

Blended Concessional Finance: Scaling Up Private Investment in Lower-Income Countries

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

Guided by the 2015 Addis Ababa Agenda for Action, the global development community has initiated efforts to help countries maximize finance for development without driving up public sector debt to unsustainable levels. Doing so requires the pursuit of private sector solutions that can help achieve development goals while reserving scarce public finance for where it is needed most.

Recognizing the Needs

According to the United Nations, in developing countries alone, the annual investment gap in sectors covered by the Sustainable Development Goals (SDGs) is an estimated \$2.5 trillion per year. At current levels of finance from official development assistance as well as private investment, the funding shortfall will be approximately \$1.6 trillion. This is an enormous gap for the public sector to fill.¹ Given the current global economic environment, public funding of this order is unlikely to materialize, so new approaches to crowding in private investment are essential.

In lower-income² and fragile countries, access to private financing is often scarce due to both real and perceived market risks, including regulatory constraints, poorly developed investment climate, inadequately educated and

trained workers, and a pronounced infrastructure gap. Comprehensive solutions and strong domestic leadership are required to tackle these issues, and blended concessional finance can help by unlocking untapped investments for sustainable development.

Blended concessional finance is needed given the difficulties inherent in financing private businesses in lower-income countries. As illustrated in Figure 1, only a fraction of lower-income countries today has investment grade ratings. Yet many private investors have a preference—or even a regulatory requirement—for investment-grade products in their core investment strategies. More than 80 percent of lower-income market investments remain below investment grade, which significantly restricts the amount of private funding available in these countries and underscores the need for blended concessional finance to initiate transactions and demonstrate their long-term commercial viability.

The challenge for crowding in private investments in lower-income countries is often to initiate first-of-its-kind investments that can showcase commercial viability in the longer run, and thereby attract subsequent private investments on commercial terms. To address common market failures in lower-income countries, the World Bank

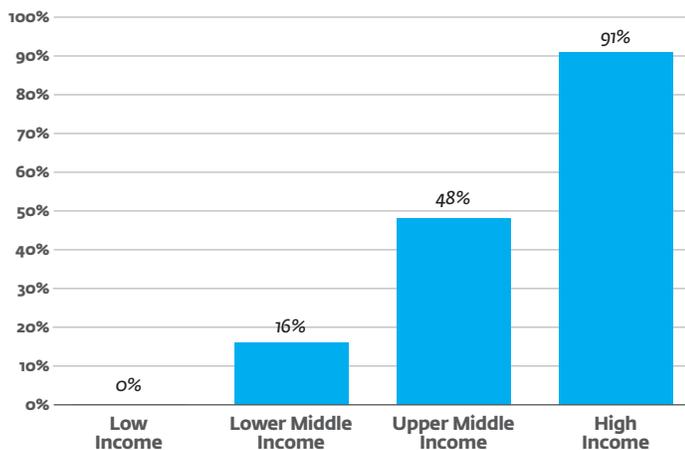


FIGURE 1 Percent of Countries with Investment Grade Ratings, 2015–17

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

Group has developed a Maximizing Finance for Development (MFD) approach. This entails prioritizing private sector solutions when possible, to promote judicious use of scarce public resources. Where markets are not conducive to private investment, the World Bank Group focuses on reforms that address market failures and constraints to private sector solutions at the country and sector level. Where risks remain high, the priority will be to apply de-risking instruments such as guarantees and risk-sharing instruments. In these situations, blending concessional funds from public or philanthropic sources with funds on commercial terms from private sector sponsors, banks, Development Finance Institutions (DFIs), and other participants has significant potential as part of a comprehensive solution.³

The Rules of the Game

Blended concessional finance can often make private investments happen that would otherwise not materialize. However, efficiency requires adherence to agreed rules across DFIs, including minimizing the risk of crowding out commercial capital and ensuring transparency. In 2017, 23 DFIs with a focus on private sector activities adopted a set of Enhanced Principles on the use of blended concessional finance.⁴ These DFI Enhanced Principles ensure, among other things, that concessionality is used to the minimum extent needed, and it supports the crowding in of other investors as much as possible.

Applying these DFI Enhanced Principles becomes even more important in lower-income countries where benchmarks for commercial terms are often less clear, and where perceived market risks are often greater. While concessional funds can be effective in opening private investments in high-risk areas, there are also potential pitfalls.⁵ Without a market test of commercial-based funding, there is potential for misuse of below-market-priced funds—that is, investing capital with more concessionality than needed or providing subsidies that are captured by the private sector and are beyond the returns required to make a project viable. Steering around these pitfalls by implementing the joint DFI Enhanced Principles can help to effectively scale up private sector engagements in lower-income countries.

Blended Concessional Finance Utilization in Lower-Income Countries

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

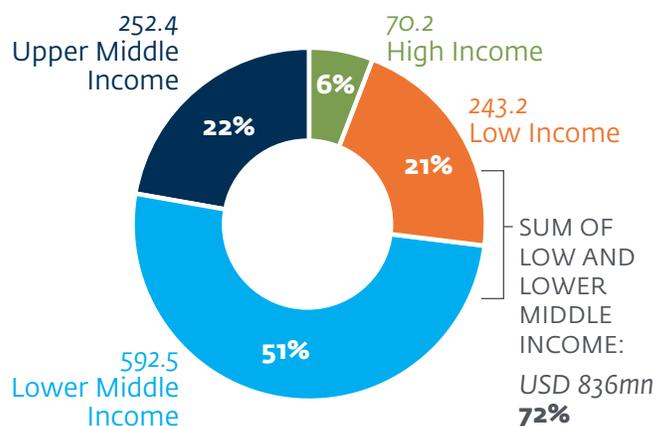


FIGURE 2 DFI Concessional New Commitments by Income Level, 2017 (USD Millions)

Source: IFC calculations based on DFI self-reporting data

Figures 2 and 3 show data from the 2017 survey of DFI's use of blended concessional finance undertaken by the DFI Working Group on Blended Concessional Finance in Private Sector Projects.⁶ Figure 4 shows the concessional amounts by income level specifically from IFC. As illustrated, blended concessional finance is particularly prevalent in lower-middle-income countries and in Sub-Saharan Africa.

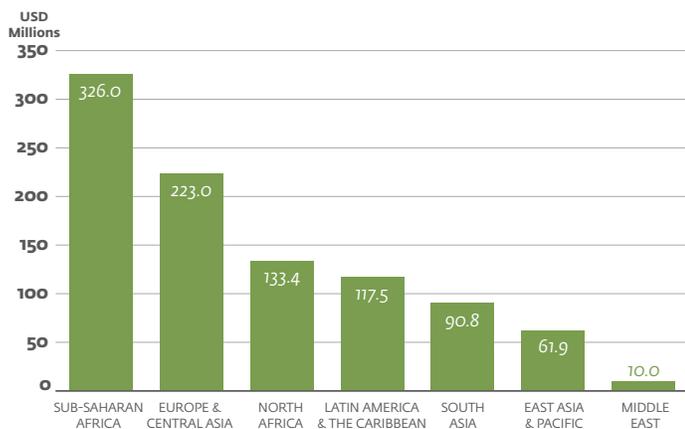


FIGURE 3 DFI Concessional Amounts by Region, 2017

Source: IFC data

Recent DFI strategies and new concessional resources indicate that the relative importance of lower-income countries in the blended concessional finance mix is likely to increase in the future. As an example, IFC has established a target to increase its share of new commitments in IDA countries—largely low- and lower-middle-income countries—from about 24 percent today to 40 percent by 2030 and increase its share in low-income and fragile countries from about 7 percent to 15 to 20 percent over the same period.⁷

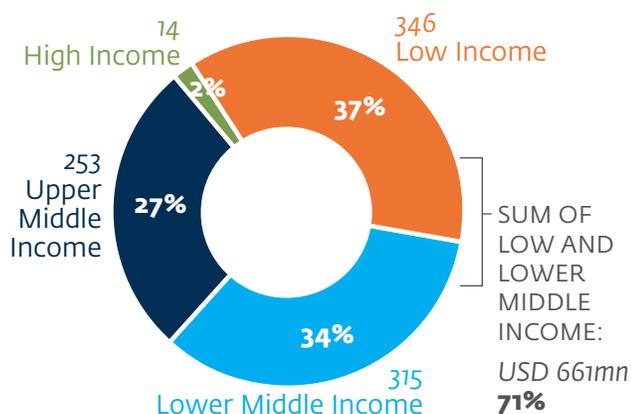


FIGURE 4 IFC Concessional Amount by Income Level, FY2010–18 (USD Millions)

Source: IFC data

New blending facilities such as the IDA-IFC Private Sector Window (IDA PSW) are specifically targeted toward lower-income countries and are becoming an important component of IFC resources available for blended concessional finance.⁸ Figure 5 illustrates the significance of IDA PSW for allocations to lower-income countries. IFC also is increasing advisory services in these countries via its new Creating Markets Advisory Window.

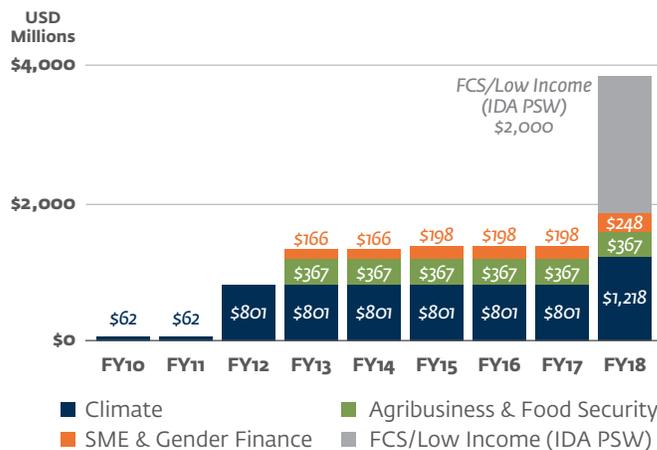


FIGURE 5 IFC Blending Concessional Funds Under Management FY2010–18

Source: IFC data

Instruments and Concessional Instruments

The blended finance instruments used by DFIs in lower-income countries have several differences from those used in higher-income countries (Figure 6).⁹ Lower-income countries tend to have a greater variety of instruments beyond senior debt, with a combination of cost and risk bearing through pricing, incentives, subordination, or use of equity or guarantees.

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

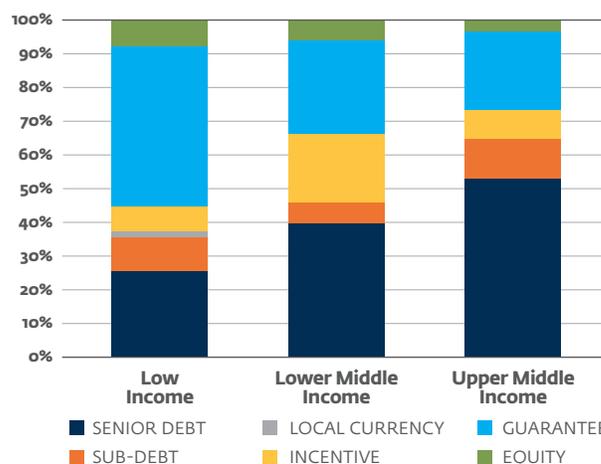


FIGURE 6 IFC Blended Concessional Finance Commitments by Concessional Instrument, by Project Count, FY2010–18

Source: IFC data

The amount of concessionality required in lower-income country projects also tends to be greater. This can be inferred from DFI data in Figure 7 below, which compares total project cost and concessional financing amounts, and indicates a relatively higher share of concessional finance for projects in lower-income countries than in upper-middle-income countries.

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

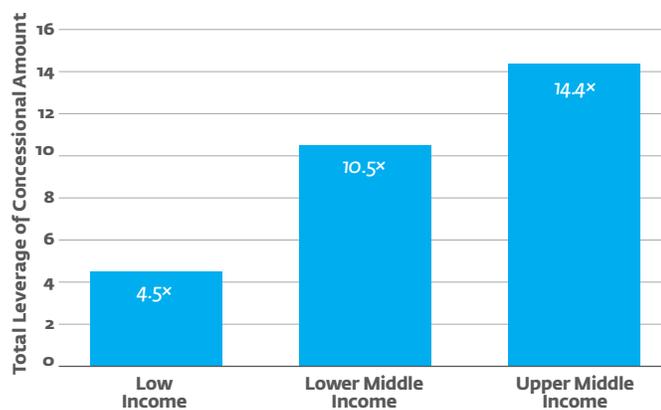


FIGURE 7 DFI Total Leverage of Concessional Amount

Source: IFC calculations based on DFI self-reporting data (2017)

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

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

Helping Farmers and Agribusiness in Madagascar

Three-quarters of Madagascar's population lives in extreme poverty, and 80 percent of them are dependent on agriculture. Although Madagascar has excellent conditions for cattle and goat production, inadequate veterinary services and infrastructure limit economic opportunities and exports. The government of Madagascar, with World Bank support, has been helping rural herders and farmers improve incomes

by expanding veterinary services, developing new road infrastructure, addressing agriculture value chain policy and governance issues, and building related technical capacity.

IFC is complementing these activities with support for a local agribusiness firm, BoViMa, which is developing the country's first modern feedlot and abattoir. With support from the Global Agriculture and Food Security Program (GAFSP), advisory services are provided to help BoViMa improve animal husbandry and strengthen the company's supply chain for both breeders and local farmers who produce animal feed. IFC and GAFSP are also providing a \$7 million subordinated debt investment in the company to make the project viable and crowd in other investors.¹⁰ The BoViMa project will help support the livelihoods and operations of more than 20,000 local herders and farmers.

This project illustrates how a comprehensive approach involving advice to government and suppliers, development institution financing, private sector sponsorship, and donor-funded concessional co-investment can help create markets. The project required extensive effort to develop but could revive the country's former export market for beef and goat meat. The project also illustrates the importance of higher risk-bearing instruments such as subordinated loans in high-risk environments.

Fruit Processing in Afghanistan

Nearly 90 percent of Afghanistan's poor live in rural areas where agriculture is dominant. The country was once famous around the world for its raisins, but currently less than 40 percent of its annual produce is exported due to instability, poor quality, and food safety standards. The World Bank-managed Afghanistan Reconstruction Trust Fund is providing \$190 million to enhance agricultural practices, introduce new technologies such as for raisin drying and handling, and connect farmers with markets.

Within the World Bank Group, IFC and the Multilateral Investment Guarantee Agency (MIGA) are complementing these efforts by working to catalyze private investments into the sector. IFC is providing \$3 million in financing support, including the support of GAFSP, and MIGA is providing \$7.8 million in political risk insurance coverage for a new raisin processing plant by the Rikweda Fruit Process Company. The goal is to double production levels and improve the quality of processed raisins by introducing modern technology and food safety practices. IFC advisory services will also help provide guidance to small farmers on how to improve farming practices. GAFSP is providing a first loss guarantee, and the

IFC-MIGA IDA Private Sector Window has allocated \$3.1 million in support of MIGA guarantees.¹¹ The project has the potential to improve livelihoods for some 3,000 smallholder farmers in remote rural areas, strengthening their access to market, and promoting roles for women in agriculture.

This project illustrates the value of a comprehensive approach that brings together government programs; development institution investment, political risk mitigation, and advisory services; private involvement; and donor support via first-loss or parallel guarantees. Donor participation supported the project in a high-risk environment and utilized first-loss guarantees which directly targeted the risk issues.

Housing Finance in West Africa

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

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

The IFC financial package used concessional funds from the IDA Private Sector Window (PSW) to assume risks associated with providing local currency financing. Over time the long-term bond market should become viable with funds coming from local investors, including institutional investors. Greater access to long-tenor mortgages would help increase the affordability and availability of housing as well as contribute to economic growth and job creation.

This project illustrates the importance of a holistic approach, with a combination of government regulatory reform, private investment, FDI involvement, and donor support to help create long-term impact and new markets. An innovative

financing instrument was also used—the PSW Local Currency Facility provided risk guarantees that allowed IFC to obtain the domestic currency funds and thereby fulfill its role in strengthening the emerging long-term housing finance market.

Distributed Generation in the West Bank and Gaza

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

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

Donor financing was important to achieve the financing structure. The project demonstrates the importance in lower-income countries of anchoring blended concessional finance in an overall sector development strategy. It also illustrates how the use of a combination of instruments—concessional, risk guarantees, and grants—or “ultra-blending” may be necessary in lower-income countries.

The Journey Ahead

Given limited public funds and the need to move development finance contributions from billions to trillions of dollars, increasing attention is being devoted to ways of crowding in private investments to contribute to sustainable development. Looking forward, blended concessional finance has enormous potential to unlock private business in developing countries if it is implemented correctly.

The data presented in this paper illustrates an increasing focus on lower-income countries among development

finance institutions. This trend is likely to continue through innovative mechanisms with an explicit focus on lower-income and fragile countries such as that of the World Bank Group's IDA Private Sector Window.

Blended concessional finance can play a critical role in mobilizing private investments and creating new commercial markets to impact sustainable development. However, solutions for blended concessional finance must always be adapted to the prevailing market context and based on comprehensive approaches to catalyze markets that will be self-sustaining in the long run without concessional finance.

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

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

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

The third lesson is the crucial importance of stronger cooperation between development banks with respect to strategies and approaches to blended concessional finance in lower-income country contexts. The latest data from the DFI working group on blended concessional finance shows that more than 70 percent of new commitments were to lower-income countries.¹³ With increasing engagements and focus on lower-income countries, it also follows that DFIs have the opportunity to coordinate and share experiences to support sustainable development and new private markets. Continued interactions among DFIs will further enhance the overall effectiveness and discipline of blended concessional finance.

ABOUT THE AUTHORS

Kruskaia Sierra-Escalante, Manager, Blended Finance—New Business and Portfolio, Blended Finance, Economics and Private Sector Development, IFC. (ksierraescalante@ifc.org)

Arthur Karlin, Consultant, Blended Finance—New Business and Portfolio, Blended Finance, Economics and Private Sector Development, IFC. (akarlin@ifc.org)

Morten Lykke Lauridsen, Principal Economist, Thought Leadership, Economics and Private Sector Development, IFC. (mlauridsen@ifc.org)

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¹ See UN (2018) concept note “Financing for SDGs—Breaking the Bottlenecks of Investment from Policy to Impact.”

² In this note, lower-income countries refer to low-income countries and lower-middle-income countries.

³ For more information on the World Bank Group's MFD approach refer to: www.worldbank.org/en/about/partners/maximizing-finance-for-development

⁴ IFC. “Blended Concessional Finance Principles for Private Sector Projects.” www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/solutions/products+and+services/blended-finance/blended-finance-principles

⁵ For a full overview of caveats and how blended concessional finance can contribute to creating markets see Kruskaia Sierra-Escalante and Morten Lykke Lauridsen. 2018. “Blended Finance – A Stepping Stone to Creating Markets.” IFC EM Compass Note 51.

⁶ DFI Working Group on Blended Concessional Finance for Private Sector Projects. 2018. https://www.ifc.org/wps/wcm/connect/9ae7c66a-d269-4707-9f4d-0fb79947ede8/201810_DFI-Blended-Finance-Report.pdf?MOD=AJPERES

⁷ Development Committee of the World Bank and IMF. 2018. “Sustainable Financing for Sustainable Development.” World Bank Group, International Monetary Fund.

⁸ The IDA PSW is specifically targeted toward the category of IDA countries called “IDA-only” countries, which are the lower-income countries of IDA, not IDA Blend countries which are eligible for World Bank IBRD lending at higher rates.

⁹ This discussion and the next sections exclude DFI data in high-income countries because of the small sample.

¹⁰ See: <https://disclosures.ifc.org/#/projectDetail/SII/38036>

¹¹ MIGA. 2017. “Afghanistan Rikweda Raisins – Project Description.” <https://www.miga.org/node/1883>; see also IFC. 2018. “IFC, MIGA Support Raisin Production in Afghanistan.” <https://ifcextapps.ifc.org/IFCExt/Pressroom/IFCPressRoom.nsf/0/DC5864BACB50E935852582A20037972E>; see also World Bank. 2018. “Afghanistan: Improving Yields and Incomes for Raisin Farmers Through Markets.” Brief, July 2, 2018. <https://www.worldbank.org/en/about/partners/brief/afghanistan-improving-yields-incomes-for-raisin-farmers-through-markets>

¹² MIGA. 2017. “PRICO Operations Rooftop Solar – Project Description.” <https://www.miga.org/node/1874>

¹³ IFC. “Blended Concessional Finance Principles for Private Sector Projects.”