Billions to Trillions – A Reality Check

Blending: Development Finance Institutions and Financing the Sustainable Development Goals

A RE-DEFINE Policy Brief for Stamp Out Poverty by Sony Kapoor

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Introduction: DFIs and Blending are the bedrock of the Billions to Trillions agenda

In 2015, the UN agreed to a set of 17 aspirational global goals, also called the Sustainable Development Goals (SDGs). They range widely across a number of ambitious social, economic and environmental issues and include eliminating global poverty and hunger by the year 2030.

To meet these will not only require institutional changes and new policies, but it will also require significant investments, for example, in energy, transport and social infrastructure, as well as the creation of hundreds of millions of jobs through both private and public investments.

However, the truth is that in countries such as fragile and conflict states, low income countries and many other developing economies, there is not enough money to fund such investments. Official development assistance (ODA), which comes in at roughly $150–$160 billion a year, helps, but is simply not enough and the overall volume has stagnated with little political room for a sharp increase. This leaves an annual funding gap of more than $1 trillion.

The biggest gaps lie in funding for infrastructure. Even though this has been broadly endorsed by the large donors and international financial institutions the matter remains controversial. The patchy record of public private partnerships (PPPs) even in developed economies such as the UK, the inherent public service element of social infrastructure in particular, and the big gaps between investor expectations and returns on offer mean that private funding of public infrastructure in developing economies has been challenged at several levels.[1]

Meanwhile, the UN and donor countries that are members of the OECD Development Assistance Committee (DAC) are actively looking at various options to provide financing for development to help plug this gap and have settled on two parallel tracks.

The first is to help increase the mobilisation of domestic tax revenues, which remain at very low levels compared to OECD economies. While there is scope for increasing revenues through better tax administration, improving tax policy and undertaking domestic and international measures to minimise tax evasion and tax avoidance, it is far from simple. For poor economies, it will still leave a large residual funding gap. Initiatives are underway on all of these, but these lie outside the scope of this paper.

This leads us to the second option, increasing the flows of private capital to developing economies and helping ensure that these help plug the residual SDG funding gap. Here the international donor community has rallied around the battle cry of "Billions to Trillions" (B2T), the idea that billions of dollars of aid can be used in such a way as to catalyse a trillion dollars of private capital.

Private sector arms of Multilateral Development Banks (MDBs) such as the World Bank, and Development Finance Institutions (DFIs) such as CDC in the UK, agencies funded by ODA that seek to promote the development of the private sector in developing countries, are central to this narrative. They have a long track record of mobilising private capital, while promoting development even as they make (modest) profits. One central theme of this B2T agenda is then expanding both the size and scope of the operations of these DFIs, while trying to get them to mobilise more private capital for the investments that they make.

1 https://eurodad.org/HistoryRePPPeated

Even as National Development Banks (NDBs) have come back into vogue, and new ones are being established, in reality most developing economies that need to ramp up investment levels, still lack such institutions. These NDBs, where they exist, do have a very important role to play, but this falls outside the scope of this paper.

The other related theme is to use aid money to address the unfavourable perception of the risk/return metrics that many investors have about developing countries. When surveyed, investors routinely overestimate the risk of investing in most developing countries and underestimate the profit potential. However, even once this misperception is addressed, many developing country investments, particularly in the fragile and conflict states and low-income countries, remain very risky. Often, they are more than those in developed countries, which most large institutional investors are familiar with. Even though returns available are also often higher, they may not be quite enough to compensate investors for the additional risk. Other issues such as the small size of the average deal size and regulatory restrictions on institutional investors further complicate matters.

Blending, the other big tool of the B2T agenda, involves "the strategic use of development finance (mostly ODA) to mobilise private capital flows to developing economies". In most cases this involves using public subsidies to either reduce the risk for private capital, for instance through first loss guarantees, or through offering preferential returns to the private sector so as to make the risk / return offering more attractive.

The structure of the paper

To understand the key policy issues the Billions to Trillions agenda raises and to come up with well-grounded policy prescriptions, it is critical to understand the following:

- That mobilisation of capital by DFIs and blending have become the latest fads in development thinking.
- That blending as a concept is not new, but in fact has a long history in development finance as practiced by the DFIs.
- That the new focus on blending, while a useful additional tool for Development, is limited in what it can deliver.
- That the bottom-up model pursued by DFIs limits their ability to scale, even if the supply of ODA money for blending is increased.
- That even with those limits, DFIs and blending have an important and growing role to play in development.
- That while this can allow the scaling up of private capital for SDGs from the present low levels to double or even triple the amounts, it will not be able to deliver the "trillions" necessary.

There has been a plethora of new blending facilities set up with a clear trend towards blending delivered using concessional ODA with DFI involvement. Consequently, this policy brief analyses blending by focusing on DFIs.

The first part of the paper addresses each of the above-stated questions in turn. The second part delves into the various criticisms and concerns that the focus on blending has given rise to. We end with policy suggestions on how to take the agenda forward in a manner that maximises the development impact and potential, while minimising the risks and the downsides.

About the author

Sony Kapoor is director of the international think tank RE-DEFINE, where he advises multilateral organisations, investors and European and emerging economies on economic and financial policy. An economist, financial sector expert and development practitioner, Sony is a consultant to institutional investors and corporations on investments and strategy.

Sony has had a multidisciplinary role at the London School of Economics both as a Senior Visiting Fellow in the Development, European and Government Departments and as a Strategy Adviser to the Systemic Risk Centre. An ex-banker, he has acted as special adviser to UNEP on green finance, and has worked with the OECD, IMF, European Commission and European Parliament on the Eurocrisis, Development, Sustainability and Financial Sector Reforms.

He was elected the first chairman of the Banking Stakeholder Group at the European Banking Authority. His contributions to Finance, Economics and Sustainability have been recognised by the World Economic Forum, which honoured him as a Young Global Leader in 2014.

Mobilisation by DFIs and Blending are the latest fads in Development

The world of international development, like the world of fashion is full of fads. But even by those standards, the rhetoric around blending has gone too far. If one listens to the hype around blending, and what it does for development and for funding the SDGs, one can be forgiven for thinking it is the "silver bullet" that can tackle all problems at once. It has risen to the top of the Development Finance agenda and is now widely credited with magical powers to turn billions of aid money into trillions of private investments. The Economist has called blending "a fad for mixing public, charitable and private money".[2]

As the Overseas Development Institute (ODI) says, the discussion has *"very little nuance about its potential, when and where it can work - and when and where it won't"*.[3] An example from the Blended Finance Task Force helps illustrate the point.

"The Taskforce estimates that if around $100 billion each year (representing roughly a quarter of the current annual ODA, MDB and philanthropic flows) could be deployed through blended vehicles that mobilize $3 of private capital at the fund level for every $1 of development capital, then this could create $400 billion of investible fund capital per year by the early 2020s. With further leveraging at the project level of another $3, this could close the SDG-funding gap".[4]

This is nothing but mathematical gymnastics with little, if any, bearing in the real world. It reflects a very poor understanding of how private sector investments are made, how aid is deployed and how DFIs and the private sector arms of Multilateral Development Banks (MDBs) actually invest.

The long history of DFIs and Soft Blending and the move to Hard Blending

Before we go on, it is important to clarify what blending and the discussion on mobilising capital by the DFIs or MDBs have to do with each other. A lot, as it turns out.

Blending, or the use of development capital to attract private capital, is in fact a development tool with a long history. Several decades back, donors set up multilateral institutions such as the International Finance Corporation (IFC), a part of the World Bank Group, and bilateral organisations such as CDC (originally the Colonial Development Corporation) with aid money to facilitate the development of the private sector in developing economies. It is widely understood that private sector development is essential for the development of an economy, given that the sector is the leading generator of jobs, and is responsible for many of the innovations and productivity gains associated with development.

Typically, these Development Finance Institutions (DFIs) seek to provide capital in the form of debt, equity or guarantees to project developers, fund managers or entrepreneurs in developing economies where capital is scarce or so expensive so as to render most private investment unprofitable. Most DFIs have a dual mandate from their owners: to promote development through catalysing the expansion of the productive private sector and to be profitable.

In theory, DFIs are supposed to provide finance on commercial terms, which are the terms on which a purely private actor would provide funding. In normal markets, supply and demand would match to clear at a fair price and there would be no need for DFIs. But in many developing countries financial markets are so underdeveloped that even profitable projects with limited downside risks may not get funded.

Given these incomplete markets, how do DFIs determine what the "fair commercial price" should be? The short answer is that often they cannot, and they do not. The best they can often do is to evaluate an investment on its own merit and look at how it fits in with their portfolio, and then price it at a margin they are comfortable with, given the risk they are taking on.

It is hard, often impossible, to say whether or not this is the case because of the absence of a benchmark and liquid market in comparable transactions. However, DFIs have a public service mandate that brings with it lower return expectations and a higher risk tolerance compared to most private sector sources of finance for the private sector in developing economies. This means that their pricing would likely be cheaper than purely commercial pricing, which means that DFI operations already offer an implicit subsidy. The fact that most DFIs have generated returns in the mid single digits rather than the double digits more typical of Private Equity Fund managers operating in developing

2 https://www.economist.com/finance-and-economics/2016/04/23/trending-blending

3 https://www.odi.org/comment/10650-can-blended-finance-work-poorest-countries

4 http://s3.amazonaws.com/aws-bsdc/BFT_BetterFinance_final_01192018.pdf

economies reinforces the notion that they operate under an implicit subsidy. For the purpose of this paper, we will call this implicit subsidy, which is modest and does not entail a loss for the donor, “**Soft Blending**”.

Given their dual mandate to contribute to development while staying profitable, the amount of this subsidy is modest and mostly implicit, as DFIs still turn a profit. As a matter of principle, DFIs seek to only invest in transactions and projects they expect to be profitable, even though they may accept lower profits or higher risks than purely commercial actors.

Private capital that invests alongside the DFIs may come in on more senior terms to reduce risk, or, as in the case of fund managers, ask for a bigger slice of the upside potential for higher profits. Even when private funds invest on the same terms as a DFI, they may free ride on the due diligence reputational advantages and improvements in business practice that DFI investments often entail.

This puts most DFI business somewhere between profitable and lucrative projects that the private sector, even in the incomplete markets in developing economies, is able to finance on its own, and those projects that may be fundamentally unviable. While DFIs can accept lower returns, and tolerate higher risks than purely private actors, they still will not invest in projects that are expected to make losses.

DFIs often finance projects that are profitable, but often not lucrative on terms that may be sub-commercial, so private investors may not flock to them in great numbers. As we will see later in this paper, this may partly explain why the measured private capital mobilisation multiples for DFIs have been less than one, or less than one dollar of private capital mobilised per dollar of own capital invested.

Recognising the very limited mobilisation of private capital by DFIs so far, which looks more like billions to billions rather than billions to trillions, donors have coalesced around the idea that blending to attract private capital to developing countries is the way to go. Given that the DFIs are the original impact investors as well as the original blending investors, it is no wonder that DFIs are at the heart of the discussion on mobilising trillions through the use of blending. Where National Development Banks exist, such as in Brazil, they have played this role, often at an even larger scale, and more focussed on challenging domestic rather than international savings.[5]

The thinking goes that much larger amounts of private capital will flow into developing countries and help directly and indirectly fund the SDGs, if the terms could be made more attractive through the use of more public subsidies to either reduce the risk for private capital, or to enhance returns, or do both. As discussed above, implicit subsidies have been part and parcel of the DFI model, what we call Soft Blending here. What is new is that the discussion has moved on to explicit subsidies, which may even entail an explicit loss for the donor, something we call “**Hard Blending**” in this paper.

Seen from the logic of DFI investments above, many of which fall in the grey zone of profitable, but not lucrative, if more ODA money was used to make the terms more attractive to private capital, then more money would co-invest alongside the DFIs and help increase mobilisation multiples.

This form of blending public capital to provide an explicit subsidy to private capital can be executed through several channels. It can be executed outside DFIs through special windows set up by aid agencies, such as the guarantees window housed by the Swedish International Development Cooperation Agency (SIDA). It can be executed by providing a subsidy window for use by the DFIs, as is the case for the IDA private sector window at the World Bank. It could be executed by lowering the portfolio level return expectations for all or part of the DFI portfolio, as DfID has done with CDC. Or it can be executed by providing technical assistance funds for project development and some upstream activities to the DFIs.

There is also a danger, as pointed out by Think Tanks such as Eurodad, that donors might also seek to “fudge” the issue by simply trying to reclassify existing DFI investments so they meet the emerging OECD guidelines on private sector instruments to claim maximum credit without changing much on the ground.

The logic and the limits of Blending

The line between the kind of “Soft Blending” used by DFIs in the past and the new-fangled “Hard Blending” we have written about in the previous section is not always clear. But is it is clear that the latter is further along the subsidy spectrum and is more explicit than the former, and may even contemplate actual losses for donors rather than simply offering sub-commercial pricing. Is this an effective and efficient use of scarce aid money? This deserves closer scrutiny.

There are definitely many instances where the use of blending can work well and makes sense.

Where the real risks faced by DFIs in their projects are less than the risks perceived by private investors who do not know the local conditions in a developing economy so well, a partial risk guarantee can help mobilise private investors without actually subsidising

5 https://eurodad.org/files/pdf/1546743-public-development-banks-towards-a-better-model.pdf

them, as the guarantees are unlikely to be called. Here blending helps address the risk misperception gap.

Where investors are keen to learn about a market and develop local understanding, capacity and expertise, it can also make sense to use blending to entice a commitment to a market. Here blending can help address the knowledge and learning gap.

Where private investors will bring additional skills to bear in an investment in the form of business practices, new technology or new business models that the host country would benefit from, blending can be justified. Here blending helps address the market gap and generates positive externalities.

Where there are insufficient investible projects, public subsidies for project development can help generate a pipeline of projects that are suitable for DFI and private sector investments. In this case, blending can help plug the pipeline gap.

In all of these instances, the assumption is that:

- Blending will be temporary in time or scope;
- Once you consider the full costs and benefits involved, there is little or no public subsidy involved, and
- That once the first phase with blending is over and private investors have learnt the ropes and corrected their misperceptions of risk, then they would continue to invest in the country with or without blending.

However, evidence is accumulating fast that blending has already gone beyond these sensible uses and approaches into something that increasingly looks like soft money to subsidise private capital.

There has been an exponential growth in blending facilities on offer to private investors, almost all of them financed through ODA money. The way many are set up, there is a pressure to meet quantitative targets, to commit to deals before year-end, which has increasingly led to competition on the terms being offered. Investors can potentially play one blending facility against another to seek even more concessional terms, implying a bigger public subsidy.

Another parallel development is the increasing use of multiple blending facilities by investors. A structure we evaluated had between four and five different sources of public subsidy for private investors, for example.

These developments are fuelled partially by many blending facilities being run by traditional ODA professionals and not private sector specialists who have experience of project evaluation and investing, as should be the case. Decisions on when to offer blending, and on what terms, should be made through a process similar to traditional project evaluation. Consequently, investment decisions should be made by professionals qualified to do that.

After all, it is an investment of public money, and deciding a fair price for a first loss guarantee is impossible unless and until one understands the business case and projected cash flows for the underlying investments. However, too many times blending decisions are being made in a top-down manner, with limited attention paid to the underlying investment case. This can distort the market sharply and result in an unhealthy race to the bottom on pricing and terms with scarce ODA money wasted on unnecessary subsidies for private investors.

What many driving the blending rhetoric fail to understand is that investing is a bottom up process. DFIs seek projects that can turn a profit and have a development impact, perform due diligence, help improve environmental, social and governance (ESG) processes, share latest business practices and perform strong monitoring and oversight, all of which is highly human-resource intensive, with a typical DFI employee only being able to invest in 2–5 projects per year.

Top down decrees to deploy $100 million in blending or mobilise $5 billion in private capital lead to mispricing and distorted decision-making that is bad for development in the long term.

If soft money is on offer, it will be taken, whether it is needed or not. Which private investor will forego the opportunity for riskless profit? Soft money windows can also distort incentives within DFIs that are otherwise known for sound financial discipline.

The effects of these distortions can be huge and felt widely across the development landscape, which is why it is critical to avoid them, and mistakes are very costly. The following examples, taken from real life, serve to highlight how this works.

An otherwise worthwhile off-grid solar plant in a poor African country gets a big injection of subsidised blending, which allows it to offer power very cheaply in a move that is celebrated in headlines. But this non-market subsidised tariff now sets the benchmark expectations for what similar projects in the same country and elsewhere should charge for power. It squeezes out non-subsidised projects from the local market, because they cannot compete. It thwarts potential investments in other countries because the expectations of power purchasers and the actual non-subsidised cost of producing power cannot be matched. In short, one single transaction, with excessive public subsidy, can distort a whole market.

A large asset manager that is coming under pressure from its customers to offer an impact investing product initiates scoping conversations with several DFIs to co-invest substantial sums alongside them. The conversations develop well, and things look promising until the asset manager says, *"but we will be subsidised by SIDA and DfID right?"*, basing it on the chatter that everybody else in the market is getting subsidies left right and centre. The idea that soft money is on offer has permeated the consciousness of investors and distorted their expectations, potentially making it less likely in the long-term that they would commit genuinely risk-absorbing capital towards private markets in countries that DFIs operate in.

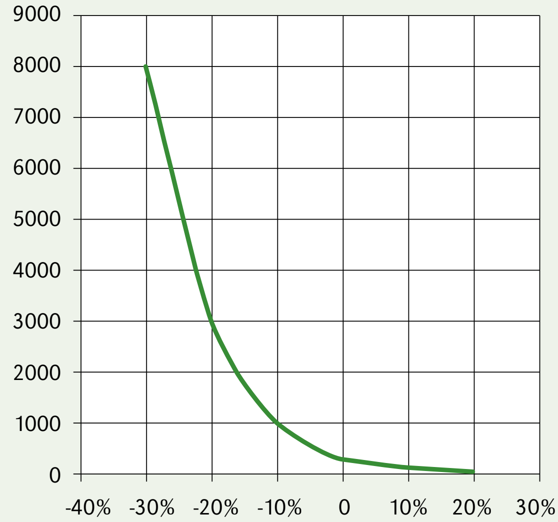
These distortions can be pernicious, and it only takes a few badly designed and poorly priced blending transactions to bring them about. That is why blending has to be rationed, time limited, priced by investment professionals and only used where it can be clearly and strongly justified.

The limits of scaling up the DFI model

At the end of the day, blending can and does help turn marginal investments into profitable ones by providing the funds and time necessary to reduce information asymmetry, improve human capital, try out new business models, improve governance, build upstream and downstream links, test technology and demonstrate viability. But even blending cannot turn a fundamentally unviable project into a profitable one, and too many blending facilities forget that fundamental truth today. Whether or not a project is viable can only be assessed bottom up, and top down pressure to disburse soft money will simply distort the market for everyone.

To understand this important point, it is useful to discuss how DFIs use a bottom-up model to make their investments. For this, the following graph is very instructive.

Number of investments versus profitability in percent



Source: Author

The first conclusion that jumps out of the graph above is the near inverse exponential relationship between the profitability of investments and the number of possible investments. This should be intuitive. There are perhaps next to no investment possibilities that yield, say 100%, annual return. Such returns are very hard to deliver in market economies with even limited competition. Even if they did exist, they would perhaps get competed away soon. Many more investments could generate expected return of 20%, around ten in the graph on the left. There should be many more possibilities to generate a 5% return, fully 200 as displayed in the graph on the left.

It is hard to make money, much easier to lose it. Lossmaking investments, say a shoe shop that gives away shoes at 2/3 the price it buys them at, should have a lot of customers. At a 30% expected loss, it is possible to make thousands of investments. Extending the logic and the intuition, there are countless ways of giving money away for free – equivalently, investing in projects with a 100% loss.

This discussion describes the scalability problem that DFIs confront. The bottom-up investment model of DFIs, of choosing projects that are both profitable and deliver a positive development impact, is subject to natural limitations of scale, as the supply of potentially profitable projects being far from inexhaustible, dries up relatively rapidly.

Blending, the modern version of good old-fashioned subsidy, can sustain a loss-making project for a limited time, but only if this helps create a path to profitability. Many new investments and projects make losses initially, but there has to be a viable path to profitability, or else the investment will deplete all capital and the project will go bankrupt.

Financial sustainability, under the DFI model, is a pre-condition for creating development impact. Otherwise, the jobs created will be lost, tax revenues will never materialise, and the loss-making nature implies that rather than increasing productivity in the economy, the project may actually reduce it. Scarce ODA money will be wasted. Few private sector actors would like to invest in such projects, no matter how high the subsidy.

It may, of course, serve a broader public role to deliver services at a cost, for example, health and education, which are often not meant to be profit making ventures but public services. But then DFIs are not the correct entities to fund them. While there is a role for the private sector, the vast bulk of social sectors can and should be funded and delivered by the public sector.

The implication is clear – DFIs can and should only fund projects that are financially profitable, at least at the portfolio level. Blending can help extend the time over which losses may be absorbed and push profitability in the future. It may also allow DFIs and private sector investors to accept lower returns and higher risks than they would otherwise be comfortable with.

But no amount of blending and subsidy can turn a dud project into an investible one. As the International Finance Corporation (IFC) admits, *"Blended finance can sometimes be helpful to tip the balance in marginally profitable, risky projects towards attracting commercial investment, but it can't alter the fundamental economics of the project."*[6]

It is also incumbent on donors to educate themselves about the working of the DFI model and its limitations. They should resist hyped up and unrealistic claims of mobilisation potential, and tone down the language of billions to trillions. They should not impose unrealistic top-down quantitative targets on mobilisation and blending, and instead listen to DFIs in designing strategies and targets that are grounded in the reality of DFI experience.

Particularly on blending, which carries the risk of wasting public resources and distorting the investment landscape, donors should listen to DFIs that are the original impact investors, and seek to simplify blending structures, channel them through DFIs where possible, limit subsidy and enforce strict monitoring and reporting.

DFIs are indeed well placed to help facilitate an increase in the private funding of development outcomes in general, and the SDGs in particular. But they do not have a magic bullet to convert their present modest scale of $40 billion of annual funding of new projects into more than a trillion dollars of private commercial investment. A hundred billion dollars is achievable in the near term, perhaps even more, but DFIs and the use of blending can only be a part of the solution to plugging the SDG funding gap.

A broader limit of the DFI model comes from the fact that DFIs often don't have sector-wide or country-wide strategies and often little or poor co-ordination with national development strategies. Their investments are often ad-hoc and driven by a demand for their services rather than by the needs of the country or a strategy to fill recognised gaps in the private sector in a country. This also limits their ability to scale but has been a fundamental part of the DFI model. New debates are being initiated as to whether this should change but it is early days yet.

Does it make sense for a small DFI, with a few hundred millions of dollars of capital, to have a country-wide or a sector-wide strategy when it will at best be able to fund only a few relatively modest investments in accordance with any such strategy. What if DFIs differ on their approach to countries and sectors? Can DFIs rally behind a single country platform or strategy as envisaged in the report of the Eminent Persons Group? Who should lead on the development of such a strategy, should there be an agreement to invest in line with such a plan? These are all yet to be answered questions in the emerging debate on national plans for private sector development and new industrial policy.

There is a significant role for DFIs and Blending in Development

No matter how successful private sector development gets, it is hard to see the role of DFIs diminishing anytime soon. More likely, given their unique model, are many opportunities for expanding. The Blended Finance Task Force also reaches this conclusion as highlighted below, although, as we have already shown above, contrary to what the Task Force concludes, the DFI model is not easily scalable.

"The private sector arms of the MDBs and the DFIs sit at the intersection of deal flow, concessionary and commercially-oriented capital. In addition, the bilateral DFIs generally operate as self-financing entities at no net cost to the public so they represent a powerful and easily scalable business model that could deliver significantly greater development impact, at little or no cost, were governments to provide relevant authorities."[7]

The DFI business model allows them to have a different approach to that which purely private fund managers might have. This approach, as will become clear from the discussion below, allows them to make investments that purely private actors may not want to do or be able to.

- First, given their mandate and permanent capital, they can afford to be more patient than private investors who may have shorter investment horizons. Unlike most private actors, they also have no restrictions on the kinds of investments they can make, as long as they are profitable and have a development impact. They can, for example, invest in unrated securities or lend to firms that others may deem not to be creditworthy.
- Second, given their long-term horizon, their perception of risk in developing economies, which is often (wrongly) conflated with short-term

6 https://medium.com/@IFC_org/untangling-misconceptions-about-blended-finance-1d57c00e3c5a
7 http://s3.amazonaws.com/aws-bsdc/BFT_BetterFinance_final_01192018.pdf

volatility, is lower than it may be for private actors, who are more liquidity-constrained and have shorter horizons.

- Third, their expectation of returns (return of capital, plus a reasonable profit margin) is lower than the level it might be for private actors. Most DFIs would be happy with portfolio returns of mid-to-single digits, while many private investors may seek minimum returns in double digits, particularly for investments in developing countries that are perceived to be risky.
- Fourth, their international focus allows them to diversify the risks that may arise from any specific country, sector or project, an option that may not be available to smaller, more local or focussed private investors.
- Fifth, DFIs are sometimes able to draw on grant windows provided by aid agencies to help subsidise the development of projects in order to make them profitable.
- Sixth, with the rise of blended finance windows, where donors are willing to take losses or provide grants to reduce risks for investments or to enhance returns, DFIs, which typically require market returns, can undertake transactions which would otherwise be financially unattractive.
- Seventh, DFIs uniquely have institutional memory as well as financial and human expertise that has been honed over several decades of working in challenging developing country environments, so they may be better placed than new private actors to understand local context and thereby risks and opportunities.
- Eighth, while DFIs sometimes compete with each other, they are also adept at working together and striking partnerships that help them spread risks, improve diversification benefits, address systemic challenges and pool complementary skills and expertise for specific transactions.

Here, it is helpful to look at how the unique tools available to DFIs have helped facilitate development-related transactions that would be very hard for the private sector to replicate.

ARISE, a joint equity funded joint venture between Norfund (Norway's DFI), FMO (the Dutch development bank) and Rabobank, is able to take minority stakes in African financial institutions in using direct equity or mezzanine funding. Its present stakes in ten financial institutions across nine African countries allow it not only to catalyse cross-border learning, but also help diversify the risk in the portfolio.[8]

The IFC's Global Trade Finance Program offers partial or full guarantees to banks covering payment risk on trade finance from their counterparts in emerging markets. The diversification of the portfolio, the IFC's extensive institutional memory and local knowledge all help it manage the risk, and it has not seen any loss since its inception in 2005.[9]

While CDC did not itself have the capacity to make loans to businesses, the bread and butter of Standard Chartered, it was able to commit to sharing risk with the bank in Sierra Leone when it was hit by the Ebola crisis, allowing it to expand lending beyond what it would have been comfortable with.

In 2007, a group of DFIs teamed up with some microfinance investment vehicles and donor governments to launch The Currency Exchange Fund (TCX), a public provider of local currency finance for its borrowing clients in developing economies, where currency risk is a major impediment to private investment.[10] TCX holds the currency risk on its own balance sheet and works well because it is able to pool together a lot of different currency risks and reap the benefits of diversification. No individual DFI or other comparable investor would be able to do that on its own.

It now offers solutions in seventy different developing country currencies, which are individually volatile and risky, but the diversification allows it to enjoy a BBB- standalone rating from Standard and Poor's. A first loss loan and subordinated convertible debt from donor governments, including the Netherlands and Germany, allow the rating to be bumped up to A-.[11]

The unique business model of DFIs that sees them deploy public funds to further private sector development thus draws on a lot of operational discretion in their mandate, long-institutional memory, large scale, ability to flexibly partner with private and public actors, ability to deploy a number of different financial instruments, and use diversification to their advantage.

As can be seen above, DFIs have had to be creative in responding to the challenges of their mandates – investing in markets where few others tread and dealing with risks that others may not be willing or able to take, while remaining profitable. As pressure on them to do more grows, expect many more DFI solutions to development finance problems to emerge. A judicious use of blending can help facilitate the emergence of such solutions.

8 https://ariseinvest.com/investment-portfolio/
9 https://www.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/financial+institutions/priorities/global+trade/gtfp
10 https://www.tcxfund.com/concept-structure/
11 https://www.tcxfund.com/wp-content/uploads/2018/01/171211-SP-full-rating-report.pdf

How much can Blending and DFIs realistically mobilise?

To really know how much more capital DFIs can potentially mobilise, it is important to know how much capital they already mobilise. However, this cannot be easily measured, especially when the broad definitions of mobilisation are considered. What matters more than the exact amount is the order of magnitude and the direction of movement – as long as DFIs mobilise more, preferably substantially more capital, things can be considered to be going well.

As discussed earlier in this report, top-down estimates of the kind made by the Blended Finance Task Force make little sense for the DFI bottom-up investment model. Perhaps a bottom up approach may work better?

Based on increasing examples of successful co-investment vehicles, the rising supply of capital, the existing pipelines of the leading DFIs and conversations, with the top management of DFIs, including the European Bank for Reconstruction and Development (EBRD), the IFC, FMO and CDC, we estimate that it should be possible to achieve a 2 X mobilisation factor of co-mobilisation. This ratio is broadly consistent with the estimates of mobilisation potential we have made privately for the CDC. This gets us nowhere near meeting the SDG funding gap, but would still be highly ambitious given that the historical level of mobilisation ratios have been significantly less than 1 X.

This would take new partnerships, much additional effort, staff prioritisation of mobilisation, and some additional human resources, if it is to be done without diluting the quality of the project pipeline too much within the next 2-3 years. This means that between the IFC and the EDFIs it should be possible to mobilise as much as $40bn - $60bn of additional private sector capital annually by 2020. Yet this is still a long way from the trillions needed to fund the SDGs.

The broader the definition of mobilisation that is used, the higher the multiple one can arrive at, but attribution may become well nigh impossible. For example, if a DFI runs an investor education service that successfully reduces the incorrect high level of perceived risk, it can unlock the door to more private investors. But measuring this or attributing this directly to the efforts of the DFI is not possible.

Instead, most DFIs focus on direct and some measures of indirect mobilisation that look at how much the private sector invests alongside them. Similarly, a DFI may fund a new business in a country, and by doing that creates a demonstration effect showing that that line of business can be profitable in the country. Should the DFI be doing this? Yes. Does it lead to further private sector interest and new investments? Almost surely, yes. Can this be measured or attributed to the DFI? No. An excessive focus on direct quantifiable mobilisation targets creates real risks that the DFI will focus on the narrow direct mobilisation that can be measured and attributed, while neglecting the broader larger indirect aspects of mobilisation that are fundamentally impossible to attribute. This defeats the overall objective of maximising the development footprint of DFIs.

To maximise both direct and indirect mobilisation, DFIs can move forward by building up syndication capacity, sharing information on historical and current investments, improving investor education, liaison and outreach, prioritising early exit from successful investments, building up new investor partnerships for co-investments and pooling vehicles. We have estimated that such measures can push the envelope of additional private capital mobilisation by DFIs to the region of $100 billion and perhaps a bit more. However, this is still an order of magnitude considerably below the more than one trillion a year required to plug the SDG funding gap.

Given this discussion, it is hard to escape the conclusion that the Billions to Trillions catchphrase is more hype than realistic aspiration, at least not via the use of DFIs alone.

Additional concerns with the focus on Blending and Mobilisation

Now, that this policy brief has successfully explained the importance of DFIs to the B2T agenda and flagged concerns about its unrealistic expectations and provided insights into how the DFI model actually operates and the limits of its scalability, it is time to turn our attention to the red and yellow flags that the current evangelical discussion on blending and mobilisation generates.

The hype around the B2T agenda risks creating a backlash against ODA

As discussed earlier in this report, there is a near evangelical zeal around the promotion of the Billions to Trillions agenda and the promise of what blending can deliver. Even otherwise respectable outfits have thrown caution to the winds to the extent that there is a one-upmanship with who can report and promise bigger mobilisation multiples, no matter how much mathematical gymnastics they involve. Billions, almost by magic, will be turned into trillions and plug the SDG funding gap.

As the previous section of this report has shown, these breathless multiples cannot be achieved. Rather than being a rallying cry that can be used to motivate, the Billions to Trillions mantra runs the serious risk of becoming a byword for hubris and folly as reality bites.

The effects of exaggerated claims are very real, particularly given how these have become part of the public discourse. We highlight just a few of them below.

- The false promise of billions to trillions may detract donors, activists, and other key developmental stakeholders from other useful policy measures, such as focusing more efforts on mobilising domestic tax revenues or fighting tax avoidance instead.
- These claims give the impression that the SDG funding gap can be met by mobilising the private sector alone, so reduces pressure for ODA volumes to be increased or even maintained.
- These claims will seriously dent the credibility of the development community as a whole when it becomes clear that they cannot be met, and when the actual amounts mobilised turn out to be a fraction of the hyped-up claims.
- In trying to meet unrealistic targets, donors are opening blending windows and offering soft money to the private sector. They are doing risk mitigation deals, many of which may end up failing. This will undoubtedly end up on the front pages of newspapers, and may create a backlash against private sector development in particular, and aid in general.

The OECD DAC's focus on Total Official Support for Sustainable Development (TOSSD) can distort the ODA landscape

The OECD, in a bid to incentivise the mobilisation of private capital, has broadened the definition of what makes it into its annual Official Development Assistance Statistics, albeit under a new category, TOSSD. One driver behind this was to stop penalising donors who used their ODA budgets in more innovative ways, particularly through partnering with the private sector. It was also meant to incentivise donors to move beyond traditional aid and experiment with partnerships with the private sector. Under the traditional aid metrics, donors got no credit for having established DFIs, for example, no matter how effective they had been at promoting development because most of them are profitable.

The discussion on TOSSD was a legitimate and important one, and the author was part of the OECD expert group that helped conceptualise it. However, it would be remiss not to point out that every change in measurement and incentives can have unintended consequences. At a time of rising populism and shrinking public support for ODA in a number of donor countries, the introduction of TOSSD can lead donors to settle on lower overall ODA contributions if they are able to show higher TOSSD numbers at the same time. ODA costs taxpayers' money, but raising reported TOSSD, for example, through recapitalising DFIs that are expected to remain profitable can come without any additional costs to taxpayers. If this is done on top of what traditional ODA contributions would have been, it is likely to increase the funding envelope and progress towards SDGs. If TOSSD leads to lower ODA levels, it might even end up with a lower development footprint.

The focus on mobilisation and blending can redirect scarce ODA away from other demands on it, for example, budget support for poor countries and humanitarian aid for conflict states. Private sector development in general and high mobilisation of private capital in particular are easier to do for countries that are richer, and for sectors that are more commercial. It is also easier to mobilise more private capital for debt rather than equity. This can easily distort the development landscape. For example, mobilising private debt for a telecom transaction in a middle-income country such as India is easier than attracting private investors to finance equity in an off-grid solar plant in Sierra Leone. And it is cheaper than funding humanitarian assistance for refugees fleeing the conflict in Congo.

The focus on private sector development increases the risk of tied aid

Tied aid, the practice of favouring a donor country's own businesses, consultants and service providers to execute ODA funded projects is widespread but frowned upon in the development world. It reduces the effectiveness of the aid budget by as much as 30%, as the country's own providers may not be the best value for money, most efficient or best in class.

Providing contracts for the delivery of humanitarian aid, for example, in an open bidding process so that third country firms can win them is one thing, but the political economy of providing direct subsidies to businesses from third countries through blending is harder. Early signs are already visible that a bigger focus on blending and private sector development is leading to pressures to tie the aid associated with it.

Even when aid for private sector development may not be tied in the strict sense, there is a danger that donors may use their own DFIs, fund managers or other institutions to disburse subsidies rather than the most efficient or effective institutions.

Exaggerated reporting and problems with additionality

Convergence, a platform set up to facilitate blending, says that *"blending can lead to as much as a ten-fold increase in investments."* Such claims, widely repeated at forums such as Davos are at best a vast exaggeration, and at worst taking serious liberties with the truth. Few, if any blending transactions have generated those kinds of multiples of mobilisation under even the most generous assumptions and interpretations. In reality, a multiple of 1:1 or even lower is far more common, and even a 2–3 X mobilisation ratio is considered to be good.

The mis-reporting goes beyond just hyped up statements into distorted statistics. For example, Convergence claims in its database that blending has mobilised significantly more than $100 billion in the past few years. Those working in the field, including all DFIs, dismiss these numbers out of hand because they are so obviously inflated. The database is designed in a way to come up with the biggest estimate possible, for example, by including Technical Assistance, the aid money that has long been allocated for project or capacity development, in its definition of blending.

This means that the $50,000 in consulting fees somebody gets paid out of a Technical Assistance budget in helping to design a $10 million project, where $1 million comes from the private sector, could be counted as blending that has produced a mobilisation ratio of 20. That is a very misleading measure.

In reality, the contributions from blending to private financial flows have been very modest so far, closer to the order of a few tens of billions with low multiples. Making the numbers look better than they are not only destroys the credibility of development actors, but also inevitably sets them up for failure.

Eurodad has also reported a wide use of such inflated and inaccurate mobilisation ratios when it has looked at various blending facilities. An important point here is that it is easy to conjure up high mobilisation ratios by blending small amounts into commercial or near-commercial projects, but it is unclear whether blending is actually additional in those cases, i.e. does it enable the closure of a transaction that would otherwise not have happened, or does it simply subsidise transactions that would have taken place anyway.

If poorly deployed, blending risks distorting the investment landscape

Depending on when and how one looks at it, between a third to two-thirds of blending facilities that have been put in place in recent years have been deployed outside of the DFIs, sometimes by the ODA agencies themselves, and sometimes using private sector fund managers.

In a surprisingly large number of cases, they are run by people who have zero to negligible experience of pricing risk, evaluating projects or estimating cash flows, so the pricing of blending facilities may have little to do with the actual risks they mitigate. This can lead to an excessive use of subsidy and a waste of scarce aid money. A related problem is that some fund managers or sponsors may be able to draw on multiple blending facilities being run by different donors or agencies so can end up with excessive subsidy, even if the pricing of each other individual blending facility is correct.

Such excessive subsidies are pernicious as they can seriously distort the investment landscape. By being able to offer their products or services at prices that undercut commercially viable transactions they can destroy and distort the competition and end up with lower levels of total investments from commercial actors, the exact opposite of what blending set out to do in the first place. Where fund managers use the excessive subsidies to increase fees, this may not just be unfair but can lead to a backlash against ODA and development. Equally bad, as news of mispricing and excessive subsidies gets around, it can distort the expectations of investors who may end up with a notion that aid agencies will take their risk and allow them to keep profits – that soft money is on offer, so they might as well take it. This too may depress the overall level of private capital mobilisation that might have happened otherwise and undermine the fundamental premise of blending.

When blending facilities are run by DFIs or MDBs themselves, as appears to be the trend, it can also lead to problems. This raises multiple questions, such as how to reconcile the traditional financial and commercial discipline of DFIs with the presence of large and rising amounts of soft money. Or how to design a Chinese wall between those who do traditional project finance and make investment decisions and those who allocate subsidies. Or, how to get the internal price of subsidies from blending right when there is no external equivalent transaction to benchmark against. Or even how to ensure that the strict standards of transparency, effectiveness and efficiency are met when blending transactions are internal to organisations. All of these questions deserve close scrutiny to which satisfactory answers are yet to be found.

Even then, a comparison of blending facilities run by DFIs and by private fund managers shows that the former appear to deliver better results. An evaluation undertaken by Commons Consultants showed that the former have lower management costs, are cheaper, easier and simpler to set up, have shorter time horizons to deploy the money, have better incentives, offer better returns to donors and are easier to supervise and oversee.

Policy Recommendations

Based on the discussion and evidence presented in this report, we make the following policy recommendations.

- There should be a moratorium on new blending facilities of 1–2 years until many of the outstanding expectations, capacity, incentives and design issues are resolved by the donor and DFI community. There has been a proliferation of new facilities, many of them poorly staffed and poorly designed. Transactions funded by these can do serious long-term damage through distortions and by provoking a backlash. It is important to take a pause and get the design right before donors commit billions more to new blending facilities.
- The default option for new blending facilities should be to use existing DFIs, MDBs and centres of financial and development expertise rather than setting up new windows under the aegis of donors or fund managers from the private sector. Where well-functioning National Development Banks exist, supporting them should be prioritised over supporting other institutions, as they have local presence, scale, and follow the national development strategy.
- There needs to be serious thinking put into the design of the best governance, oversight, incentive, transparency and pricing mechanisms for blending facilities housed within DFIs and MDBs.
- Donors and outfits such as the Blended Finance Task Force, Convergence and others need to ease up on the hype and exaggerated claims made for B2T, mobilisation ratios and what blending can deliver. They need to manage expectations in order to make sure they have a reasonable chance of being met. Being ambitious is one thing but being unrealistic or deliberately misleading can be very damaging.
- Mobilisation targets should be based not on mathematical gymnastics or unrealistic assumptions, but on bottom up estimates of what MDBs and DFIs can actually deliver.
- Serious thought needs to be put into the institutional changes necessary for DFIs and MDBs to deliver more ambitious mobilisation targets, and address concerns discussed in this report and elsewhere about how this can lead to unintended harmful consequences.
- An independent audit of some of the larger blending facilities in existence should be carried out, made public and lead to policy recommendations and improvements.
- ODA is scarce, so any use of this money for blending needs to be justified against the opportunity costs and in terms of being able to make a good case for delivering a bigger development impact. While DFIs need to significantly strengthen their transparency, measuring and reporting of their development impact, even higher standards should apply whenever blending is involved, given that this is taxpayer money.
- Strict rules should govern the use of blending, including:
  1) limiting the amount of subsidy offered;
  2) limiting the time for which it is offered;
  3) pricing by professionals only;
  4) a clear exit strategy and
  5) an explicit upfront development justification for why the subsidy is needed in the first place.

Stamp Out Poverty 44-48 Shepherdess Walk, London, N1 7JP, UK
Tel: +44 (0)20 7324 5052
Email: office@stampoutpoverty.org
Web: www.stampoutpoverty.org

RE-DEFINE
Tel: +44 7721 690808
Email: info@re-define.org
Web: re-define.org