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A global blended concessional finance hub



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Summary

The Sustainable Development Goals (SDGs) cannot be achieved without the material participation of the private sector. Blended Finance is critical to facilitating private-sector participation. Because public and philanthropic concessional resources are limited, and because private-sector investors prefer tradeable securities to private placements, the provision of sophisticated Structured Solutions and Capital Markets capabilities on an arm's-length basis, as well as with consistent methodologies and uniform standards, is a necessary condition for consequential and expeditious development impact.

The 2030 agenda and the private sector

Efficiency and effectiveness, as well as a reinvigorated sense of purpose and a renewed sense of urgency, lie at the core of the 2030 Agenda for Sustainable Development (2030 Agenda), which all United Nations (UN) Member States adopted in 2015. Under Means of Implementation, the 2030 Agenda states the following:³

[The Partnership] will facilitate an intensive global engagement in support of implementation of all the Goals and targets, bringing together Governments, the private sector, civil society, the United Nations system and other actors and mobilizing all available resources. ... We acknowledge the role of the diverse private sector ... in the implementation of the new Agenda. ... An important use of international public finance, including ODA, is to catalyse additional resource mobilization from other sources, public and private. (UN Department of Economic and Social Affairs, 2024)

Essentially, the 2030 Agenda advocates for a global partnership in which each partner is incentivized to participate optimally, and it recognizes that the SDGs cannot be reached without the adequate participation of the private sector. This is why, while striving to maximize development impact in line with the SDGs, the Multilateral Development Banks (MDBs) with pri-

vate-sector operations and the Development Finance Institutions (DFIs), which are controlled by Member States, have been trying to crowd the private sector into their initiatives.⁴

Blended finance, structured solutions, and capital markets

One approach to incentivize private-sector participation in SDG-positive initiatives is Blended Finance. Utilizing concessional resources, Blended Finance modifies risk-return profiles to meet the requirements of private-sector investors. To make meaningful progress towards the SDGs, Blended Finance needs to crowd in the private sector at scale. Scale depends on the accessible amount of public and philanthropic resources, the prudent use of public and philanthropic resources, and the sophistication of Structured Solutions and Capital Markets capabilities.

To elucidate the fundamental logic behind Blended Finance, consider the hypothetical situation in which a donor offers a DFI a grant of USD 1 to be lent to small and medium-sized enterprises (SMEs).⁵ Instead of lending the USD 1, the DFI proposes to utilize the USD 1 grant as a first-loss tranche in a new SME Debt Fund comprised of junior debt and senior debt. The DFI promises to invest USD 1 of its own resources in the junior debt and crowd USD 2 of private-sector resources in the senior debt.⁶ Therefore, instead of artlessly delivering USD 1 of SME loans, the DFI ingeniously delivers USD 4 of SME loans and mobilizes USD 2 from the private sector in the process.⁷ Whatever remains of the first-loss tranche is to be utilized in a subsequent SME fund.

If, according to the donor's initial request, the DFI lends USD 1 straightforwardly to SMEs, interest payments and principal repayments by the SMEs are to be reinvested in SMEs. Assuming SME loans of five-year maturities and a roll-over factor of four, the DFI ends up delivering USD 4 of SME loans over about fifteen years. Even ignoring the possibility of reusing the first-

loss tranche, USD 4 of SME loans today is preferable to USD 4 of SME loans over fifteen years.

What is more, private-sector mobilization is critical to achieving the SDGs. (UN Meetings Coverage and Press Releases, 2023.) Hence, strategies that crowd in the private sector are superior to strategies that do not. For this reason, structuring the SME Debt Fund is the better of the two outlined choices, and a Structured Solutions skill set is invaluable. In fact, Blended Finance, which "is a structuring approach" and which "is not an investment approach, instrument, or end solution," is defined by Convergence Finance (Convergence) as "the use of catalytic capital from public or philanthropic sources to increase private sector investment in sustainable development." (Convergence, 2024.)

Crowding the private sector into SDG-positive projects at scale is not trivial. To attain scale, an appreciation for risks other than credit risk, such as liquidity risk and market risk, is indispensable. In particular, private-sector investors usually prefer tradeable securities to private placements. So, if the senior debt is listed in the form of notes—or bonds—on an exchange, demand is certain to increase. Furthermore, the junior debt may be listed, allowing the DFI to exit its position and redeploy the resources to other projects. As a result, a Capital Markets skill set is also invaluable.

The hypothetical situation above highlights the crucial importance of Structured Solutions and Capital Markets expertise to the success of Blended Finance. This crucial importance has been acknowledged by the Global Partnership for Effective Development Cooperation (GPEDC) MDB working group, which has identified six key enablers of the Financing for Development agenda:

- mobilizing all sources of finance
- leveraging public finance
- crowding in the private sector in financing development

- improving investment data
- harnessing technology and disruptive business models
- creating development finance partnerships and six channels to crowd the private sector in SDG-positive projects
- creating markets
- deepening local capital markets
- preparing bankable projects
- creating conducive business environments
- mitigating risks
- mobilizing private investments. (Asian Development Bank, 2019.)

GPEDC's six key enablers, Convergence's definition of Blended Finance, and the 2030 Agenda's Means of Implementation implicitly take into account the scarcity of public and philanthropic resources. Being scarce, these resources ought to be used prudently: they should be directed to high-impact initiatives, and they should be utilized minimally. Therefore, deploying these resources on an arm's-length basis, as well as with consistent methodologies and within uniform standards, is both practical and rational.

Blended concessional finance

In the hypothetical situation illustrated in the previous section, the DFI does not misprice the junior debt, and the private-sector investors do not misprice the senior debt. The first-loss tranche provided by the donor simply alters the risk-return profile of the debt instruments: lower risks imply lower returns. Thus, to break even, the SME Debt Fund can charge lower interest rates on its loans to the SMEs. The difference between the price of a comparable SME loan in the market and the price of an SME loan extended by the SME Debt Fund is a measure of concessionality.⁸

The DFI Working Group on BCF for Private Sector Projects defines BCF as:

Combining concessional finance from donors or third parties alongside DFIs' normal own-account finance and/or commercial finance from other investors, to develop private sector markets, address the Sustainable Development Goals (SDGs), and mobilize private resources. (IDB Invest, 2023.)

The Working Group has produced the following Enhanced BCF Principles:

- i. Rationale for Using Blended Concessional Finance:

DFI support for the private sector should make a contribution that is beyond what is available, or that is otherwise absent from the market, and should not crowd out the private sector. Blended concessional finance should address market failures.

- ii. Crowding-in and Minimum Concessionality: DFI support for the private sector should, to the extent possible, contribute to catalyzing market development and the mobilization of private sector resources and minimize the use of concessional resources.

- iii. Commercial Sustainability: DFI support for the private sector and the impact achieved by each operation should aim to be sustainable. DFI support must contribute towards the commercial viability of clients. Level of concessionality in a sector should be revisited over time.

- iv. Reinforcing Markets: DFI support for the private sector should be structured to effectively and efficiently address market failures and minimize the risk of disrupting or unduly distorting markets or crowding out private finance, including new entrants.

- v. Promoting High Standards: DFI private sector operations should seek to promote adherence to high standards of conduct in their clients, including in the areas of corporate governance, environmental impact, social inclusion, transparency, integrity, and disclosure. (Ibid)

The first principle is the Additionality condition. The second, third, and fourth principles ensure that projects create economic value, are financially sustainable, and can be operationally replicated.

To put the opportunities for BCF in perspective, the BCF experience of the International Finance Corporation (IFC), which is one of the largest implementers of BCF in the world, may be informative.⁹ Since 2010, the IFC has raised USD 4.6 billion from donors, supported 457 projects in around 100 countries, and mobilized USD 23 billion in supplementary financing. (IFC, 2024. "Blended Concessional Finance.")

Towards a global blended concessional finance hub

There are three main reasons for donor BCF resources to be pooled in a Global BCF Hub:

- to promote and safeguard donors' interests, BCF structuring ought to be performed on an arm's-length

basis;

- to maximize effectiveness and efficiency, BCF structuring ought to have consistent methodologies and uniform standards; and
- to develop capital markets, viable projects have to be identified and brought to bankability.

Since Member States fund MDBs and DFIs, which are major financing entities, with equity and debt, and since they fund the UN, which is not a major financing entity, with contributions and grants, the UN is best placed to operationalize first-loss tranches on an arm's-length basis.¹⁰ Thus, the Global BCF Hub should be based at the UN.

Moreover, due to its honest broker reputation and unrivaled convening power, the UN can offer competence and transparency to the development community. Having agencies that possess in-house Structured Solutions and Capital Markets expertise, the UN can generate extraordinary long-term development impact by providing equal treatment, sharing proprietary data, and transferring accumulated knowledge.

References

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Footnotes

1. The views expressed herein are those of the author and do not necessarily reflect the views of his employer.

2. Writing in his personal capacity.

3. ODA stands for Official Development Assistance. Relevant information can be found at OECD, 2024.

4. A DFI is a development institution that finances private-sector projects.

5. The DFI’s intervention is assumed to satisfy the Additionality condition: “make a contribution beyond what is available in the market and should not crowd out the private sector.” While investing on market terms, the DFI is active “where market failures exist, rather than compete with private markets.” Details on Additionality can be found in IFC, 2018.

6. The junior debt and the senior debt are assumed to be fairly priced at par. The first-loss tranche and the junior debt have merely made the risk-return profile of the senior debt acceptable to the private-sector investors.

7. A definition of “mobilization,” which is also known as “cofinancing,” can be found in World Bank, 2024.

8. In the absence of comparable market pricing, a model may be used to indicate a fair price. Information on IFC average concessionality levels is available online (IFC, 2024. “How Blended Finance Works.”).

9. The IFC, as a UN Specialized Agency, is part of the UN System.

10. The official institutions of Member States invest in MDBs’ and DFIs’ bond issues.