

THE WHY AND HOW OF BLENDED FINANCE

Recommendations to Strengthen the Rationale for and
Efficient Use of Concessional Resources in Development
Finance Institutions' (DFI) Operations

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ABSTRACT

Blended concessional finance (BF)—the use of catalytic capital from public or philanthropic sources to increase private sector investment—is becoming an important instrument to support the 2030 Agenda for Sustainable Development. Together with other Development Finance Institutions (DFIs), IFC has been at the forefront of developing and upholding high standards as an implementing entity of concessional resources. Building on these standards, this paper offers recommendations to further strengthen the rationale for and efficient use of blended concessional resources. Central among these is the need to unpack better the rationale for BF, which requires justifications for development impact, additionality and the use of concessionality. The paper discusses ways to deploy concessional finance more efficiently once the rationale is correctly identified and articulated. It argues that the COVID-19 pandemic not only raises the urgency to deploy BF efficiently and effectively, it also represents an exceptional circumstance to consider the use of BF in portfolio.

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1. INTRODUCTION

With the growing emphasis on mobilizing private capital to accelerate development progress, blended concessional finance (BF) has moved beyond its niche position to become a significant tool for development finance and mobilization. By combining concessional finance from donors or third parties with a DFI's normal own-account finance and/or commercial finance from other investors, DFIs are aiming to mobilize and catalyze private resources, develop private sector markets and in the process advance progress on the Sustainable Development Goals (SDGs).

Together with other DFIs, IFC has been at the forefront of developing and upholding high standards as an implementing entity of BF resources. For example, in 2017 the DFI Working Group on Blended Finance for Private Sector Operations developed a set of Enhanced Principles for Using Concessional Finance in Private Sector Investment Operations, ('DFI Enhanced BF Principles') that are meant to underpin all operations involving BF. These *DFI Enhanced BF Principles* include: (1) clarity on the rationale for the use of concessional resources; (2) the goal of minimizing concessionality and crowding-in of the private sector; (3) the commitment to commercial sustainability; (4) the objective of reinforcing markets; and (5) the application of high standards of conduct in projects, including governance and transparency.

Building on the DFI Enhanced Principles, this paper offers recommendations to further strengthen the rationale for and efficient use of blended concessional resources. Following rapid growth from a low base, the expanding use of concessional resources has led to a broadening of experience with this development finance tool. This paper draws on that experience in the deployment of BF resources and offers recommendations where the rationale (the why question) and the efficient use (the how question) of blended concessional finance can be further strengthened. The recommendations are relevant for the larger community of DFIs engaging in blended concessional finance.

The general recommendations are summarized in Table 1. Recommendations (1-2) aim to articulate more clearly the rationale for the use of BF, by distinguishing development impact and DFI additionality from the need for concessionality. Existing frameworks emphasize the first two aspects while often leaving the third implicit. This paper proposes a separate evaluation of the unique need for concessionality, which reinforces the view that impact and additionality are necessary but not sufficient for concessionality. These recommendations build on and aim to reinforce Principle 1 of the DFI Enhanced Principles on the 'Economic Case for Using Blended Concessional Finance'.

With the correct rationale identified, the second set of recommendations (3-5) pertains to the modalities of the deployment of concessional resources so that scarce concessional resources are allocated efficiently. Among them are the need to match the instruments more directly to the distortion being addressed, scrutinize the use of BF to directly de-risk DFI investments, and establish governance and benchmarking frameworks for adhering to the DFI Enhanced Principle of minimum concessionality in a manner that is coordinated effectively and efficiently across institutions. These recommendations are related to Principle 2 of the DFI Enhanced Principles on 'Crowding-in and Minimum Concessionality'.

Table 1. Overview of Recommendations

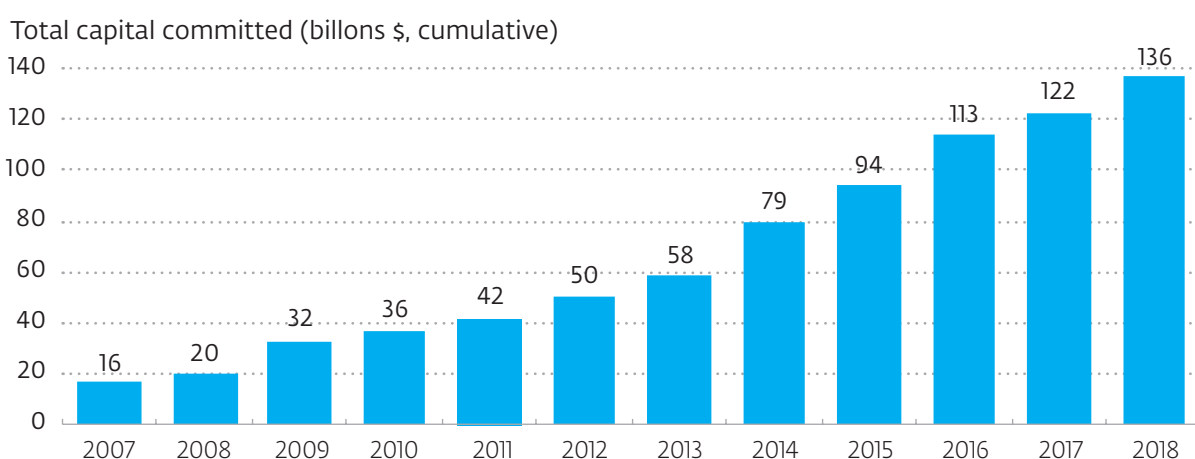
Articulating Fully the Why of Blended Concessional Finance	
<p>Recommendation 1. Unpack the Rationale for Blended Concessional Finance into Three Components</p>	<p>Making the case for blended concessional finance requires an assessment of development impact, additionality as well as the unique contribution of concessionality. These three components are the 'sub-rationales' of blended concessional finance. They need to be distinguished and motivated clearly.</p>
<p>Recommendation 2. Identify the Sub-Rationale for Concessionality Correctly</p>	<p>By addressing underlying 'participation' and 'behavioral' constraints, concessionality can improve outcomes. Concessionality may help (1) enable or broaden participation through de-risking and return enhancement, and (2) enhance development impact through behavioral incentives and technical assistance.</p>
Deploying Blended Concessional Finance More Efficiently	
<p>Recommendation 3. Align the Instrument of Concessionality Closely with its Rationale</p>	<p>To minimize concessionality and enhance its effectiveness, ensure that the instrument is closely aligned with the underlying participation and behavioral constraints. Particular attention should be paid to structures where multiple sources or instruments of concessionality are being used.</p>
<p>Recommendation 4. Scrutinize the Use of BF Resources to Directly De-Risk DFIs</p>	<p>Where BF is used to directly de-risk the DFI investment, establish clearly why the DFI cannot take that risk as part of its standalone additionality.</p>
<p>Recommendation 5. Avoid Use of BF Resources to Gain Competitive Advantage</p>	<p>DFIs appraising an investment opportunity should avoid use of BF resources to gain competitive advantage. Instead, DFIs should adopt modalities to strengthen discipline and compliance with the DFI Enhanced BF Principles.</p>

2. CONTEXT AND VALUE ADDED

Blended concessional finance is defined by the DFI Working Group (2017) 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 SDGs, and mobilize private resources”. More concisely, it refers to the use of catalytic capital from public or philanthropic sources to increase private sector investment in sustainable development.

Blended concessional finance forms part of the ‘global partnership for development’ toolkit for achieving the SDGs, where the private sector has an essential role as a driver of development. At the launch of the SDGs in 2015, there was little clarity on a wide range of issues related to BF, from definition to practice, which raised questions about its potential to deliver anticipated impact. Since then, DFIs have made great strides in establishing harmonized principles, developing operational guidelines and increase the volume of BF deployed through their private sector operations. Five years on, practitioners and scholars have begun to take stock of where we are in designing the rules of the game and achieving outcomes.

Figure 1. Cumulative Growth of Blended Finance Activities 2007-2018



Source: <https://www.convergence.finance/blended-finance>

Evidence shows a moderate growth in the volume of BF deployed since 2015 (Figure 1). More importantly, BF is yet to leverage private capital at scale. Estimates range from on average US\$0.8 to US\$4 of private capital leveraged per dollar of BF resources extended, against more ambitious 2030 Agenda targets (Convergence 2018 and 2019). A leverage ratio of 9:1 would be necessary to convert US\$100 billion of development finance to US\$1 trillion of private sector investments.¹ Though BF is only part of the financing puzzle, low leverage ratios have a bearing on its potential to contribute to the achievement of the SDGs (Kenny, 2019).

Other studies have looked at how BF resources are allocated to private sector investors and the efficiency of those allocations. Part of the earlier work (e.g. Buiter and Schankerman 2002, Hainz and Hakenes 2012, Carter 2015) made proposals that resonate with the *DFI Enhanced BF Principles* later adopted by DFIs, such as minimum concessionality and reinforcing markets. Other studies have focused on minimizing costs and conflict of interest in the deployment of BF by development banks (e.g. Jenkins 2018). More recently, Carter and Plant (2020) made proposals on how DFIs may identify firms that truly require a subsidy in the presence of imperfect information. This literature concludes that there is scope for improvement in the practice of how DFIs allocate concessional resources to minimize ‘wastage’ and improve transparency.

Concessional capital providers are establishing the architecture that is anticipated to deliver a positive impact on the practice of blended finance going forward (Convergence 2019). For example, as part of the new OECD DAC Community of Practice on Private Finance for Sustainable Development, there is an ongoing effort to develop Guidance on the OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the Sustainable Development Goals. This work will provide DAC donor governments with guidance to implement the Principles. The tools to operationalize the individual DFI Enhanced Principles developed by the DFI Working Group are also in the early stages of development.

As the COVID-19 crisis unfolds, it reveals a gap in both knowledge and practice, on the appropriate use of concessional resources by DFIs for projects in their portfolios. Given the scale and systemic nature of large macro shocks such as COVID-19, governments have a distinct responsibility to mutualize losses and protect the private sector, on which many livelihoods depend. When markets fail, public support preserves the capacity for recovery. Yet, the pressing need for government support faces the hard reality of tight fiscal constraints in many developing countries.

This paper leverages the experience of IFC as one of the biggest channels for BF among DFIs to shed some light on (1) the justification for the use of blended concessional finance (i.e. the why question) and (2) the efficient use of concessional resources (i.e. the how question). The paper makes actionable recommendations to aid the implementation of the DFI Enhanced Principles with a focus on those aspects that present the most significant resource misallocation risks. Our recommendations address three issues: establishing an economic rationale to support a given project with BF and effectively articulating this rationale, minimizing concessionalism in deploying support, and avoiding market distortion. These apply also to the potential use of BF as a crisis-response tool.

The paper is situated in the context of an evolving development finance architecture in which there is growing understanding that sector de-risking and upstream project pipeline development can reinforce and complement the effectiveness of BF interventions at the project level. Given the dearth of bankable projects and functioning markets, advisory resources applied upstream play an important role in the development of a strong pipeline of bankable projects, creating an enabling environment for private capital flows, and creating precedence. Under its 3.0 Strategy, IFC is recalibrating its internal resources to enhance upstream engagement, with a line of sight to future investments. Such efforts facilitate the development of an enabling environment for project level support; and should also benefit from increased BF where appropriate.

It is useful to clarify what this paper does and does not do. First, the paper should be read in the context of the DFI Enhanced BF Principles and associated guidelines, where its main objective is to improve on the implementation of some—not all—of the existing principles. Second, the paper focuses on investment opportunities with an established role for the private sector in developing countries and emerging markets. Third, the paper focuses on the DFI private sector operations but holds broader relevance for BF facilities not intermediated by DFIs. Fourth, while many examples in the paper have in mind the financing of particular projects, the recommendations can be easily transposed to facilities that deliver impact through a programmatic approach.

3. THE COMPOSITE RATIONALE FOR BLENDED CONCESSIONAL FINANCE

DFI Enhanced Principle 1 calls for BF co-investments to be anchored in a solid economic rationale. However, DFIs have varied modalities to go about this. Some establish a rationale at an envelope level, under broad justifications such as environmental externalities. Others do this at project level though lack adequate efforts to identify why concessionality is needed (beyond impact and additionality, which could be achieved without BF).

The economic rationale for BF is often a mix of both impact and additionality. For example, reaching underserved beneficiaries, externalities and demonstration effects are the predominant rationales for the use of BF reported by DFIs in the DFI Working Group's pilot audit of 2016. This list is a mix of distortions that justify why a DFI may participate in the deal, and broad sources of social welfare gains. They do not tell us why a particular engagement cannot be concluded without BF (or indeed, if a private operator should be addressing the distortion).

Unpacking the components of the rationale for BF helps DFIs make informed decisions on the optimality of the contract. Against this general backdrop, this section offers recommendations to motivate and articulate better the rationale for blended concessional finance. To make the recommendations more concrete, Annex 1 provides three case studies that illustrate the application of the framework.

Unpack the Composite Rationale

Recommendation 1. To present the case for the use of concessional resources, unpack the following three constituent components: (1) the overall development impact of a project, (2) the additionality of DFI participation, and (3) the rationale for concessionality.

The composite rationale for BF builds on three aspects of an investment decision: the overall development impact, additionality and justification for concessionality.

The Overall Development Rationale

The overall development rationale is concerned with the question whether an investment into a project, or any other financial engagement as part of a broader program, contributes to development effectiveness. The development rationale of an investment should be the cornerstone of any investment decision by a DFI, regardless of whether concessional resources are used for a particular investment. Investment in a project can contribute to development impact in several ways, for example by supplying a new good or service, fostering allocative and productive efficiency or reaching better distributional outcomes relative to a social welfare norm.

The development rationale should clearly articulate, based on the available evidence, the anticipated development impact of the project. Several DFIs have developed ex-ante impact measurement systems, such as IFC's Anticipated Impact Measurement and Monitoring (AIMM). AIMM distinguishes between project outcomes (derived directly from the investment supported including its economy-wide effects) and market outcomes (systemic effects that are catalyzed by the project in the market through demonstration, capacity building and increased competition among market players). This tool measures the investment's total anticipated impact, including any additional outcomes enabled by BF. It also evaluates the likelihood of replication and risk of market distortion. Scoring tools, such as AIMM, are also useful in prioritizing investments based on the strength of their expected impact.

The Additionality Rationale for DFI Participation

The additionality rationale for DFI participation addresses the question whether DFI involvement in an investment adds value beyond what is available in the market. Additionality is necessary to ensure that a DFI's involvement addresses distortions and crowds in (rather than crowds out) private investment. Additionality could be financial (provision of financing on terms not available from the market, including mobilization) or non-financial (non-commercial risk mitigation, higher standards and adoption of project-design features that accentuate development impact). While BF indeed augments a DFI's additionality, since by definition these are not resources available from the market, it is critical that concessionality is itself not the sole source of additionality in supported projects. Otherwise BF risks destroying rather than creating self-sustaining markets.

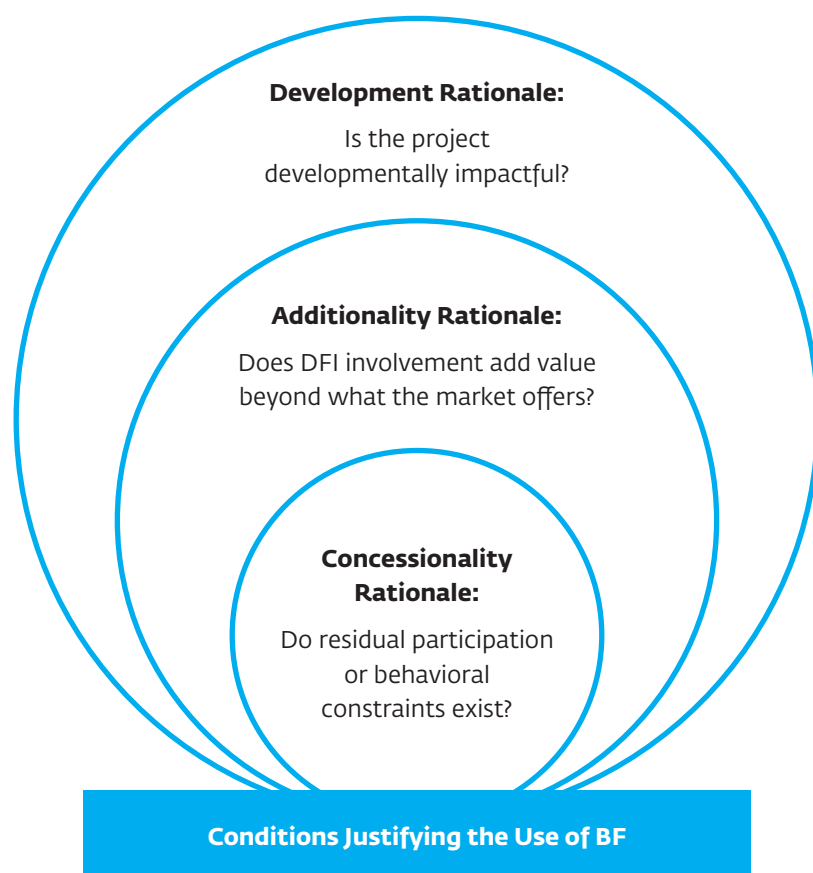
The discussion of DFI additionality needs to refer explicitly to the underlying distortions. A broad set of distortions—public and private—should be considered. Box 1 and Annex 2 recap the elements of a detailed additionality assessment. The Box provides a non-exhaustive list of the distortions and equity objectives that underpin DFI's financial and non-financial additionality as defined in the MDBs' Harmonized Framework for Additionality. The list includes efficiency distortions (imperfect competition, imperfect information, externalities, public goods) and equity distortions.

While additionality applies to DFI investments more broadly, not just investments involving BF, the careful assessment of distortions (beyond describing simply the DFI's value-add) is imperative in projects relying on concessional resources, as it sets the stage for the optimal choice of instruments (Recommendation 3). It is worth emphasizing that a DFI's additionality either enables developmental projects to proceed or accentuates development impact expected from supported projects through adoption of specific design features. Therefore, development impact is the ultimate objective.

The Concessionality Rationale

The concessionality rationale focuses on whether it is justified to use concessional terms to tackle residual obstacles that hold back investment and constrain development impact. Through their financial additionality, DFIs offer terms and products unavailable in the local market. Even then, residual bottlenecks may deter private and DFI investment. Subject to other conditions, concessional resources may help. Similarly, on the non-financial side, there may be cases where BF can enhance development impact such as by reaching underserved populations through performance-based incentives.

Figure 2. The Composite Rationale for BF



The three components of the composite rationale need to hold simultaneously to justify BF (Figure 2). Positive development impact is necessary but not sufficient to justify BF (there are conditions under which social welfare can be increased by providing goods and services without subsidies, even in the presence of distortions e.g. large positive externalities). Likewise, positive DFI additionality is necessary (BF resources should only be used to extend support that the market is unable or unwilling to provide on reasonable terms—the same basis for DFI participation) but not sufficient (DFI additionality is often enough to fully address the underlying distortions). By unpacking the composite rationale, it is possible to identify the distortions and benefits that justify the use of concessional resources at the right level.

Box 1. Distortions that Underpin Additionality

Efficiency Distortions

Various distortions – of both private and public origin – may distort the efficiency of market outcomes.

- **Imperfect competition and economies of scale:** (partial) monopoly power elevates 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 (e.g. 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 adverse selection and agency problems. This increases transactions costs and may result in undersupply e.g. 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 agglomeration externalities when firms cluster may not be captured due to coordination failures, in which case there is under-clustering and lower productivity. Learning-by-doing external to the firm, as in the case of learning-by-exporting (Aitken and others, 1997), may produce demonstration effects that are not priced in at the level of the firm.
- **Public goods:** goods (and services) that are non-excludable and non-rivalrous. Public good attributes make it difficult or costly for private firms to appropriate rents. 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.

Equity Distortions

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, inclusion, among others. In either case, 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.

Identify the Correct Sub-Rationale for Concessionality

Recommendation 2. The rationale for concessionality is that it can deepen a DFI's financial and non-financial additionality by addressing residual constraints. BF may enable optimal participation (through de-risking and return enhancement) and enhance development impact (through incentives and technical assistance).

Blended concessional finance ultimately comes in to address a 'contracting failure'. For those investments where a development rationale has been established, and there is justification for a DFI's participation, there may be certain distortions that prevent investors and lenders from concluding a contract using their regular instruments (we call these 'residual bottlenecks'). Some of these distortions affect participation (of investors or lenders), others have to do with distorted behavior (e.g. investors' inability to provide a solution that maximizes social welfare or equity outcomes). In such situations, concessional resources may help.

Residual bottlenecks are best understood by viewing them through a contract theory lens.² In contract theory and mechanism design, a project can reach financial close in the presence of distortions when the contract terms enable participation and when they align incentives.³

- **Enabling participation.** Participation constraints (also known as individual rationality constraints in contract theory and mechanism design) require that each party to the contractual relationship prefers participation to non-participation. Parties to the relationship may include the DFI, the sponsor, the co-capital provider, the developer and the end-user. In investment language, a project will proceed when bankable at a reasonable cost of financing. Such a cost allows investors and lenders to make a reasonable return without significantly curtailing demand.
- **Aligning incentives.** Behavioral constraints (or incentive compatibility constraints) impose the need for contractual terms to be mutually beneficial (i.e. simultaneously in line with the preferences of every participant). Information asymmetries make it hard for lenders with a development mandate to know the true cost to investors of reaching a given target group. By designing contracts with performance incentives, we incentivize clients to reveal this information in the first set of transactions, and hopefully, reduce concessionality thereafter. As a result, both investors and lenders have adequate incentive to ensure delivery of the good or service to targeted customers at the right price.

Typical ways through which residual bottlenecks are addressed include return enhancement, de-risking and performance incentives.

- Where risks are too high or returns too low, concessional resources can help alter the risk-return profile, enabling investors including the DFI to participate. The DFI, for example, may find the project's risk-adjusted return on capital (RAROC) too low. A sponsor may require a higher internal rate of return (IRR) to participate given a project's risk profile. Concessional resources may help in raising these metrics to an acceptable level.
- Where distortions produce market outcomes that fail to maximize social welfare, concessional resources can provide incentives that facilitate a behavioral change by investors. For example, if a clean energy investment produces tariffs that are too high for utilities to switch away from carbon intensive resources, concessional resources can help lower these tariffs. BF-supported performance incentives and other instruments that extend non-financial additionality may also influence behavior towards desirable outcomes (e.g. mitigate climate change, improve equity).

By alleviating residual constraints, BF unlocks a DFI's financial and non-financial additionality, and enables impactful investments to proceed. BF co-investments enable implementation of projects that would otherwise not proceed (or proceed under a different, sub-optimal structure), through risk-reward rebalancing and additional incentives that help to deepen impact. Through both direct channels (e.g. return enhancement for clients or performance incentives for clients to reach specific customer groups) and indirect channels (e.g. de-risking the DFI's investment to enable participation), BF enables or augments additionality and development impact. The economic incidence of a subsidy is illustrated in Figure 3.

It should be emphasized that there are other conditions that need to apply for the deployment of concessional resources. This paper is not meant to provide an exhaustive list of good practices, which as mentioned earlier are summarized by the DFI Enhanced Principles. For example, it is implicit that other good practices such as the need to ensure commercial sustainability, reinforce markets and uphold high standards (including for governance and transparency), while promoting crowding-in and minimizing concessional resources are adhered to as well.

Table 2 presents an illustrative project-based typology that describes situations in which blended finance could be considered (subject to development impact and additionality being strong). The typology categorizes projects according to their presumed contribution to market development: early-stage projects establishing feasibility of a business concept in a new market; pioneering projects with demonstration effects; scaling projects to expand production; and transformative projects to alter the character of the market. Project preparation support (through early-stage risk capital) is also emphasized, given the importance of bankable pipelines in achieving mobilization targets from BF.

Figure 3. Channels Through Which BF Has an Impact

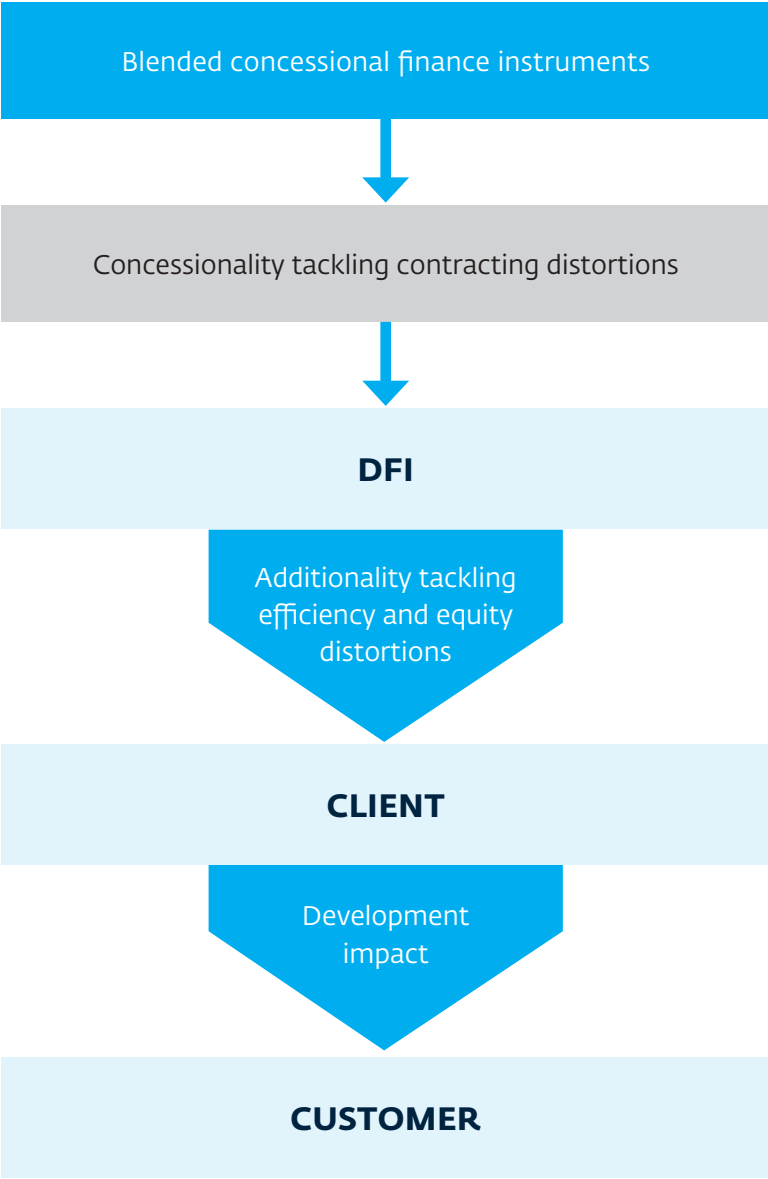


Table 2. An Illustrative Typology for Situations When BF Could Be Considered

DEVELOPMENT IMPACT	ADDITIONALITY	CONCESSIONALITY
Pre-investment		
<p>Pre-investment support aims to (i) establish the business case for new products in the market and (ii) increase the pool and quality of bankable projects. Discuss the stakeholder, sector and macro-level development impact of such projects.</p>	<p>Distortions: Upstream risks deriving from lack of full information about project feasibility, financial close, construction risks and the market's willingness to pay. Project are taking place in a context with thin venture capital markets, inadequate product innovation by financial intermediaries, and inadequate project preparation budgets of firms, governments and development partners.</p> <p>Additionality: Financial, deriving from provision of early stage risk capital; Non-financial, deriving from advisory, non-commercial risk mitigation.</p>	<p>Participation constraints: Risk-return profile may still be inadequate for DFI or private investors. Show how concessionality can expand project preparation financing and catalyze early stage investments in highly underdeveloped markets.</p> <p>Behavioral constraints: Residual distortions produce socially sub-optimal outcome. Show how concessionality aligns incentives to augment impact in upstream investments.</p>
Pioneering		
<p>Pioneering projects produce demonstration effects in strategic sectors where feasibility has been recently established. Discuss the stakeholder, sector and macro-level development impact of such projects.</p>	<p>Distortions: Higher risks, uncertainties and transaction costs due to unproven technologies, non-existent or untested policies and regulatory frameworks, risk of policy reversal, learning externalities, etc.</p> <p>Additionality: Financial, deriving from structuring and innovative instruments to manage risks, mobilization; Non-financial, from providing comfort to investors, developing sector frameworks, capacity building, and standards.</p>	<p>Participation constraints: Risk-return profile may still be inadequate for DFI or private investors. Concessionality may help bridge initially excessive costs and perceived risks.</p> <p>Behavioral constraints: Residual distortions produce socially sub-optimal outcome. Concessionality may expand non-financial additionality (e.g. by providing comfort and expertise to new investors).</p>

Scaling

Anchoring projects help build scale. Discuss the stakeholder, sector and macro-level development impact of such projects.

Distortions: Shallow capital markets (illiquid, limited refinancing and exit options), inadequate institutions/public sector capacity, incomplete price discovery. Standards may be weak.

Additionality: Financial, from filling a funding gap through structuring, innovative instruments and mobilization; Non-financial, from providing comfort to investors, advisory, helping clients to improve creditworthiness, and standards.

Participation constraints: Risk-return profile may still be inadequate for DFI or private investors. Highlight ways in which concessionality can alter risk or returns.

Behavioral constraints: Residual distortions produce socially sub-optimal outcome. Show how concessionality can improve market adoption and non-financial additionality.

Transformative

Transformative projects help alter the character of the market by introducing more advanced technologies and business models. Discuss the stakeholder, sector and macro-level development impact of such projects.

Distortions: High perceived risk and insufficient knowledge by global investors regarding market or sector (imperfect information) or feasibility of proposed market advancement models. Limited exit options for early investors. Standards may still be weak and frameworks incomplete.

Additionality: Financial, from financing structure, innovative financing instruments to lower cost of debt; Non-financial, from providing comfort to investors, standard setting.

Participation constraints: Risk-return profile may still be inadequate for DFI or private investors. Highlight ways in which concessionality can alter risk or returns.

Behavioral constraints: Residual distortions produce socially sub-optimal outcome. Highlight ways in which concessionality can contribute to the market's transformation.

4. THE EFFICIENT USE OF BLENDED CONCESSIONAL FINANCE

The identification of the correct rationale for BF will contribute to the effective deployment of concessional resources. Once the rationale has been identified correctly, opportunities may remain to improve also its efficiency. What follows are a number of general recommendations that will aid in ensuring that concessional resources are deployed efficiently. These recommendations align to DFI Enhanced Principle 2 in that they contribute to minimizing concessionality and in the process maximizing the crowding in of private resources. Here we offer three recommendations:

Align the Instrument of Concessionality Closely with the Rationale

Recommendation 3. To minimize concessionality and enhance its effectiveness, ensure that the instrument is closely aligned with the underlying distortions. Particular attention should be paid to structures where multiple sources or instruments of concessionality are being used, potentially in collaboration with other DFIs.

In cases where the rationale for BF is not properly unpacked, there is greater risk that the instruments are not well-aligned with the distortions that motivate concessionality. Most major DFIs need to adhere to the BF Enhanced Principles that call for minimum concessionality in the use of BF resources. Misalignment in the use of concessionality may not only undermine effectiveness in facilitating beneficial development outcomes; it may also result in an excessive degree of concessionality.

Achieving minimum concessionality has proven to be quite challenging for DFIs implementing BF investments. The questions of whether and how much concessionality is needed depend on project and sector specifics, context and interpretation of risk, and expectations for returns. This leaves some room for divergent views on the need for concessionality, and the optimum levels. It is important to recognize that achieving minimal concessionality requires both credit judgment and intention to co-invest blended concessional finance in a disciplined manner by all DFIs. Cases when a DFI uses more than one BF instrument in a project or when DFI-administered blended facilities are combined with facilities from other DFIs to support the same investment, pose a particular challenge.

As most distortions (discussed above) increase a project's risk or risk perceptions, we should expect to see more use of BF resources through de-risking instruments. There may be cases in which the distortion affects a project's returns directly (e.g. in a dynamic setting where returns are initially too low due to untested business models, low-income market segments, or limited scale). In this case, instruments focused on improving a project's internal rate of return (IRR) (e.g. with interest rate buydown on specific standalone project components) could be used. De-risking instruments (e.g. guarantee, first loss, subordination) could also be applied to reduce risks faced by project sponsors and improve risk/reward balance.

IFC's BF investments in renewable energy projects between 2009 and 2020 illustrate this instrument-matching process. In these IFC investments, the 'rationale for concessionality' has been to enable participation. The main constraints faced by those projects that benefitted from BF evolved from risk-reward imbalance explained by high capital costs, to imbalance explained by high risk.

- Earlier BF co-investments in renewable energy (RE) helped projects to address high upfront costs from more expensive technologies, and cost premiums on first generation projects. Either the anticipated equity IRR fell below the threshold commensurate with risks, or the bankable tariff was high relative to the marginal cost of operating thermal power plants connected to the grid.
- More recently, BF co-investments supported the expansion of RE into frontier markets facing higher risk. While technology costs on solar PV and on-shore wind have declined, these projects face elevated risk from the context and the first-generation nature of projects.

In this context, concessional funds have generally been provided as senior debt to project sponsors. Senior concessional loans have been used both to achieve risk-reward rebalancing, and enable participation of international RE developers in frontier markets, by enabling lower bid tariffs while keeping sponsors' equity returns at acceptable levels. Subordinated debt has also been considered for de-risking. It has helped meet debt service cover required by senior lenders to offer non-recourse project financing to first-generation projects in markets with no track record, and support projects with low leverage.

The use of equity is limited mainly to early-stage projects, through BF co-investments with InfraVentures, helping to catalyze project development capital. Historically, the choice of blended finance instruments was driven by the availability of those instruments. As the toolkit expanded, better matching of instrument to underlying distortions became feasible. The increasing potential to deploy risk-mitigation instruments (e.g. liquidity support or political risk insurance which remain limited in scope) should be fully leveraged.

Scrutinize the Use of BF Resources to Directly De-Risk DFIs

Recommendation 4. When BF is used to directly de-risk the DFI investment, establish why the DFI cannot take that risk as part of its standalone additionality.

Current practices and facilities allow for and may be designed to support DFI risk-taking directly. As noted earlier, DFIs may face participation constraints in the transaction (e.g. the project's RAROC may be too low). By enhancing project risk-return characteristics, DFI participation is made possible, and a developmentally impactful project can proceed.

- From an economic point of view, the use of concessional resources to support DFI risk-taking is entirely adequate. The question of who benefits most directly is subsidiary to whether or not the eventual development impact materializes i.e. what matters economically is the incidence of the subsidy. If BF is needed to improve the DFI's risk/reward profile to ensure that the project with a high development return goes ahead, then BF will have enabled the DFI to impart its valuable financial and non-financial additionality, resulting in an investment that would otherwise not have taken place or would otherwise have proceeded in a much different scale or form. The ultimate development benefits thus accrue to project beneficiaries. In this process, there may be accrual of some (limited) benefit to the DFI or the project sponsor because the sizing and targeting of concessionality is not an exact science.

- Several BF facilities are explicitly designed to de-risk DFI participation in risky transactions. This applies, for example, to the IDA Private Sector Window (PSW), where the intent is to achieve de-risking at the transaction level, which can mobilize pioneering investments that generate substantial learning externalities and welfare gains. An IDA PSW Board paper states, furthermore, that “in the PSW context, de-risking a transaction means that through the PSW, a portion of the risk in individual transactions will be transferred from private sector participants as well as IFC and MIGA, to IDA in order to make otherwise risk-prohibitive, yet impactful, projects viable.” Such support allows IFC and MIGA to safeguard financial sustainability while increasing exposure in high risk markets.

When the DFI is the most direct beneficiary of concessional resources, questions may be raised as to why the DFI cannot take this risk on its balance sheet.

- IFC and other DFIs are already taking higher risk on their balance sheets in frontier markets than elsewhere. Most DFIs practice a ‘portfolio approach’ that facilitates risk balancing at a portfolio level, by booking low-risk transactions that balance increased risk exposure in frontier markets. The portfolio approach sometimes extends to the allocation of overhead costs across projects, to avoid an onerous cost competitiveness hurdle for small projects in higher risk markets. Given increased demands to deploy resources in underdeveloped and risky markets, raising risk levels further might unbalance these DFIs’ financial sustainability models. However, governance and approaches need to be in place to always test overall risk appetite within the context of the broader portfolio, and push the frontier in individual cases. With DFIs fulfilling a role as impact investor, greater flexibility is warranted in absorbing risk through non-concessional means in specific projects.
- How do we make sure that concessional resources do not subsidize DFIs’ cost structures, but are directed to the actual de-risking of projects? In a RAROC based approach it is hard to de-link risk, cost and return expectations. For example, bringing a project to market in frontier markets is inevitably more costly. A DFI’s financial sustainability ultimately model requires recovery of this cost. What is needed therefore are benchmarks for risk, cost and return that are ambitious but compatible with financial sustainability. DFIs should take significant risk, but such risk-taking must be consistent with long-term financial viability. BF allows DFIs to choose a more ambitious point on the risk-return spectrum.
- There is broad agreement among DFIs that concessional resources should not be used to cover unduly high overhead costs of DFIs, or confer rents to project sponsors. This calls for scrutiny of DFIs’ costs, risk appetite and returns whenever BF resources are deployed. Lessons can be learnt from IFC’s BF approval process, which involves scrutiny of IFC’s RAROC with and without BF, a cap on this return and sharing of downside risk. Ideally, DFIs should focus on cost competitiveness relative to relevant benchmarks, as much as they do managing risk and preserving returns.

DFIs could pursue pipeline building more aggressively by using BF in project development especially in low-income and high-risk markets. This is because the portfolio approach has limits (we cannot assume that there is an endless volume of low-risk projects in more developed markets to compensate for high-risk exposures in low-income and high-risk markets without compromising DFIs’ financial sustainability). A further limit is that developing markets require sustained efforts before risk (and the level of concessional resources required to improve bankability) decreases. At IFC, for example, project development efforts are being elevated by supporting co-investments with facilities such as InfraVentures and SME Ventures, through additional capital and the redistribution of risk.

While deploying BF to de-risk DFIs' investments, clear guidance is needed to ensure that the concessionality serves the ultimate purpose of enhancing development impact. A DFI may face participation constraints in a transaction, so that the use of concessional resources to enhance the risk-return characteristics of the project makes DFI participation possible. To avoid any impression that the concessionality provided were to benefit the DFI alone or primarily, it is essential to articulate well how DFI participation contributes to additional development impact. To support this objective, safeguards can be put in place that require (i) strong DFI additionality including efforts to crowd-in private investors; (ii) greater use of contingent instruments and, ; (iii) effective targeting of intended end beneficiaries (Annex 3).

Avoid Use of BF Resources to Gain Competitive Advantage

Recommendation 5. DFIs appraising an investment opportunity should avoid use of BF resources to gain competitive advantage. Instead, DFIs should adopt modalities to strengthen discipline and compliance with the DFI Enhanced BF Principles.

With increasing investment into upstream project work, there is risk of losing investment opportunities to other financiers post-preparation, which should not be managed through BF. This may occur when a DFI commits upstream resources to develop a project and make it bankable, following which other financiers (possibly with some level of concessionality in their financing packages) provide more competitive financing terms for the investment. While the upstream support can be considered as a public good, that DFI's loss of business to other financiers means that the upstream costs incurred do not lead to a corresponding revenue stream at investment stage. While BF resources could potentially help the DFI to retain the investment by improving pricing, the fundamental rationale for BF support should remain the need to address private and public distortions that limit investors' participation or project impact.

There may be a need for governance arrangements to be put in place to find a solution among DFIs. This may entail agreeing a common methodology for establishing minimum concessionality or assessing market distortion risks. One could also require the payment of fees to compensate for the upstream work, and treating third-party investments into projects developed by the DFI as mobilization or catalyzation.

To avoid a 'race to the bottom', modalities to strengthen discipline and compliance with the DFI Enhanced BF Principles should be considered. DFIs should set a high bar for coordination, transparency and minimum concessionality with respect to BF coinvestments. This includes harmonizing disclosure standards and defining the 'rules of the road' to optimize the level of concessionality in projects. IFC, together with other DFIs at the fore of supporting renewable energy investments across the globe are designing such rules for BF deployment in the renewable energy industry.

5. THE USE OF BF IN PORTFOLIO

The discussion so far has been premised on BF supporting new investments through various types of instruments that enable a project to proceed under an optimized contract. DFIs also provide support to existing clients that aims to achieve several objectives e.g. addressing liquidity constraints, refinancing at lower cost, and crisis relief support. Exceptional shocks may justify the use of BF, alongside a DFI's own-account resources, to support transactions in their portfolios and ensure the continuity of operations and preserve development impact. To avoid creating perverse incentives, such support should be considered only when DFIs have skin in the game in the relief transaction, the project was in good financial standing prior to the external shock, and a strong development rationale is provided. COVID-19 presents an example of such exceptional circumstances (Box 2).

Box 2. The COVID-19 Pandemic and the Use of BF in Portfolio

The COVID-19 pandemic presents an extraordinary challenge to lives and livelihoods. It also presents an extraordinary opportunity to deliver impactful support made possible by blended concessional finance. At a time where the needs are unprecedented and fiscal resources are scarce, these exceptional circumstances may justify the use of BF to support transactions in DFIs' portfolios and ensure the continuity of operations for otherwise well-performing projects.

The use of BF in portfolio projects to rescue underperforming assets may create perverse incentives. It also increases the risk of failing to return capital to donors who require capital preservation. If a project is underperforming, equity holders and existing lenders should ideally bear the risk as envisaged at origination.

However, there could be cases in which an exceptional shock that puts at risk development impact justifies providing BF. This may be especially the case in fragile and dynamic environments, as in low-income and high-risk countries, where distortions could also materialize during project implementation. If concessional resources are used for portfolio projects, this should be accompanied by a strong development case, e.g., the preservation of important development gains, and by appropriate structuring to ensure alignment of interest and compensation to the donor tranche taking the 'newer' risks.

The COVID-19 pandemic is an example of an exceptional circumstance that may warrant the use of BF in portfolio projects. Given the scale and synchronized nature of the shock, governments have a distinct responsibility to mutualize losses and protect the private sector, on which so many livelihoods depend.

Yet, the pressing need for government support faces the hard reality of tight fiscal constraints in many developing countries. BF can play a useful role to ensure continuity of critical and developmentally impactful private sector operations while avoiding long-term damage to economic capacity by keeping otherwise viable firms afloat, workers employed and financial intermediaries able to finance working capital and other needs. It would be important though that the DFI has skin in the game, the client was in good financial standing before the shock and a solid development rationale is provided.

6. CONCLUSION

With concessional resources becoming more prevalent in the private sector operations of DFIs, there is room to articulate more clearly the rationale for their use. Following a review of current frameworks, this paper proposes that the composite rationale for blended concessional finance is unpacked into three constituent components: (1) the development rationale, (2) the rationale for DFI additionality, and (3) the rationale for concessionality. These components hold simultaneously, where (1) and (2) are necessary in the justification of the overall rationale but not sufficient. Existing frameworks for establishing the rationale for BF tend to focus on social welfare, or the distortions that justify DFI participation. There is need also for (3), which amounts to a separate evaluation of the unique need for concessionality.

This paper proposes that the need for concessionality derives from critical residual participation and behavioral constraints that prevent projects with high development impact from going ahead. For example, a project's RAROC may be too low from a lender financial sustainability point of view, preventing it from participating in the investment. Or tariffs in a solar investment may be too high to induce a change in the behavior of utilities towards cleaner forms of energy. These are examples of investment hurdles where concessional resources can help.

The paper also makes several recommendations to improve the modalities for extending concessional resources efficiently. Among them are the need to match the instruments more directly to the distortion being addressed, and to ensure that when different instruments of concessionality or multiple sources are used to support one investment, the BF principle of minimum concessionality still holds. It also presents potential modalities to mitigate risk of use of BF to gain competitive advantage. Finally, it argues that the COVID-19 pandemic has reinforced the need for the use of BF to preserve development gains from past investments during periods of extreme economic shocks. In so doing, DFIs must introduce safeguards to avoid creating perverse incentives.

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ANNEX

Annex 1: Case Studies

Case Study #1: Llenova Renewable Energy

Summary

The Project entails the development, construction, management and operation of a 30 MWp solar photovoltaic (PV) project in Llenova. The investment constitutes the first application of the country's flagship Renewable Energy Independent Power Producer (RE-IPP) Program in Central Asia and is Llenova's first solar IPP. The Project is being developed by Global Power, the project sponsors, who had lowest winning bid in the first round of the Renewable Energy IPP Program with a fixed tariff of 5.2 US¢/kWh. The Project signed a 20-year power purchased agreement with state-owned utility, Llenova Electricity Company (LEC), and benefits from a guarantee provided by the Government of Llenova (GoL), including a DFI counter-guarantee, on LEC's revenue obligations. If successful, the Project will help establish a benchmark in the Central Asia region for competitively priced power from solar PV, especially important in a region with persistent supply-demand imbalances. The Project is expected to generate up to 60 GWh of electricity annually, leading to greenhouse gas (GHG) emissions reductions of approximately 58,000 tons of CO₂-equivalent (CO₂e) per year. The estimated total Project cost is US\$38 million, financed with 30% equity and 70% debt comprised of (i) a DFI A Loan of up to 25% of Project costs; (ii) a Blended Finance (BF) senior loan up to the A Loan amount; and (iii) a B loan from a commercial bank in the same amount as the A Loan.

The Composite Rationale for Blended Concessional Finance

1. The Sub-Rationale for Development impact

Anticipated outcomes at the level of the project: (i) *Reduce carbon footprint.* By displacing carbon-intensive emergency power relied upon to stabilize supply during the dry season, the Project marginally improves the carbon footprint of the power sector in Llenova. (ii) *Promote affordability.* While the Project's tariff of 5.2 US¢/kWh falls below the cost of emergency power incurred by LEC (up to 10 US¢/kWh) during periods of severe load shedding. The RE-IPP auction, where a term sheet with indicating terms for a DFI instruments package including BF was offered pre-bid to all prospective bidders, realized competitive solar tariffs. The DFI estimates that BF resources reduced the tariff by 15%, and contributed to establishing a new benchmark tariff for future projects in the region.

Anticipated outcomes at the market level: enhance competitiveness of the sector. The Llenova RE Project is the first project selected in the country's debut round of the Renewable Energy IPP Program, which sets out the rules of engagement for subsequent procurements. This project contributes to establishing a *low-tariff benchmark*, a framework for coordination of GoL entities, and bankable project documentation, that constitute a solid channel for replication. Based on GoL's sector development plan and pipeline, the DFI estimates that 200 MW worth of solar power projects will be procured through the RE-IPP framework in the next 5 years. Moreover, the successful conclusion of the first tender of the Renewable Energy IPP Program in Central Asia is expected to have regional *demonstration effects*, influencing the design of similar programs within the region.

2. The Sub-Rationale for Additionality

The DFI package enables development of a renewable energy resource with good development outcomes, including positive externalities, that faces significant market barriers. The barriers to solar market development in the region include: (i) high project costs, due to high transaction costs, lack of track record and insufficient competition; (ii) high costs of capital, due to underdeveloped capital markets and high country and off-taker risk premiums; and (iii) absence of bankable project documents, which increases the time needed to reach financial close on projects. In the case of the Llenova RE Project, factors outside Global Power's control, including delays in effectively managing resettlement, significantly delayed financial close and contributed to the deterioration of project economics post-bid.

Financial additionality: DFIs will provide a financing package including long-term loans (up to 18 years plus up to 18 months grace) and a BF concessional portion, that ensures project bankability at a reasonable tariff. The financing terms provided by DFIs in this transaction are also not readily available in local capital markets.

Non-financial additionality: DFIs' participation provided non-commercial risk mitigation, from project structuring that mitigates market, sector and political risk. Through its upstream advisory services support, DFIs brought knowledge, innovation and capacity building, including support to public implementing agencies involved in competitive tender for the first time, in a market with very limited IPP experience.

3. The Sub-Rationale for Concessionality

Enable participation by enhancing returns: The DFI considers that the stapling of BF to the indicative term sheet offered to prospective bidders in the debut Renewable Energy competitive tender in Llenova was instrumental in increasing developers' interest, which increased competition. In this debut round of the program, 8 of the 12 pre-qualified bidders submitted bids. The implementation of the Renewable Energy IPP Program as a transparent competitive tender that includes a bid on tariff implied lower equity IRRs for sponsors, relative to similar projects concluded under direct negotiation in comparable markets. As a result of delays in reaching financial close in this nascent market, the equity IRR for the winning bidders in the Llenova Renewable Energy IPP Program further declined. At better debt terms, Global Power could maintain equity IRR levels consistent with the risk assumed.

Case Study #2: VITO Rice

Summary

The Project is a corporate loan to VITO Rice, one of the leading rice millers and exporters in Caledonia, a low-income post-conflict country, to support the construction of a new rice mill and expand permanent working capital. The corporate loan will help the Company to increase its production capacity, increase purchases from local rice farmers in its supply chain, and extend further technical support to those 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 US\$12 million, to be financed through a loan package including (i) a US\$5 million DFI senior loan with a tenor of 6 years (ii) a Blended Finance subordinated loan of the same amount and tenor (iii) and internally generated cash.

The Composite Rationale for Blended Concessional Finance

1. The Sub-Rationale for Development impact

Anticipated outcomes at the level of the project: (i) *Smallholder farmers' 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 increase productivity, stabilize incomes and improve livelihoods; and (ii) *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: enhance 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, and 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, despite its importance and solid growth in recent years, the rice sector still suffers from significant constraints. The sector faces environmental externalities resulting from unsustainable cropping practices and climate change effects (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 underdeveloped in terms of production practices. For these segments, market entry is restricted by lack of knowhow, a small domestic market, and lack of market information to assess risk. Finally, agriculture in Caledonia faces investment barriers deriving from underdeveloped capital markets, high cost of debt and unfavorable financing terms. Local regulation also makes security enforcement difficult for lenders.

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.

Non-financial additionality: DFI participation will provide technical knowhow and access to global networks through Advisory Services to the sector aimed at improving farmers' capacity in new niche markets, and achieving certifications on sustainable farming practices. DFIs also contribute to improving environmental and social impact management practices from the application of DFI E&S performance standards which exceed national standards.

3. The Sub-Rationale for Concessionality

Enable participation by de-risking senior lenders and interest rate buy-down: The BF 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 (i) lower the cost of financing and preserve project economics, given the thin operating margins faced by firms in the rice industry, and the Company's cost structure, which reflects its extensive engagement with smallholder farmers; (ii) address risk from weak enforceability of security faced by lenders in the industry. Without BF, project risk is un-bankable for senior lenders. As VITO is unlikely to find alternative sources of affordable long-term financing, BF is necessary for the Project to go ahead at the full scale, within the expected timeframe.

Case Study #3: Atlantis Bank

Summary

The Project is a corporate loan to Atlantis Bank, a financial institution and third largest commercial bank in Cumar, to finance micro, small and medium sized enterprises (MSMEs), including women-owned SMEs. Through this Project, the DFI will support Atlantis' expansion following a recent successful restructuring. The growth strategy is also supported by an advisory engagement involving the DFI, to build the bank's capacity in supply chain financing and banking for women. Specifically, the AS engagement will strengthen Atlantis' capacity in designing a supply chain financing strategy, broadening products, and adopting electronic platforms that help to increase penetration rates in underserved areas. The Project cost is US\$120 million, to be financed through a loan package including (i) a US\$80 million DFI senior loan with a tenor of 5 years (ii) a Trust Loan provided by an institutional investor amounting to US\$40 million. A complementary Blended Finance performance incentive valued at US\$1 million, structured as an interest rebate, was extended to motivate lending to women-owned enterprises. To access the full amount of the rebate, Atlantis should reach a target of US\$80 million in new loans to women-owned SMEs in three years. Notably, 50 percent of the Project cost is earmarked for this underserved group.

The Composite Rationale for Blended Concessional Finance

1. The Sub-Rationale for Development impact

Anticipated outcomes at the level of the project: (i) *Access to finance for underserved groups:* The Project is expected to increase financial access for the underserved MSME and women-owned SMEs through an expansion of product and service offerings to these groups. The Project is expected to enable Atlantis to increase its loan portfolio to MSMEs by 65 percent (from about 3,000 to 5,000 loans in the portfolio) and to double the size of its lending to women-owned SMEs (from about 1,500 to 3,100 loans in the portfolio). (ii) *Economy-wide effects:* The expansion of credit to local firms is expected to increase economic activity with implications on jobs and growth. Through SME finance, the Project is estimated to create and facilitate between more than 25,000 jobs in Cumar over a 3-year period.

Anticipated outcomes at the market level: enhance competitiveness and inclusiveness of the sector. The Project is expected to enhance market competitiveness by demonstrating the potential and viability of supply chain finance targeting local MSMEs to other players in the banking sector in Cumar. This is expected to facilitate replication and an increase of product and service innovation in the financial market. The Project will also help Atlantis to support underserved market niches at scale, and demonstrate new modalities to efficiently reach underserved groups.

2. The Sub-Rationale for Additionality

Competitive MSMEs have an important role to play in Cumar, a fast-growing middle-income country, as they account for more than 90 percent of all firms and contribute about 70 percent of total employment. Despite Cumar's recent financial sector reforms, access to long-term local currency financing is generally restricted, and financial inclusion remains low, with an unmet financing need for MSMEs totaling about US \$25 billion, of which a fifth relates to women-owned SMEs. Access to finance for underserved groups is restricted by higher collateral requirements, lack of firm financial records, and low bank penetration rates in low-income urban and rural areas.

Financial additionality: Through this Project, the DFI will mobilize long-term financing to support growth of a mid-tier bank's MSMEs portfolio, with a strategic focus on women-owned businesses. Atlantis currently has limited ability to mobilize long-term financing from international sources, necessary to achieve maturity matching and diversify funding sources.

Non-financial additionality: Leveraging its expertise and experience in supporting financial institutions to develop MSME products and supply chain finance solutions, the DFI will support Atlantis in building internal capacity to effectively expand its MSMEs portfolio. The DFI will also provide technical assistance to Atlantis to build capacity to better evaluate the risks and adopt relevant products for women-owned SMEs. A complementary BF facility will support these efforts by providing an interest rebates to incentivize loans to women-owned SMEs.

3. The Sub-Rationale for Concessionality

Align incentives to through a BF performance incentive: The BF facility structured as a performance incentive aims to encourage Atlantis to grow its women-owned SMEs lending portfolio. The blended finance subsidy embedded in the interest rebate will support the initial costs of integrating systems for more effective integration of women-owned SMEs and the roll-out of dedicated product lines. The Bank envisions allocating at least half of the DFI loan proceeds to finance women-owned SMEs. To access the interest rebate, a target of US\$ 80 million in new loans to the target group over three years has been agreed.

Annex 2. Types of Additionality

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 on the market. Due to their development mandate, higher risk tolerance, long-standing presence in emerging markets, DFIs can provide long tenor, extended grace period 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*: Provision of 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.

Non-Financial Additionality

This includes benefits to projects that come from mitigation of non-financial risks, improvements in standards, changes in design to enhance development outcomes, and strengthening regulatory and policy environments.

- *Non-commercial risk mitigation*: Providing comfort to clients and investors that political or regulatory risk are adequately mitigated. Non-commercial risk mitigation could be implicit (DFI lending its name and due diligence reputation to the project), or explicit (DFI providing non-commercial 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.

Annex 3. Blended Concessional Finance with DFIs a Direct Beneficiary

As noted earlier, a DFI may face participation constraints in a transaction, so that the use of concessional resources to enhance the risk-return characteristics of the project makes DFI participation possible. To avoid any impression that the concessionality provided was to benefit the DFI alone or primarily, it is essential to articulate well how DFI participation contributes to additional development impact. To support this, a number of broad guidelines could be considered:

- *Contingent instruments:* Risk mitigation BF instruments help a DFI to protect itself against bad states of nature, in addition to other risk-mitigation efforts including structuring, conditionality and technical assistance. With contingent instruments, DFIs benefit only in the event that a downside risk materializes. Assuming liquidity is present in the market, this type of support should be preferred in high-risk markets, where DFIs' key mandate of de-risking is well understood by stakeholders. An upfront interest rate subsidy that improves profitability of an investment for all investors unconditionally is less preferred; so a funded structure could be used with an interest rate step down. Greater use of contingent instruments may also entail revision of BF donors' principal repayment requirements.
- *DFI additionality:* In cases of strong additionality, the non-participation of a DFI will carry a high social opportunity cost that deserves careful consideration, even in the presence of some reputational cost attached to de-risking the DFI directly. DFI's strong additionality implies higher impact delivered more efficiently (e.g. DFI advisory service engagement that helps a client improve its internal systems in order to serve a new customer base is linked to a DFI investment that faces a participation constraint; the DFI is offering a product that can only be provided by a DFI in the local market). Indeed, in the extreme case, projects in which DFIs have high additionality would not proceed without a DFI's support.
- *Benefits to end-users:* DFIs may be the most direct beneficiary but need not be the ultimate beneficiary of concessionality. In some cases, the BF facility alleviates multiple participation constraints for multiple parties, including the DFI. In others, BF alleviates a participation constraint at the level of the DFI, but the benefit of concessionality is ultimately transmitted to end-users (through lower electricity tariffs, lower interest rates for borrowers, lower availability payments for governments in a PPP), in addition to facilitating the project's standalone impact, which strengthens the rationale for concessionality.

Ultimately, DFIs have agreed on a set of enhanced principles (e.g. minimum concessionality) that apply to all investments that use BF to alleviate the DFI's participation constraint. The BF Principles also suggest limiting the use of concessional finance to enhance the risk/return position of a DFIs' own funds in a project financing package—without extending the benefits to other investors; and carefully considering financing structures that place BF resources at par with or senior to commercial investors, in order to maximize crowding-in effects. Finally, transparency will be key in communicating both the beneficiaries and impact associated with this type of BF support.

NOTES

- 1 See for example, Devinit (2016), Pereira (2017).
- 2 Contract theory studies how economic actors can and do construct contractual arrangements, generally in the presence of asymmetric information.
- 3 For an incomplete contracting framework which establishes a rationale for the use of concessional resources in alleviating credit market imperfections, see Schellekens (2000).