved. There is no scope for getting deluded by the sometimes too championing tunes of its proponents. But then again, there has been enough evidence of its potential not to get dissuaded by the attendant risks.

Indeed, we are dealing with moving frontiers of a novel concept. There is a demand to undertake systematic and regular monitoring of the process to maximise the benefits of blended finance in a manner that is optimal and inclusive.

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