

OECD DAC BLENDED FINANCE PRINCIPLE 1 Guidance

Revised Note following public consultation



OECD DAC Blended Finance Principle 1 – Anchor blended finance use to a development rationale

Detailed Guidance Note

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Background and Process

In 2017, members of the Development Assistance Committee have officially adopted the [OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the SDGs](#). Therein, Principle 1 relates to anchoring blended finance use to a development rationale.

This document presents the Guidance Note on Principle 1, along with the Detailed Background Guidance. This document was developed by an OECD team including Priscilla Boiardi, Valentina Bellesi and Esme Stout, under the oversight of Paul Horrocks and Haje Schütte. This Guidance Note benefited from the Senior Strategic Review of Nancy Lee, Senior Policy Fellow at the Center for Global Development and Cameron Khosrowshahi, Director, Invest Initiative at the United States Agency for International Development (USAID).

This Guidance Note was developed through a participatory process and has benefited from comprehensive feedback from the DAC, public blended finance experts, MDBs/DFIs, private sector entities, philanthropy and civil society representatives during a webinar on 3 June 2020. A public online consultation process was also conducted to reflect the experience of the broad development finance community, experts, practitioners, civil society organisations (CSOs) and other relevant stakeholders. The online consultation on the Guidance Notes took place between 15 April and 10 July. This document reflects the comments and feedback received throughout the consultation process as described above.

As blended finance is still a relatively new tool in the development co-operation toolkit and the blended finance environment is rapidly changing, new practices and approaches can develop quickly. This Detailed Guidance Note should thus be seen as a living document, which will continue to be updated in the future. It should be noted that this guidance note should not be seen as a replacement for effective due diligence, although it can assist in ensuring key elements are identified.

Principle 1: Anchor blended finance use to a development rationale

Reminder of the principle

All development finance interventions, including blended finance activities, are based on the mandate of development finance providers to support partner countries in achieving social, economic and environmentally sustainable development.

1. The UN 2030 Agenda for Sustainable Development is the current action plan and vision for achieving development and prosperity for people and the planet (United Nations General Assembly, 2015^[1]). Signed by world leaders in 2015, the 2030 Agenda calls for the engagement of both public and private actors in the pursuit of sustainable development. As part of the 2030 Agenda, countries collectively ratified the Sustainable Development Goals (SDGs), a development impact framework that comprises 17 goals, 169 targets and over 200 indicators.
2. Recognising the challenge of meeting the SDG financing gap by 2030 with limited public resources, governments called for further involvement of the private sector in financing and implementing the SDGs. The Addis Ababa Action Agenda (AAAA) provides the global framework for financing the 2030 Agenda and encourages public and private actors to join forces and act together to support the achievement of the SDGs (United Nations, 2015^[2]). Specifically, the AAAA encourages harnessing the potential of blended finance instruments for sustainable development with careful consideration to the appropriate structure and use of such instruments.
3. Blended finance is a central tool in mobilising additional resources towards the SDGs. It can help multiply the impact of public development finance, bring in the private sector and contribute to bridge the investment gap in particular locations or sectors. Blended finance can also support partner countries in reaching self-sustaining market-based solutions for financing sustainable development.
4. However, as stipulated in the OECD DAC Blended Finance Principle 1, this tool, like all development finance interventions, needs to be anchored to a development rationale (OECD DAC, 2017^[3]). The need to anchor blended finance to the SDGs is also recognised by the Tri Hita Karana Roadmap for Blended Finance, a multi-stakeholder initiative to coordinate public and private actors for a more effective and informed use of blended finance (THK, 2018^[4]). Likewise, the Kampala Principles of Effective Private Sector Engagement in Development Co-operation emphasise that effective partnerships with the private sector must focus on maximising development outcomes in line with the SDGs and national development priorities
5. Anchoring blended finance to a development rationale represents a promising way of contributing to building partner countries' economic, social and environmental resilience. This is of outmost importance now, with most partner countries under pressure to adequately respond to and recover from the COVID-19 crisis. Blended finance can contribute to strengthening local markets and diversifying sector-reliance, which is crucial in helping countries to weather international economic crises. Altogether, placing the SDGs and the Paris Agreement front and centre at all levels of decision-making can help countries be more resilient to future shocks.

1A - Use development finance in blended finance as a driver to maximise development outcomes and impact.

The development mandate provides the rationale for deploying development finance through blended finance¹, as an effective and efficient financing approach towards its policy objectives. Consequently, the SDGs are at the core of how and why official development finance is used in blended finance.

6. The use of Blended Finance should be based on **clear development strategies and policies**, underpinned by an understanding of the role of the private sector, including opportunities as well as risks, in achieving development outcomes.

Link blended finance to overarching development objectives, in line with the 2030 Agenda and the Paris Agreement

7. Donor governments' development co-operation strategies and overarching objectives should be rooted in international and regional agreements on sustainable development. Examples of such agreements include, at the international level, the 2030 Agenda on Sustainable Development (United Nations General Assembly, 2015^[11]) the Addis Ababa Action Agenda (AAAA) (United Nations, 2015^[2]) the Paris Agreement on Climate Change (United Nations, 2015^[6]) and, at regional level, the Agenda 2063 (African Union Commission, 2015^[7]), inter alia. The SDGs are the international sustainable development framework ratified in 2015, and as such, they constitute the most recognised mission for achieving development by 2030. Hence, the primary objective of all public policies and interventions should be the achievement of the SDGs.

8. Even where interventions are implemented in collaboration with the private sector – such as in the case of a blended finance intervention – the SDGs should remain the overarching objective. From the perspective of development policy makers, blended finance is first and foremost a **development instrument** that involves the use of public development finance so as to support their policy mandate, consistent with their overarching strategies.

9. Donors play a catalytic role in mobilising the private sector, and are mandated to **achieve social, economic and environmentally sustainable development**. Therefore, it is crucial that the engagement of development finance providers in blended finance is built on a development rationale. To ensure this, **donors should formulate the strategic ambition and policy objectives for blended finance and link blended finance to overarching development objectives**, such as leaving no one behind, eradicating poverty, advancing gender equality, inter alia.

10. When it comes to specific blended finance projects, implementing a robust Theory of Change (ToC) is a practical method for ensuring that interventions target the achievement of specific SDGs. An explicit focus should be put on the process of change that the blended finance intervention aims at. Before entering a blended finance operation, all actors should clearly understand and articulate how the particular investment is expected to lead to outputs, outcomes and eventually development impact. This should include assessments of expected impacts before investments (ex-ante), throughout the duration of the investment (ongoing) and evaluating (ex-post) the outcomes and impact of completed investments. When

¹ The OECD DAC defines blended finance as the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries. Additional finance refers to commercial finance that does not have an explicit development purpose and that has not primarily targeted development outcomes in developing countries, and development finance is public and private finance that is being deployed with a development mandate (OECD, 2018^[79]).

conducting such assessments, transparency should be ensured, including an assessment of the availability and lack of robust data. This upholds Blended Finance Principle 5, by enabling tracking the causal links that connect the investment to the development objectives. It also fulfils the Kampala Principle 4, in that it encourages transparency and accountability among partners (GPEDC, 2019^[8]). It is recommended that in setting development impact objectives and developing the theory of change, parties apply the Glossary of key terms in evaluation and results based management, adopted by the OECD DAC EvalNet, given its well-accepted and flexible cross-thematic nature (OECD, 2002^[9])².

Align the objectives of blended finance to local policy priorities

11. All investments involving the use of public funds, including those that are implemented in collaboration with the private sector (such as in the case of a blended finance intervention) should have carefully considered policy objectives, aligned with **partner countries' national development priorities that are the result of a democratic process** and in line with the SDGs, as stipulated in Principle 3.

12. To the maximum extent practicable, the development objectives should be linked to the **SDG targets and development strategies of the partner country. Within this, investors should work closely with developing country partners to consolidate local ownership and capacity.** Ideally, this would also entail mobilising local investors and crowding in domestic finance, as outlined in the OECD DAC Principle 3 and further discussed in the Principle 3 Guidance Note.

13. As outlined in both Blended Finance Principle 3, the principles set out in the Busan Partnership for Effective Development Co-operation and Principle 1 of the Kampala Principles, when implementing blended finance operations, it is important to respect each country's policy space, absorption capacity, and ownership to implement policies for sustainable development (GPEDC, 2011^[10]); (GPEDC, 2019^[8]). One of the core principles of the 2011 Busan Partnership Agreement for development effectiveness (GPEDC, 2011^[10]) recognises the centrality of the "*ownership of development priorities by developing countries, stating that "partnerships for development can only succeed if they are led by developing countries, implementing approaches that are tailored to country-specific situations and needs"*" (GPEDC, 2011^[10]). In addition to the aforementioned Principles, the crucial importance of the local ownership of development has also been recognized in numerous international agreements. The AAAA, for example, outlines the need to mobilise multiple sources of finance - public and private, domestic and external - but also underlines the requirement for "*cohesive **nationally owned sustainable development strategies, supported by integrated national financing frameworks***" (United Nations, 2015^[2]).

14. To maximise the development results of blended finance investments, the financial resources should be mobilised in line with the partner country's specific development agenda towards achieving sustainable development and should **target sectors with the highest impact and spillover effects.** This is particularly important in fragile contexts, where any external investments can shake uncertain resource equilibria in societies at risk of conflict. Blended finance providers operating in fragile contexts should thus ensure dialogue prior to launching blended investments, to secure space for the expression of diverging interests, to avoid an excessive weight of private commercial interests, and ultimately to foster ownership by local actors (Basile and Neunuebel, 2019^[12]).

15. In conflict-affected settings, all actors involved in blended finance should consider the need for an effective implementation of the DAC Recommendation on the Humanitarian-Development-Peace Nexus, under a "do-no-harm approach" (OECD, 2019^[13]).

² Please note that, following the revision of the OECD DAC Evaluation criteria in 2019, a second edition of the Glossary is being produced and will serve as a useful reference point as it defines many terms used in the document – including intervention, results, output, outcome, and objective (OECD/DAC Network on Development Evaluation, 2019^[13]).

Set clear and measurable development targets for blended finance funds and facilities

16. A typical instrument used to blend public and private finance are **collective investment vehicles (CIVs)**. These vehicles are emerging as one of the primary channels for blended finance flows, and foster financial innovation with the purpose of attracting additional financing for the SDGs. The OECD distinguishes between two different pooled models (Basile, Bellesi and Singh, 2020^[14]):

- A *blended finance fund* is a pool of capital, which can be comprised of a mixture of development and commercial resources, that provides financing to direct investees (e.g. projects or companies) or indirect investees (e.g. through credit lines or guarantees) that provide on-lending. Funds can mobilise private investment also through the so-called “fund-of-funds” approach, whereby a fund provides equity to other funds, which in turn invest in projects and companies, usually through equity and mezzanine instruments. In addition to mobilising commercial capital at the fund-level, this type of CIV may also mobilise additional financing at the project, or investment, level. Funds can be structured in two ways, either in a flat structure where risks and returns are allocated equally to all investors, or in a layered structure where risks and returns are allocated differently across investors.
- A *blended finance facility* is an earmarked allocation of development finance resources (sometimes including support from philanthropies), which can invest in development projects through a range of instruments with the purpose of mobilising additional finance (e.g. commercial) through its operations.

On top of providing financial support, blended finance funds and facilities can provide strategic advice and technical assistance to grow the business or project, which is crucial in partner countries, where oftentimes the eco-system of growing projects smartly does not exist. This is more typical in case of the deployment of risk capital (equity), while is more rarely provided in the case of debt.

17. As shown in Box 1, the OECD Blended Finance Funds and Facilities Survey reports that more than half of the blended finance vehicles anchor their strategy to international agreements on sustainable development, with the SDGs being the most referenced framework (Basile, Bellesi and Singh, 2020^[14]).

18. Blended finance vehicles mostly pursue economic development objectives, followed by social and environmental ones. This reflects their ambition to foster private sector development and job creation in sectors where the business case is clearer and the potential for revenue streams stronger.

19. The Survey also indicates that over a third of respondents did not **formalise quantitative development targets**, which may hinder the capacity of investors to capture their (intended and actual) contribution to the sustainable development objectives (Basile, Bellesi and Singh, 2020^[14]).

20. While grounding the investment strategy of funds and facilities on one of more SDGs is of fundamental importance, **blended finance vehicles should go one step further and anchor their activities to SDG targets**. For instance, while over 70% of blended finance vehicles target SDG 1 (ending poverty in all forms), not enough evidence is available on the extent to which they focus on specific targets, e.g. eradicating extreme poverty (target 1.1), or building the resilience of the poor and those in vulnerable situations (target 1.5).

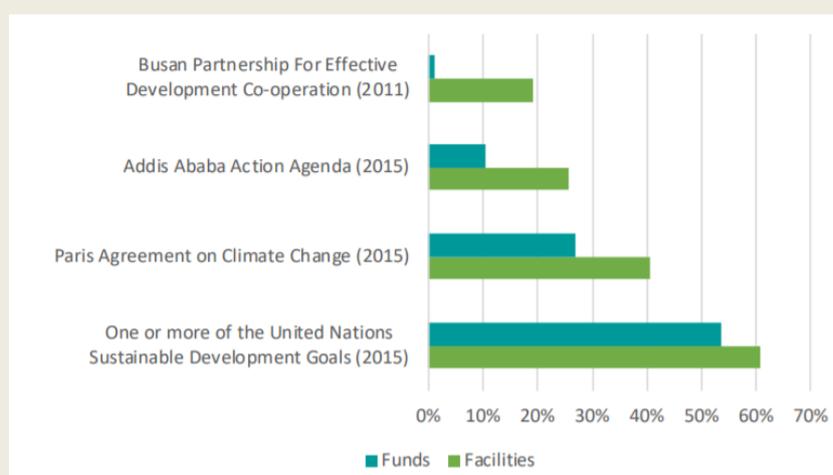
Box 1. More than half of the blended finance vehicles anchor their strategy to international agreements on sustainable development

Over half of the surveyed funds (54%) and facilities (61%) anchor their investment strategies to one or more of the United Nations Sustainable Development Goals (SDGs), as shown in Figure 2.1. The surveyed vehicles target around 7 SDGs in their investment strategies, the average being slightly higher for facilities.

No Poverty (SDG 1), and Decent Work and Economic Growth (SDG 8) are targeted by over 70% of vehicles. More than half also target Climate Action (SDG 13) and Gender Equality (SDG 5). In contrast, SDGs that were targeted the least include Life below Water (SDG 14) and Peace, Justice and Strong Institutions (SDG 16). These findings have been confirmed in both the 2017 and the 2018 OECD Survey editions.

In general, facilities are more likely to ground their investment strategy to international agreements on sustainable development. This is likely attributable to the fact that such vehicles are more publicly driven. By definition, facilities only pool sources of capital which have a development mandate, whereas funds also mobilise purely commercial investors.

Figure 1. International agreements referenced in blended finance vehicles' investment strategy



Note: Based on 180 answers (86 funds and 94 facilities). Multiple choice question.

Source: OECD 2018 Survey on Blended Finance Funds and Facilities

The SDGs are the most popular international reference among funds and facilities, independently of the sector targeted by their investments. While the Paris Agreement is generally less popular, it is unsurprisingly more prominent among those vehicles operating in energy, agriculture and general environment protection.

Source: (Basile, Bellesi and Singh, 2020^[14])

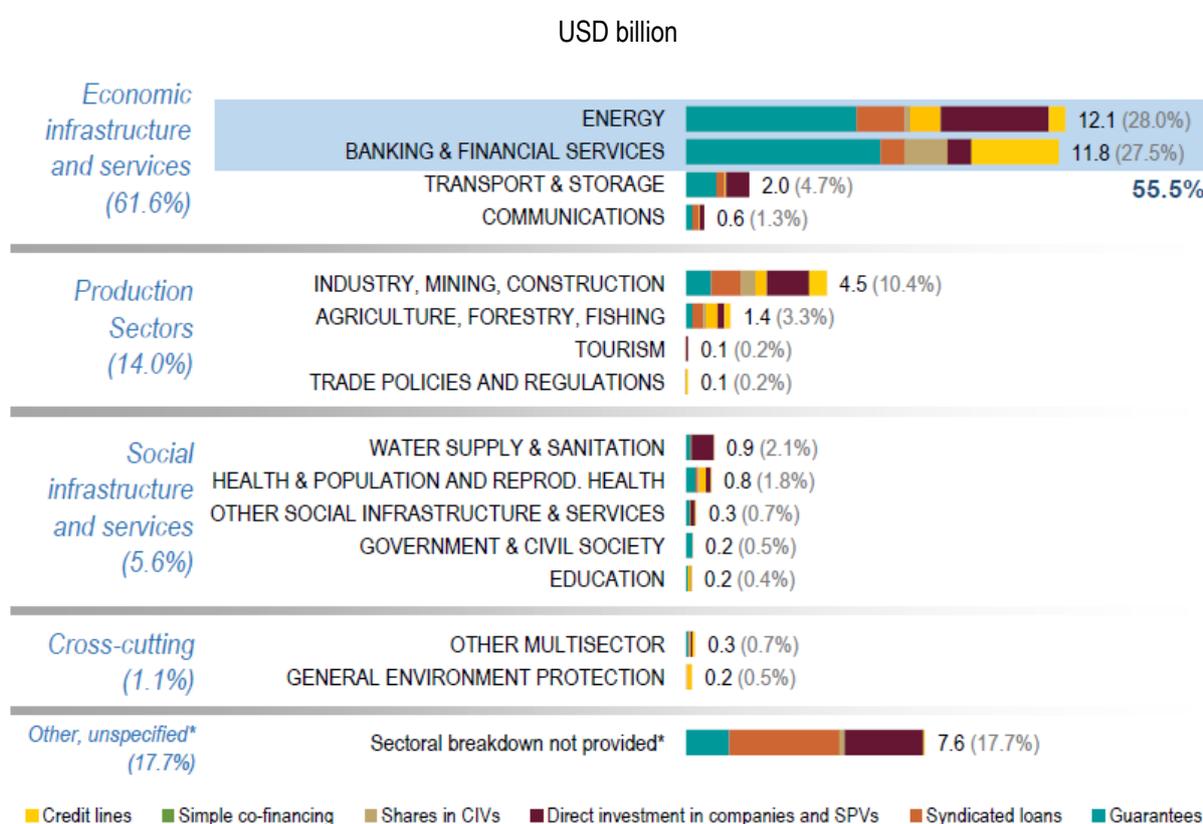
21. The Survey also finds that facilities typically evaluate their development performance more than funds do. This suggests that development finance providers hold facilities to a higher level of direct and

systematic scrutiny. It is notable that the more a vehicle is publicly driven the more it will be likely to anchor its strategy to international agreements on sustainable development.

Focus blended finance on sectors where it can achieve maximum development impact

22. Today, blended finance is only deployed in a subset of sectors. As previously indicated, data on amounts mobilised from the private sector by official development finance interventions shows that 55.5% of the amounts mobilised targeted the energy and financial services sectors, whereas only 5.6% was mobilised in social sectors, on average over 2017-18 (see Figure 2) (OECD, 2020^[15]). However, a strong economic case exists for both public and private actors to invest also in the least-financed sectors. For instance, a recent OECD report on the water and sanitation sector shows how blended finance has the potential to attract additional commercial finance as well as act as a market building instrument to provide a bridge from reliance on concessional financing towards more self-sustaining financing approaches (OECD, 2019^[16]).

Figure 2. Amounts mobilised by sector, 2017-18 average



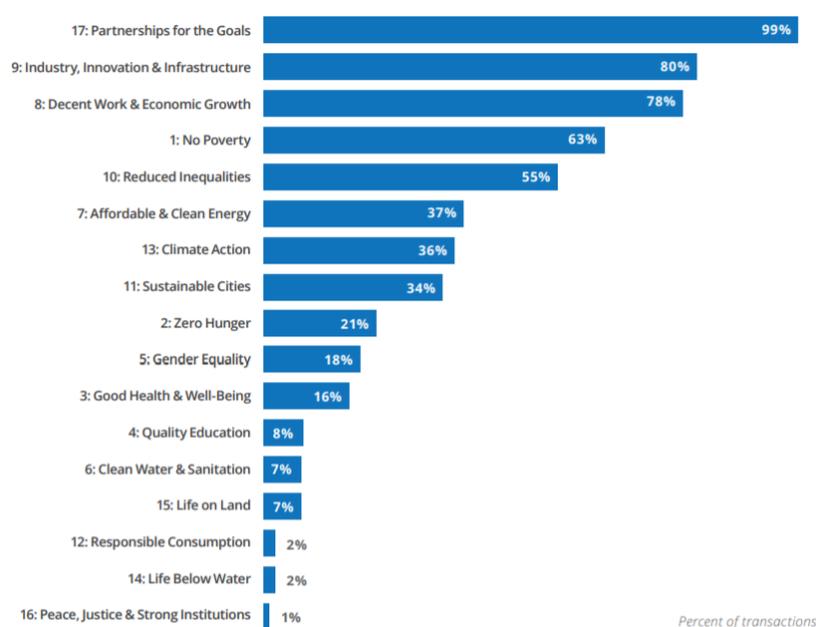
* Of which USD 6.9 billion (91%) relates to the International Finance Corporation (IFC) that provided data at an aggregate level due to confidentiality constraints.

Source: OECD DAC Statistics (OECD, 2020^[15])

23. As noted by Convergence, today, only a subset of SDG targets presents investable opportunities and can thus be targeted through blended finance (Convergence, 2019^[17]). As shown in Figure 3, blended finance is deployed mostly for SDG 9 (industry, innovation and infrastructure), SDG 8 (decent work and economic growth) and less for SDGs on health (SDG 3) and education (SDG 4). That said, the current pandemic is likely to change this dynamic; more resources are likely to be directed towards health-related

investments in the years to come. According to Convergence, blended finance may have a key role to play in leading efforts to scale-up health security measures in developing countries (Andrew Apampa, 2020^[18]). However, blended finance investments in health should carefully consider existing issues in health systems of developing countries, such as fragmentation and inequalities. The financing mechanisms chosen to deliver healthcare services should be chosen based on their ability to ensure that they benefit citizens and address inequalities. Blended finance providers should contribute to build the evidence base, assessing the impact of blended transactions on both the expansion of health coverage (quantity) and on its affordability, accessibility and appropriateness (quality) (Eurodad, 2019^[19]).

Figure 3. Alignment between blended finance transactions and the SDGs (2013-2018)



Source: (Convergence, 2019^[17])

24. One of the objectives of blended finance is to reduce the (actual or perceived) risks for private investors to invest in a certain geography or sector, hence demonstrating the viability of a transaction to ultimately open new markets for the private sector, while benefitting those furthest behind. Blended structures may be needed initially to address the risk-return balance and bring the perception of risk down to its actual level, but also may serve to build a track record and gather experiences in uncovered jurisdictions or sectors, so as to gradually facilitate financially-sustainable investments in the future.

25. According to the results of a Survey conducted among DAC Members³, **half of the respondents reported to focus their blended finance efforts on specific sectors**. The most targeted sectors by DAC Members' blended finance activities are social and economic infrastructure, climate, energy, agriculture and health. Two respondents indicated that their blending approach does not focus on specific sectors, but rather align with sectorial priorities of their development strategy. Diversifying in terms of sectorial allocation can contribute to mobilising private investors, which typically value flexibility across sectors and geographies, so that they can diversify and thus minimise risks.

³ In February – March 2020, authors circulated a Survey among DAC Members to further explore their practices on blended finance, in relation to the OECD DAC Blended Finance Principles. Survey responses amounted to 15.

26. Depending on the local context and project opportunities, both public and private **investors may wish to prioritise certain SDGs that have the ability to catalyse other positive development effects.** Proper prioritisation and sequencing can accelerate progress toward sustainable development by facilitating the realisation of positive spillovers and limiting the impact of negative trade-offs without downplaying the importance of any specific SDGs. Blended finance providers should work with local governments to identify least financed sectors, where there is the need to support the initial involvement of the private sector and in which the private sector can bring new solutions or expertise to tackle specific development challenges (in line with Principle 3).

Deploy blended finance when more effective than other financing approaches, within the broader development co-operation strategy

27. Donor governments should consider blended finance within a broader financing and development co-operation strategy and support its deployment where it is the most useful tool to achieve specific development outcomes and results. Both development and financial additionality should be considered before making a blended finance intervention, as further explored in the Guidance Note of Principle 2.

28. Blended finance is one approach in a toolkit of development co-operation approaches. As such, it should be deployed when its comparative advantage and value-added relative to other tools is clear, based on ex ante assessments taking into account alternative financing approaches. The assessment of the effectiveness of the blended finance approach would need to consider both the expected development outcomes and a comparison in terms of “costs”, including the fiscal implications for the partner country.

29. According to the results of a Survey circulated among DAC Members⁴, the vast majority of respondents reported not to have a dedicated strategy for the use of blended finance, although some are currently planning on developing one. However, blended finance is often integrated in the overall development co-operation strategy.

1B - Define development objectives and expected results as the basis for deploying development finance

Development objectives and expected results should be defined before the deployment of blended finance. They should be mutually agreed and embraced by all parties, as a key basis for the deployment of blended finance. The overarching objective for the use of blended finance is the expansion of sustainable, market-based solutions for development financing needs.

30. Principle 1B recognises that blended finance transactions involve multiple parties (donors, partner countries, private sector actors⁵ and philanthropic organisations) with different objectives that need to be clearly communicated and aligned.

⁴ In February – March 2020, authors circulated a Survey among DAC Members to further explore their practices on blended finance, in relation to the OECD DAC Blended Finance Principles. Survey responses amounted to 15.

⁵ The organisations that make up the private sector are those that engage in profit-seeking activities and have a majority private ownership (i.e. they are not owned or operated by a government). The term includes financial institutions and intermediaries, multinational companies, micro, small and medium sized enterprises, co-operatives, individual entrepreneurs and farmers who operate in the formal and informal sectors. The term excludes actors with a non-profit focus, such as civil society organisations.

Set clear, mutually agreed and measurable development objectives with a coherent narrative

31. A recent OECD review of policies for private sector engagement (PSE) identified having a coherent narrative matched with clear communication of objectives, activities and results as the success factors in the implementation of private sector engagement strategies (OECD, 2016^[20]). This success factors also apply to blended finance transactions.

32. The focus and objectives and expected results of blended finance should be clearly articulated and communicated to all stakeholders at the outset of a project. When objectives are not clearly identified and communicated at the outset, the project might end up not bringing the desired development outcomes.

33. Public funders need to clearly articulate the development rationale and share it with the private partner(s), as well as set clear development objectives, indicators and reporting expectations. On their side, private partners should be asked to articulate their needs and understanding of what they expect from the partnership.

34. Keeping an open dialogue and setting co-ordination mechanisms help to get a common understanding of objectives and expected results, and to monitor their achievement and the effectiveness of the blended finance partnership. As outlined in the Kampala Principles, and the Busan Principles on Effective Development Cooperation, mutual agreement of development objectives is fostered by trust, and by the recognition of the importance of complementary skills between the public and private sector (GPEDC, 2017^[21]).

35. Assessing whether or not a blended finance intervention has reached its development objectives and achieved the expected results identified ex-ante by the investment team requires thorough and consistent monitoring and evaluation. In line with the DAC Blended Finance Principle 5a, all parties involved in a blended finance operation should converge towards a common monitoring and reporting system. Recent years have witnessed a mushrooming of different initiatives with the explicit objectives of supporting investors to achieve development impact. However, to date, no single, harmonised and unified best practice has emerged. In line with the OECD guidance, development actors should develop a results system that is manageable and reliable, in line with each organisation's needs and capabilities (OECD, 2019^[22]).

36. Overall, there is a concrete need to plan for Monitoring and Evaluation well in advance. Successful monitoring and evaluation practice should ultimately feed into future decision-making in that it outlines previously lessons learnt and thus the most effective way to maximise development impact, in accordance with Principle 1 A.

Balance donors' and investors' expectations on development outcomes vis-à-vis financial risks and returns

37. In blended finance, public and private actors come together to work on areas of mutual interest that promote sustainable development. However, as already indicated, they approach the investment in the context of their own institutional and legal frameworks, and coherently with their shareholders' mandates. The public sector primarily aims to achieve a set of development outcomes, while the private sector mainly targets financial returns, profits and market access. All actors need to recognise each other's strengths, but also mandates and objectives, as also stipulated in the Kampala Principles (GPEDC, 2019^[8]).

38. Private investors might privilege investments in sectors and countries that present a more attractive risk/return profile (such as middle-income countries and sector such as energy or infrastructure) (OECD, 2016^[20]) (Convergence, 2019^[17]) and that do not necessarily aim at achieving development outcomes that benefit the poorest (GPEDC, 2019^[8]). This is particularly true for investors that have a

fiduciary duty towards their shareholders, such as institutional investors, which are bound to the achievement of a certain level of financial return in a definite time span.

39. However, if the right checks and balances are in place when structuring the blended finance deal, development objectives and private sector objectives can work in tandem towards a shared goal (GPEDC, 2017^[21]).

40. The Corporate Plan 2018-2022 of FinDev Canada provides a case in point. The authors of the plan indicate synergies between one of the DFI's stated goals of working towards facilitating the economic empowerment of women in developing countries, and returns to investors as a result of mobilising capital towards women-owned Small and Medium Enterprises (FinDev Canada, 2018^[23]).

41. Moreover, it shall be recognised that the "spectrum of capital" is rapidly evolving, with a growing number of private sector actors focusing on investing for specific social, environmental or economic outcomes. On the one hand, foundations and philanthropists, traditionally deploying grants, are now embracing innovative investment models such as impact investing. On the other hand, mainstream investors have increasingly been moving from a sole focus on financial returns to seeking to mitigate environmental, social and governance risks, and, for a growing number, to pursuing investment opportunities which focus on achieving specific positive outcomes (OECD, 2019^[24]). In the blended finance landscape, diverse actors, including philanthropic foundations and commercial investors, are increasingly engaging in blending as a part of their financing strategy towards developing countries (Basile and Dutra, 2019^[25]). For instance, foundations and venture philanthropies play a major role in blended finance in the water and sanitation sector, providing grants, technical assistance and concessional finance to help service providers reach scale and transition towards a sustainable business model that attracts the private sector (OECD, 2019^[16]). However, it will be increasingly important for blended finance to provide ways of tapping into domestic and international pools of capital (like pension funds and asset managers), if we want to close the SDG funding gap.

The development objectives and desired results should determine the selection of partners

42. Making desired development results the starting point in the decision-making processes can guide the selection of potential private sector partners and investments. Given that blending is a means to realise development objectives, rather than a goal in itself, engagement mechanisms should support overall development co-operation objectives. As such, scarce public resources such as ODA must continue to be used to "leave no one behind" and in line with development effectiveness principles.

43. The decision to partner with the private sector should be rooted in a theory of change that establishes whether and how the private sector is best placed to help realise specific development results and contribute to leaving no one behind. Partnerships should only be undertaken where there is a clear ex ante articulation of expected impact (further guidance on effective partnering can be found in the Principle 4 Guidance Note).

44. Focusing on development objectives is also particularly important given the trade-offs that governments often face when selecting investments to support (OECD, 2016^[20]).

Build institutional incentive structures that promote public-private co-operation and balanced sharing of risks and returns

45. A central issue in the creation of shared objectives between the public and private sector is the development of the right incentive structures for the private sector. Within this, a distinction should be made between incentives intended for investors and incentives for the implementing organisations operating on the ground. The incentive framework will also differ between investors. For those funds and

facilities that serve a limited number of clients, for example, incentives risk to be deal-focused, as opposed to encouraging broader market impact.

46. Private sector actors should have the right incentives to (i) pursue blended finance deals and (ii) pursue development impact objectives alongside financial returns. Blended finance can help achieve both by structuring deals that have an acceptable risk-return profile for private sector investors and that provide premiums for the impact achieved.

47. On the one hand, the public sector needs to provide the right incentives to mobilise the private sector. This can be achieved either by de-risking the private investment or by enhancing the returns of the private sector (Convergence, 2020^[26]). On the other hand, the public sector needs to maximise the focus of blended finance operations on development impact objectives.

48. At the outset, the different mandates and objectives of public and private sector entities can create an imbalance between the achievement of the development rationale behind the investment, and the achievement of financial returns. While this is always a careful balance, it is worth constructing a suitable incentive structure to ensure that the development rationale is foregrounded throughout the investment process.

49. Impact-based incentive mechanisms could include linking the financial returns to the achievement of specific development impact objectives⁶ (EIF, 2020^[27]), encouraging fund managers to have a personal stake and buy shares in the fund, or allowing co-investment of managers in funds to ensure optimum performance. The GIIN observed growing interest in impact-based incentive structures among impact funds, e.g. by tying a share of general partners' compensation to social and environmental performance (GIIN, 2011^[28]). The impact-based incentive structure should be carefully designed and implemented to avoid unintended consequences. With such structures, a credible impact measurement system, with a solid impact data collection system, is of crucial importance.

50. In general, the best way to develop the right incentives structure is to co-create it with private sector partners, and where possible, partner countries stakeholders and end-beneficiaries. Investments in the relationship with partners should be maintained after successful collaborations (DCED, 2017^[29]). Ultimately, the private sector should enhance their ability to work more effectively with donors.

Develop internal skills and capacities in the public sector necessary to effectively engage with private sector actors in blended finance

51. Organizational capacity, including the technical expertise of staff to structure, manage, and execute transactions has been recognised as one of the barriers that limited the adoption of blended finance across donors' organisations (OECD and WEF, 2015^[30]). In recent years the public sector has started investing in institutional capacities that help partner effectively with the private sector, as advocated by Kampala Principle 1C (GPEDC, 2019^[8]). Strengthening institutional capacity can also help scale public-private engagement (GPEDC, 2017^[21]), including blended finance. In particular, some donors started training and recruiting staff with new skills and cultures, and adopted new administrative and legal systems (DCED, 2019^[31]). Beyond skills, effective engagement with the private sectors requires credible mechanisms to ensure integrity and accountability of all partners involved.

52. Some donors also developed internal policies to improve their private sector engagement approaches. For instance, in the case of USAID, the PSE policy is conceived as a first step within a broader cultural, operational and institutional transformation to expand their PSE activities. The PSE policy

⁶ Fund managers are typically already incentivized for financial returns through carried interest provisions in their GP agreements with investors. This performance incentive on the monetary side can be mimicked by "Carried Impact" provisions that tie financial carry to the achievement of certain impact metrics.

integrated the development of blended finance models that focus on both financial returns and development impact, as one of the several PSE approaches to be scaled up in the future (USAID, 2019^[32]).

53. It is also important that blended finance projects are accompanied with measures and activities that support building local capacity, e.g. to negotiate, structure and deploy appropriate financing arrangements. In contexts where limited blending currently takes place, such as LDCs and fragile countries, blended finance providers should also work with all stakeholders to maximise the sharing and transfer of knowledge and skills in partner countries (OECD/UNCDF, 2019^[33]); (Basile and Neunuebel, 2019^[12]). The Detailed Guidance Note on Principle 3 further discusses issues linked to building local capacity.

1C - Demonstrate a commitment to high quality.

High quality in the design and execution of projects financed by development finance, including blended finance, are central to the objective of supporting the development of functioning and effective markets. Blended finance should be based on high corporate governance, environmental and social standards, as well as internationally recognised responsible business conduct instruments, providing an opportunity for commercial partners to acquaint themselves with quality standards in unfamiliar markets.

Encourage integrating Environment, Social and Governance (ESG) factors when selecting blended finance projects

54. Both the OECD DAC Blended Finance Principles and the Kampala Principles are geared towards supporting national and global sustainable development priorities, including the 2030 Agenda, and aim at helping those furthest behind (GPEDC, 2019^[8]). Committing to and implementing the OECD DAC Blended Finance Principles and the Kampala principles is a way to demonstrate commitment towards high quality development impact.

55. Environmental, social and governmental (ESG) factors are indicators used to analyse a (investee) company's prospects based on measures of its performance on environmental, social, ethical and corporate governance criteria (OECD, 2017^[34]). ESG factors can be used to screen potential partners and investments to exclude those that are underperforming or to assess the potential to improve their performance (Boiardi, 2020^[35]).

56. ESG factors have been developed to help identify those investors that have a commitment to mitigate negative impacts on people and the planet and to shift finance away from investments that have a degrading effect on the planet, such as fossil fuels and projects with a high level of carbon emission. The Principles for Responsible Investment (PRI), for example, are based on the premise that institutional investors and asset managers have a duty to act in the best long-term interests of their investors (PRI, 2006^[35]). As a result, investors and asset managers need to give appropriate consideration to how environmental, social and governance (ESG) issues can affect the performance of investment portfolios. There is growing evidence that ESG factors have material impact on financial corporate performance and it is increasingly argued that integrating ESG factors – especially climate change factors – can help institutional investors avoid significant shocks to their portfolios related to physical and transition risks (OECD, 2017^[36]). Growing evidence also points out to the relatively strong performance of ESG funds during the COVID-19 crisis, relative to conventional funds (Casey, 2020^[37]).

57. The minimum level of commitment to considering ESG factors an investor can show is to apply criteria to exclude certain industries, projects and companies from partnerships for development, including

explicitly excluding companies convicted of corruption, fraud or criminal activity (NSI, 2014^[38]). Donors should strive to implement the maximum level of ESG commitment practicable during the due diligence phase of the investment cycle. Corporate structures and business models of potential partners should be screened, as well as the company's transparency standards.

58. When it comes to blended finance funds and facilities, numerous international commitments exist, to help identify suitable high-quality partners that integrate ESG factors. The most common ones are briefly presented in Box 2 below. It is worth noting that some funds and investors apply their own proprietary standards or may adapt them on an ad-hoc basis, depending on the characteristics of each blending project and on the requirements of the investors involved (Basile, Bellesi and Singh, 2020^[14]). However, applying internationally recognised standards is preferable as it signals commitment to align to best practice.

Box 2. Common international sets of commitments for environment, social and governance (ESG) safeguards in the financial sector

The **UN Global Compact** is a set of principles to which companies commit and are designed to promote the integration of sustainability in business affairs. Companies agree to submit an annual report or sustainability report detailing their efforts to support the UN Global Compact's principles which cover human rights, labour, environment, and anti-corruption. The UN Global Compact reserves the right to demote and eventually expel members for failing to submit the requisite reports.

The **Principles for Responsible Investing (PRI)**, born under the auspices of the United Nations, represent a co-operative effort of investment industry experts, intergovernmental organisations, and civil society. They specifically target asset owners, investment managers, and service providers, and attempt to incorporate ESG factors in investment and ownership decisions. While there is no explicit mention of specific ESG measures and indicators, the PRI outlines possible actions under principle 3, which is "We will seek appropriate disclosure on ESG issues by the entities in which we invest". One of these possible actions suggests using tools like the Global Reporting Initiative. Another suggests standards like the UN Global Compact.

The **Equator Principles** are a risk management framework for assessing the risks associated with development projects. As of 2013, the principles apply to four financial products in particular: project finance advisory services, project finance, project-related corporate loans, and bridge loans.

The **International Finance Corporation (IFC) Environmental and Social Performance Standards** are a detailed set of criteria defining IFC clients' responsibilities for managing their environmental and social risks throughout the life of an investment by IFC. They deal with environmental and social management, workers treatment, resource efficiency and pollution prevention, community health and workplace safety, land acquisitions and resettlement issues, biodiversity conservation, indigenous peoples' rights, and cultural heritage.

The **B Corporation certification**, launched by B Lab, an American-based non-profit, with support from The Rockefeller Foundation, aims to measure a company's social and environmental performance focusing on governance, workers, customers, and the broader community. Many large multinational companies have been certified, but the majority of the 2 500+ B Corps are small businesses. Even without any official public backing, the B Corp certification has gained mainstream acceptance to convey third party verified social and environmental performance.

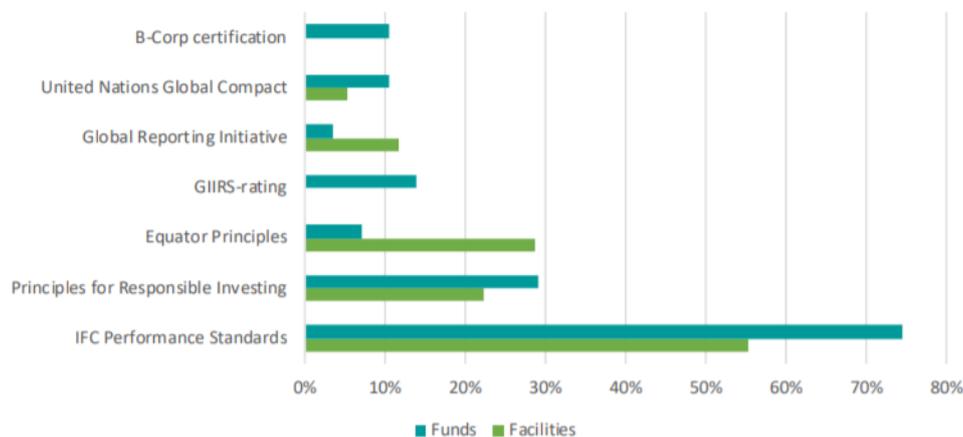
In 2011, the B Lab initiative further span into the **Global Impact Investing Rating System (GIIRS)**, in partnership with JPMorgan Chase & Co. and the Inter-American Development Bank. The rating system is primarily intended for emerging market companies and funds, to assess their impact in the areas of governance, workers, community, and environment using an analytics approach similar to Morningstar

investment rankings and Capital IQ financial analytics. The methodology for rating funds includes a weighted average of companies within the fund's portfolio as well as the fund manager. Various social stock exchanges such as Mission Markets, NeXii, the Social Stock Exchange, and BRiX are GIIRS Partners, making the rating system compulsory for listings and participation.

Source: (Basile, Bellesi and Singh, 2020^[14]), Blended Finance Funds and Facilities - 2018 Survey Results Part II: Development Performance, <https://dx.doi.org/10.1787/7c194ce5-en>

59. As shown by a recent OECD Survey (see Figure 4), the most common international standards for ESG safeguards applied by blended finance funds and facilities are the IFC Performance Standards (IFC, 2012^[39]), the Principle of Responsible Investing (PRI) (PRI, 2006^[35]) and the Equator Principles (EPA, 2019^[37]).

Figure 4. Alignment of environmental, social and governance safeguards adopted by blended finance vehicles



Note: Based on 180 answers (86 funds and 94 facilities). Multiple choice question
Source: (Basile, Bellesi and Singh, 2020^[14])

Apply the highest level of responsible business conduct

60. Donors should screen potential partners to guarantee that they abide to the highest possible level of responsible business conduct (RBC). This is valid in all private sector engagement initiatives, including blended finance. Implementation of RBC standards can support donors in better engaging with the private sector and ensuring that private sector partners act responsibly, according to international standards. Box 3 below provides the OECD definition of RBC.

Box 3. What is Responsible Business Conduct (RBC)?

According to the OECD, “*responsible business conduct (RBC) entails above all compliance with laws, such as those on respecting human rights, environmental protection, labour relations and financial accountability, even where these are poorly enforced. It also involves responding to societal expectations communicated by channels other than the law, e.g. inter-governmental organisations, within the workplace, by local communities and trade unions, or via the press. Private voluntary*

initiatives addressing this latter aspect of RBC are often referred to as corporate social responsibility (CSR)."

Source: (OECD, 2015^[40]), Responsible Business Conduct

61. The OECD Guidelines for Multinational Enterprises (OECD, 2011^[41]) and the UN Global Compact principles (Un Global Compact, 2004^[42]) can guide donors in selecting blended finance partners with the highest possible levels of responsible business conduct. In addition, these sources can help donors support enterprises in developing countries in improving their RBC practices. The OECD Guidelines for Multinational Enterprises (OECD, 2011^[41]) are the only multilaterally agreed and comprehensive code of responsible business conduct that governments have committed to promote. The MNEs Guidelines include principles and standards in all major areas, including information disclosure, human rights, employment and industrial relations, the environment, bribery and corruption, consumer interests, science and technology, competition, and taxation (OECD, 2018^[43]).

62. To help implement the guidelines, the OECD has also developed the OECD Due Diligence Guidance for Responsible Business Conduct (OECD, 2018^[44]). This guidance builds on the work of the International Labour Standards of the International Labour Organisation (ILO), the ILO Tripartite declaration of principles concerning multinational enterprises and social policy (ILO, 2017^[45]) and the United Nations' Principles on Business and Human Rights (UN OHCHR, n.d.^[46]), which are internationally-recognised standards outlining the notions of responsible business conduct. All of these guidelines and principles must be considered at the ex-ante stage of an investment, to ensure that the development rationale underpinning the intervention will be achieved in an ethical way.

63. Overall, responsible investment has grown exponentially over the past decade, and there is now even an increasing trend for governments to mandate Responsible Business Conduct in their investment. The EU, for example, announced in April 2020 legislative initiative next year on mandatory due diligence for companies (RBC, 2020^[47]).

64. As a recent ILO report highlights, donors have a key role in promoting a sound enabling environment in relation to Responsible Business Conduct. Practically, this means working with local governments to reduce key risk factors (ILO, 2019^[48]).

65. The OECD conducted a stocktaking exercise on how bilateral donor agencies and development financial institutions (DFI) promote and enable RBC. From this, it emerges that while many donor agencies and DFIs have taken important steps to promote, incentivise and exemplify RBC, this has not yet the case across the board. There is scope for donors mainstream RBC standards within institutions and to communicate clear expectations to partners and create a level-playing field (OECD, 2018^[43]). Box 4 below presents an illustrative set of good donors' practices related to RBC. Although not directly related to blended finance transactions, these good practices of private sector engagement can provide guidance also in the blended finance context.

Box 4. Good donors' practices on responsible business conduct

When providing support to private entities in the form of grants or loans, some donors developed screening and appraisal mechanisms that integrate some RBC elements. Development agencies of Austria (ADA), Denmark (DANIDA) and France (AFD), for example, have published a list of criteria for exclusion of projects that they may not finance because of ethical, environmental or social concerns. The Netherlands has developed a methodology to screen applications that do not meet minimum RBC criteria. When applying for funding from the Good Growth Fund, a Dutch government fund providing

funding to both national and local SMEs, companies need to meet eligibility criteria aligned with the OECD Guidelines. RBC criteria are also increasingly applied in actual evaluations. In Austria, every application for funding is subject to an appraisal by ADA on environmental, social and gender issues (ADA, 2017). Same goes for the Canadian development agency, which shares each application for funding with environment, gender equality and governance specialists. Assessment criteria include identification of risks and mitigation strategies, on themes such as “do no harm” as regards to human rights (Global Affairs Canada, 2017).

Only a few donors have made due diligence a systematic process for assessing and addressing risks of adverse impacts that projects or partnerships may create. Among them, Norway’s development agency (Norad) clearly communicates that grant applicants and recipients should act in accordance with the UN Guiding Principles and the OECD Guidelines, and only awards grants when it is feasible to conduct a proper due diligence of the applicant. DFID has also taken important steps to strengthen its own due diligence process and to ensure that suppliers meet RBC standards.

Source: (OECD, 2018^[43]), Promoting and enabling responsible business conduct through development co-operation efforts, <https://mneguidelines.oecd.org/Promoting-and-enabling-RBC-through-development-cooperation.pdf>

66. Anticipating future trends in this field, donors and investors should, to the maximum extent practicable, require investees to demonstrate and report how they implement Responsible Business Conduct in practice. From the outset of a blended finance investment, it is important to clarify responsibilities and allocate resources for monitoring of RBC practices throughout the project cycle

67. Blended finance actors are also expected to follow RBC principles and standards in their own role as economic actors (e.g. through public procurement, export credits, and development finance) and as owners of enterprises (OECD, 2018^[43]).

Guarantee commitment to quality through transparency

68. The Kampala Principles outline ways in which to better engage the Private Sector through development cooperation more effectively. Principle 4 of the five mutually reinforcing principles highlights the importance of measuring and disseminating sustainable development results for learning and scaling up of successes. Similarly, DAC Blended Finance principle 5 recommends the monitoring of blended finance for transparency and results.

69. Although more in-depth guidance on transparency can be found in the Guidance note on principle 5, it is worth noting that high quality should be maintained throughout, including a commitment to learning from the results of previous blended finance operations. Aside from the obligation to report to external stakeholders, and informing social and commercial performance management, the evaluation of blended finance interventions can help prioritise the right strategies moving forward (Winckler Andersen et al., 2019^[49]).

70. Within this spirit of learning, it is imperative to transparently share data and enhance access to information on existing blended finance facilities and information on development impact. That said, realistically, this will only be achieved if accurate data is obtained. Where this is not possible due to either geographical or personnel restrictions, organisations should be honest and transparent regarding data limitations. Still today, limited transparency, accountability and evaluation of PSE projects is considered to be one of the main challenges in private sector engagement (GPEDC, 2019^[8]). One of the main reasons for this pertains to financial intermediaries’ claims to commercial confidentiality. However, public sector actors should question the validity of this argument, based on the fact that trade secrets are not necessarily written in contractual agreements. As far as possible, all actors should contribute to and uphold reporting obligations.

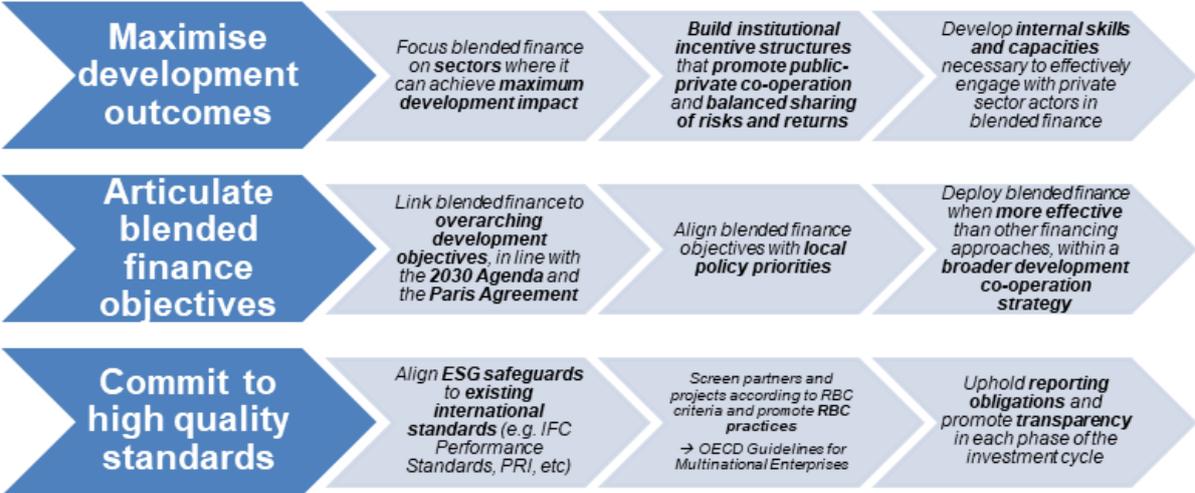
71. As the Tri Hita Karana (THK) Transparency Working Group (WG) notes, as the international community enters the last decade of action for the SDGs, there is a need to foster greater understanding of the transparency needs of all relevant stakeholders and the challenges that hinder such needs from being fulfilled. The THK Transparency WG Report outlines opportunities and limitations on transparency over the blended finance project cycle:

- **Project design and tendering:** Transparency starts before the transaction phase. Information on target regions and sectors, as well as on anticipated returns (both financial and developmental) should be available at the tendering stage in an equal and transparent manner to all blended finance stakeholders in the ecosystem, including public and private actors. This transparent allocation is possible in particular to PPPs and project benefiting from a government concession.
- **Implementation:** Scope remains for further efforts in reporting across other blended finance actors at the implementation level, including increased standardisation and enhanced comprehensiveness and relevance of available data on the scale, scope and performance of existing investments, which would also strengthen the ability of relevant stakeholders to improve monitoring of ongoing blended finance projects.
- **Evaluation:** There is a significant variety among blended finance actors when it comes to evaluation practices, approaches, capacity and information disclosure, which makes it difficult to develop a complete picture of what current evidence suggests. Different interpretations of terms such as additionality and impact further hinder comparability of evaluation findings. Moreover, evaluations are highly dependent on monitoring systems which means that current limitations in the ability to robustly monitor blended finance projects translate into challenges in evaluations too (THK Transparency Working Group, 2020^[50]).

Step-by-step process for the implementation of the OECD DAC Blended Finance Principle 1

72. To assist DAC donors to implement recommendations laid out in the previous section in blended finance operations, a step-by-step approach is proposed in Figure 5 below.

Figure 5. Step-by-step process to implement Principle 1



Source: Authors

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