

OECD DAC BLENDED FINANCE PRINCIPLE 3 Guidance

Revised Note following public consultation



OECD DAC Blended Finance Principle 3: Tailor blended finance to local context

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 3 relates to tailoring blended finance to local context.

This document presents the Guidance Note on Principle 3 along with the Detailed Background Guidance. The document was developed by an OECD team including Lasse Moller, Faty Dembele, Weronika Garbacz and Natalia Lemanska under the oversight of Paul Horrocks and Haje Schütte. This Guidance Note benefited from the Senior Strategic Review of 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 DAC Blended Finance Actors, MDBs/DFIs, private sector entities, philanthropy and civil society representatives during a virtual workshop held on 17 June 2020, as well as bilateral discussions and interviews. A web-consultation was conducted with CSOs specifically on 29 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 lasted from 15 April until 10 July. This document reflects the comments and feedback received during the consultation process.

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. The Detailed Guidance Note will thus be updated accordingly in the future. It should be noted that the guide should not be seen as a replacement for effective due diligence, although it should assist in ensuring key elements are identified.

1 Introduction

1. The OECD DAC Blended Finance Principles provide the framework for good practice amongst blended finance actors, including, but not limited to, DAC donor governments. The OECD Development Co-operation Directorate is currently preparing further policy guidance to support implementation of these principles. The guidance will support the design and implementation of effective blended finance programmes at the policy level, provide good practice examples, and facilitate accountability. The Guidance aims to leverage knowledge of the whole blended finance ecosystem while focusing on the practical side of designing and implementing blended finance programmes.

2. **The OECD DAC Blended Finance Principles provide good practice in designing and implementing blended finance approaches.** The five principles each target a specific area of blended finance relevant to DAC members:

- Principle 1: Anchor blended finance use to a development rationale
- Principle 2: Design blended finance to increase the mobilisation of commercial finance
- Principle 3: Tailor blended finance to local context
- Principle 4: Focus on effective partnering for blended finance
- Principle 5: Monitor blended finance for transparency and results

3. This working document presents the draft policy guidance on Principle 3 for consultation purposes, as part of a broader process that will run until end of 2020. Principle 3 pertains to tailoring blended finance to local context. It aims at ensuring all blended finance is appropriately used and sufficiently accountable as a tool for development co-operation. The document provides an elaboration of the importance of local context for blended finance operations, the benefits of crowding-in local capital and finally the need to build sustainable markets and a sound enabling environment.

4. The OECD's effort to elaborate guidance around policy principles for blended finance is complementary to other initiatives, such as the Tri Hita Karana Roadmap for Blended Finance (THK, 2018^[1]), which addresses bottlenecks in the broader market that prevent blended finance from achieving scale and impact. Other policy inputs include the DFI Working Group Enhanced Principles on Blended Concessional Finance for Private Sector Projects (DFI Working Group, 2018^[2]), the GPEDC Kampala Principles on Effective Private Sector Engagement in Development Co-operation (GPEDC, 2019^[3]) and the recommendations formulated by the Business & Sustainable Development Commission (BSDC, 2018^[4]). The OECD is also active in broadening the evidence base for blended finance, most notably through the Blended Finance Funds and Facilities Survey (Basile and Dutra, 2019^[5]) and other sector-specific deep dives, such as the recently published report on Blended Finance in the Least Developed Countries (UNCDF, 2018^[6]), Making Blended Finance Work for Water and Sanitation (OECD, 2019^[7]), as well as issue-specific discussions around other Principles, such as blended finance evaluation (OECD, 2019^[8]) governance and methodology (. The Blended Finance Principles Guidance will be published in its totality covering all principles by the end of 2020.

Box 1. Local context and other principles

The local context principle should not be seen in isolation, as it builds on a coherent principle-and-value based approach to blended finance. In particular, the local dimension of blended finance is strongly connected to and also present in the other OECD/DAC Blended Finance Principles, namely:

- ▶ *Principle 1* “Anchor blended finance use to a development rationale”, which can only be properly articulated if it rests on **local considerations and ownership of development** objectives, outcomes and impact;
- ▶ *Principle 2* “Design blended finance to increase the mobilisation of commercial finance”, which includes **local initiatives to mobilise commercial finance**, as well as efforts to **mobilise local commercial finance**;
- ▶ *Principle 4* “Focus on effective partnering for blended finance”, which should include **partnership with local actors**; and
- ▶ *Principle 5* “Monitor blended finance for transparency and results”, which should explicitly integrate the local dimension and include the **perspective of local actors**.

Source: (Bilal, 2019^[9])

2 Principle 3: Tailor blended finance to local context

Development finance should be deployed to ensure that Blended Finance supports local development needs, priorities and capacities, in a way that is consistent with, and where possible contributes to, local financial market development.

5. To facilitate practical use for DAC members and other blended finance actors, the guidance is structured around the three sub-principles, as follows:

- 3A - Support local development initiatives;
- 3B - Ensure consistency of Blended Finance with the aim of local financial market development;
- 3C - Use Blended Finance alongside efforts to promote a sound enabling environment.

Through this Principle, DAC members hence strive to establish the necessary governance and feedback loop that will ultimately enable policy learning and public accountability.

Introduction

6. As the role of blended finance earns more recognition in international development dialogue, particularly in light of the current Covid-19 crisis, the ways for ensuring its highest quality and effectiveness must be researched, advocated and applied. Tailoring blended finance to local context is a pre-requisite for materialising those efforts and achieving the highest development impact as well as optimal returns. It should therefore be a key objective for both investors and development stakeholders as emphasised in a variety of international statements (Box 2 below)

Box 2. International statements on tailoring blended finance to local context

“We call on the multilateral development banks to work more closely with domestic financial markets, and in local currencies wherever possible, in order to build local markets.” (G7, 2018^[10])

“Local engagement and ownership in blended finance should be pursued as it will contribute to sustainable impact.” (THK, 2018^[11])

“Greater effort should be made to include local intermediaries and local pools of institutional capital in projects.” (G20, 2017^[11])

“We will strive to support local governments in their efforts to mobilize revenues as appropriate.” (AAAA, 2015^[12])

7. Comprehensive inclusion of local context perspective discussed in this guidance note embraces a variety of aspects. Most importantly, it encourages investors and other development actors to be aligned with local priorities, as well as committed to building inclusive partnerships with local stakeholders at each stage of blended finance interventions. Whenever possible, investors should seek to establish direct relations with local stakeholders on the ground and ensure local ownership of the undertaking. Local networks and partnerships can serve as platforms for gaining an in-depth understanding of local needs and conditions, which in turn allows for tailoring a financing approach. Having credible partners on the ground in developing countries also have potential to reduce risk perception among private investors. This can enhance mobilization of private finance towards developing countries. Alignment with local priorities and better context-specific knowledge could later on translate into higher development impact and long-term sustainability. Whilst one could argue that local governments may seek to support any types of investments to further develop their countries, it should be noted that certain investments may align more specifically to a set of priorities defined at the local level. Local partners' commitment as well as capacity for collaboration are pre-requisites for effective and efficient implementation of blended finance projects.

8. Furthermore, involvement of local financial institutions is encouraged, especially in view of advancing local currency financing and domestic finance mobilisation. Developing countries often have a sizable domestic resource base, but it is often not effectively deployed in their real economies to drive development. Sharing experience and lessons learnt from the local contexts in emerging markets and developing economies (EMDEs) may help to fill knowledge gaps and reduce information asymmetries for other development finance actors and new entrants to the market. This in turn is likely to contribute to the overall economic development of the region and, in the long-run, to fulfill the leaving no-one behind commitment (UN CDP, 2015^[13]).

3A Support local development initiatives

Achieving positive development impact means meeting people's priority needs. Blended finance can fulfil local development priorities by enabling the financing of businesses that serve local consumers and create decent jobs. Blended finance should support investments that are aligned with national priorities as is the case with all development finance interventions. However, local priorities need to be assessed to ensure that they effectively contribute to the achievement of the SDGs. Finally, it should be noted that a balance needs to be found between tailoring blended finance projects to local contexts and scaling up financing. Aggregating up several local projects could be explored to increase scale.

3A.1. Stakeholder consultation

Why stakeholder consultation is critical

9. In-depth and systematic consultation with local stakeholders is advantageous for blended finance deals. It should be inclusive and where possible bottom-up in order to increase the range of partners involved at community level (GPEDC, 2019^[3]) as suggested by the Kampala principles. Such consultation helps ensure consistency with the country's development priorities and ownership of results as well as provide the most desirable benefits to local beneficiaries. Apart from enhancing impact, engagement with local stakeholders can significantly contribute to enhance returns and reduce risks. Furthermore, such consultations contribute to build public trust, pre-empt disputes that may arise in course of project implementation, and control external risks that may be otherwise overlooked by foreign investors.

10. Effective stakeholder consultation should not be perceived as a single event but rather as a process parallel to the whole investment. In practice, such iterative approach can encourage stakeholders to actively engage in decision-making processes throughout the project cycle. In addition, consultations

also help conduct detailed impact monitoring and evaluations which can extend beyond project completion phase. Finally, continuous engagement with local actors may, in times of crisis such as the current Covid-19 pandemic, prove critical to devising an accurate and rapid response, potentially leading to improved sustainability of blended finance projects. It is important to distinguish what is meant by consultation and participation of stakeholders.

11. In relation to evaluation, it should be noted that empowerment evaluation, collaborative evaluation and participatory evaluation are different stakeholder involvement approaches to evaluation, which are all relevant and need to be adjusted to the local needs (David M. Fetterman, 2017^[14]). Collaborative evaluators are in charge of the evaluation, but they create an ongoing engagement between evaluators and stakeholders, contributing to a stronger evaluation design, enhanced data collection and analysis, and results that stakeholders understand and use. Participatory evaluators jointly share control of the evaluation. Participatory evaluations range from program staff members and participants participating in the evaluator's agenda to participation in an evaluation that is jointly designed and implemented by the evaluator and program staff members. Empowerment evaluators view program staff members, program participants and community members as the ones in control of the evaluation. However, the empowerment evaluators serve as critical friends or coaches to help keep the process on track, rigorous, responsive and relevant.

12. It should also be noted that a differentiated approach needs to be taken depending on the type of projects as large infrastructure projects for example may require extensive consultations with different stakeholders, whilst in other cases, such as a direct investment in a SME, extensive consultations may be less applicable. In addition, due diligence costs may significantly increase with extensive stakeholder consultations processes. When engaging with local stakeholders, it is also beneficial to think beyond individual project and consider the broader systemic changes.

Unfortunately stakeholder consultation is not always done due to several challenges

13. In practice, however, concerns have been raised that local stakeholder's consultation tends to be insufficient in blending projects for various reasons (Pereira, 2017^[15]). One of them is that consultation may be perceived by investors as an extra cost and effort. This is a rather short-sighted approach, as a lack of local stakeholders' input can lead to a mismatch of expectations around blended finance, missed opportunities as well as adverse decisions.

14. In some cases, inaccurate consultation may be a result of tying aid, which generally refers to the fact of limiting procurement to companies in the donor country or in a small group of countries according to the OECD (OECD, 2020^[16]). Risks regarding tied aid could potentially be higher in case of blended finance deals, which, by definition, involve private sector entities. This could result in donor's preference to private companies from their own countries. As an example, a study by Eurodad-Oxfam found that some blended finance initiatives gave preference to private companies located in donors' countries (Pereira, 2017^[15]). However, it should be noted that technological gaps could justify procurement in donor countries in some instances. Yet, donors should strive to remove the legal and regulatory barriers to open competition for aid-funded procurement to the fullest extent possible. As documented by Eurodad, common strategies for opening up procurement to local firms in developing countries include advertising contracts in the local media, setting manageable contract sizes and undertaking procurement in local languages (Eurodad, 2018^[17]).

15. Another example is a study on "Strengthening the Local Dimension of Blended Finance" undertaken by ACET, ECDPM and the OECD under the G20 Compact with Africa. This study showed that blended finance projects are often generated from external institutions or follow a standardized approach, and with insufficient considerations for local context and dynamics. They may also be client-driven, but with little consultation with local stakeholders (ACET, 2019^[18]).

16. Another challenge regarding stakeholders' consultation is related to the fact that the priorities of donors and those of beneficiary countries may not necessarily always align. For example, there might be a disagreement between donors from developed countries and developing countries on the importance of favouring environmental protection over economic development considerations (OECD, 2018^[19]). Such situation requires further consultation between the different parties and greater emphasis on finding compromises.

Equally important is that consultation with governments should not happen at the cost of marginalising other stakeholders. In authoritarian regimes for example, government priorities may not fully align with the actual needs of citizens, which has to be accounted for at the outset of designing the blended finance deal. Engagement with regimes rather than local population has already become an object of Civil Society Organisations' (CSOs) criticism of international financial institutions (Bilal, 2019^[9]). Therefore, an in-depth understanding of local political economy is particularly relevant for blended finance and this will further be discussed in the paper later on.

Examples of practices on stakeholder consultation

17. The process of stakeholder consultation should be carefully designed before the project begins and appropriately adapted throughout the project lifecycle. In order to ensure that consultation is both efficient and not too burdensome for the stakeholders, it could be organised in co-ordination with other development actors in the field. Examples are other DFIs or donors, who are usually present and well connected with the local communities. Furthermore, a report from Trade Union Development Cooperation Network (ITUC-TUDCN) and the CSOs Partnership for Development Effectiveness (CPDE) (ITUC, 2016^[20]) highlights the benefits of creating an independent complaint mechanism for all pertinent stakeholders. This includes, but should not be restricted to, explaining criteria used to evaluate complaints, providing online and offline complaint forms, making a local address available for information and complaint purposes, accepting complaints made in local languages and ensuring some form of support for pertinent representatives and independent organisations who want to make a complaint.

18. Although the scale and breadth of the consultation must be adjusted to the nature, size and context of the operation, it is preferable that both key local partners and those affected indirectly are included. Examples of good practices to follow when planning a consultation include:

1. Agree on the objectives of consultation
2. Identify relevant stakeholders to be invited
3. Adjust details of consultation meeting to target group (e.g. time, place, invitations)
4. Define content and format of the information available to stakeholders
5. Define issues to consult on and means stakeholders can provide feedback through
6. Analyse consultation results and include them into the strategy
7. Ensure transparency of the feedback mechanisms and results
8. Ensure means for continuity of the consultation throughout the project

Key stakeholders to be consulted

19. Some of the key stakeholders are identified below. The list, however, is by no means exhaustive and different potential actors could be consulted in different contexts. Apart from consulting separate stakeholders, contact with already existing local actors' networks could also serve as a relevant source of feedback. Engaging with other development finance institutions or philanthropic organizations operating in the same areas could also be explored.

Local/national authorities

20. The Addis Ababa Action Agenda (AAAA) calls for 'strengthening national and regional development planning, within the context of national sustainable development strategies' (AAAA, 2015^[12]). Consultation with local government stakeholders can lead to a better understanding of regulatory environment in which blended finance intervention has to be anchored. In addition, local networks, including representatives of local governments and public administration are valuable partners to consult regarding regulatory obstacles that may arise during project preparation and implementation. Such relations need to be transparent and follow carefully established working methods in order to increase effectiveness.

21. As an example, research on the relation between MDBs and national governments in Ethiopia and South Africa found that when reflecting on the project after its closure, both sides recognised the need for more structured pre-project dialogue and for maintaining it during the project's lifetime. Even though this exercise was often seen with scepticism considering the long timeline of MDBs' interventions, it brought significant time-savings throughout the implementation process (C. Markowitz, 2017^[21]).

Local communities

22. The need to include local communities in decisions affecting them has been acknowledged by the international community (AAAA, 2015^[12]). It has also been noted that particular attention has to be paid to individuals and groups that may have a higher risk of becoming vulnerable or marginalized, as stipulated in the UN Guiding Principles on Business and Human Rights (UN Human Rights, 2011^[22]). The UN Special Rapporteur on the Rights of Indigenous Peoples specifies that if project objectives were to colligate with rights which are "essential to the survival of indigenous groups and foreseen impacts on the rights are significant, consent to those impacts is required beyond simply being an objective of consultations" (OHCHR, 2012^[23]). Donors should ensure that human rights risk information is well integrated into all blended finance due diligence processes (UN Human Rights, 2011^[22]) (OHCHR, 2019^[24]) and that private sector stakeholders participating in blended finance projects are able to identify, prevent, mitigate and account for how they address potential negative impacts of their projects. The prevention of adverse impacts of blended finance should be based on meaningful local stakeholder engagement and consultation.

23. Communication channels with local communities who are final beneficiaries of blended finance projects can prove particularly useful when established at the outset of blended finance interventions and maintained throughout the whole intervention. This is particularly important in view of allowing local communities to voice their expectations, as well as detect risks of potential harm that they might be exposed to. Concerns include dispossession issues, procedural justice linked with resources allocation, as well as people's rights to compensation for foregone losses (Vermeulen, 2010^[25]). Involvement of local communities is therefore a core tenet for pre-empting adverse human rights impacts of blended finance interventions.

24. Last but not least, local engagement may serve as a practical tool to guide a blended finance transaction, especially in view of supporting the long term sustainability of projects. G20 has acknowledged this indicating that 'engagement with local communities helps DFIs to identify and mitigate risks, as well as improve investment results' (G20, 2018^[26]).

25. An example of consultation with local communities may be found in the Lake Turkana Wind Power Project presented below. Efforts to engage with local communities included designing consultation and engagement strategy, as well as proposing grievance mechanisms (LTWP, 2020^[27]).

Civil society

26. CSOs vary widely in nature and scope and include various types of organizations including trade unions, women's rights associations, indigenous movements, or environmental organizations. In certain sectors and areas of development co-operation they benefit from a comparative advantage as they work

closely with local beneficiaries, grasp local dynamics, and understand local needs and challenges. Systematically engaging in purposeful dialogue with CSOs may allow blended finance actors to tap into their knowledge of beneficiary needs and local expertise. CSOs' embeddedness in local contexts and overall engagement in awareness raising activities may also allow them to bring different perspectives to those of blended finance actors. This may translate into incubating new financing solutions, e.g. in conservation finance. In addition, CSOs often prove to be guards of accountability of development interventions, including in blended finance projects (C. Markowitz, 2017^[21]) and may not always be adequately involved in the design and evaluation of projects. GPEDC found that in practice they are often not included in the blended finance projects (GPEDC, 2019^[3]). As an example, the Global Partnership examined 919 projects involving development partners and the private sector across four countries – Bangladesh, Egypt, El Salvador and Uganda over 2017-18. The results indicate that only 9% of those projects were established in partnerships with civil society (GPEDC, 2019^[3]). Greater efforts should be made to increase DFIs awareness on the benefits of engaging with CSOs. Finally, specific engagement with workers and employer organizations also provide an opportunity to contribute to the achievement of the SDG 8 focusing on the promotion of decent jobs.

27. The often limited engagement with CSOs may also come from the fact that in practice they might face their own challenges, such as accountability issues or political bias (C. Markowitz, 2017^[21]). In certain situations local CSOs may become a preferred channel of consultation for development finance actors, which may in turn undermine accountability of government stakeholders. To minimize such risks, consultation with a diverse range of stakeholders should be favoured when designing blended finance transactions.

DAC Members have committed to providing and promoting enabling environments for civil society (OECD, 2020^[28]) as CSOs are crucial partners in reaching people on the frontlines of poverty, inequality and vulnerability. CSO enabling environment refers to “an environment that supports the establishment and operation of CSOs and their engagement in development processes” (Task Team on CSO Development Effectiveness & Enabling Environment, 2019^[29]) It is a prerequisite for CSOs to be able to act as independent development actors, but also as watchdogs for accountability of development interventions. It is particularly important given current challenges in the declining use of country systems and limited CSOs roles in multi-stakeholder mechanisms, such as national development cooperation policies (NDCPs) (UNDESA, 2020^[30]) Moreover, around the world restrictions on civil society are intensifying, as various governments are using laws, policies and practices to restrict the space in which civil society operates. (OECD, 2020^[28]) (GPEDC, 2019^[31]). In addition to that, new organizational and political limitations for CSOs have also emerged in the context of COVID-19, as local organisations have to deal with health, economic and social priorities, while they face total or partial lockdown measures (CSO Partnership for Development Effectiveness (CPDE), 2020^[32]) In that context it is even more important to make dialogue and consultation with CSOs more systematic throughout blended finance interventions, especially at partner country level.

Local private actors

28. Other stakeholders to consider when planning for a stakeholder consultation could be local private actors such as industry organisations and labour market institutions. Understanding local context and bringing sectoral knowledge and expertise to the table are some of the ways they can contribute. In addition, blended finance deals may in certain instances lead to the emergence of a new value chain and result in positive spill over effects in the supply chain. Given the catalytic effect of blended finance to create new markets, undertaking a value chain analysis could prove particularly beneficial and help assess the indirect positive impacts of a given blended finance deal.

Box 3. Lake Turkana Wind Power – An example of stakeholder consultation

All blended finance investments affect local actors. The scope of dialogue with those actors, however, varies between projects. While some projects have a natural monetary incentive for consulting local actors, others do not. Nevertheless, many projects make conscious effort to listen to local voices in order to increase the development impact of the project.

Lake Turkana Wind Power (LTWP) is the single largest investment in Kenya's history. Its wind turbines generate approximately 17% of the country's installed power capacity. It is owned and financed by a range of development banks, private companies and other actors including donors. LTWP is located in Marsabit County, by some called the 'forgotten' region of Kenya. Thanks to the project, numerous new jobs were created in that region, especially during the time of construction. Apart from bringing economic benefits to local communities, the LTWP also made efforts to listen to local voices. As for any other project though, local consultation can sometimes be challenging.

One of the initiatives undertaken by the project to promote local consultation is the Stakeholder Engagement Plan (SEP). It lays out the public consultation and engagement strategy and aims at reaching actors such as NGOs, affected communities and community based organisations (CBOs). Due to different characteristics of these groups, SEP includes different engagement methods such as visual presentations, leaflets, non-technical summary documents, interviews, surveys and public meetings. Any external feedback can also be provided through the Grievance Form, which can be found on the LTWP project website. Additionally, the project runs a formal review of the stakeholder engagement process annually, or more often if needed.

Any project of such scale, however, will meet challenges and critics. Some have accused the LTWP of land-grabbing and corporate negligence and hence a detrimental impact on some of the local communities (Cormack and Kurewa, 2018^[33]). To research the case further, Danwatch conducted interviews with 24 local ethnic groups (Danwatch, 2016^[34]). It found that most communities approve of the wind power project, however, they complained about lack of public consultations before their land was leased. Another challenge the project identified is that there is no one "community" defined. Many of the groups living around the project area do not know each other; they come from different cultures and might have different priorities, which makes consultation with them more challenging.

While there is no one-fit-for-all approach for local consultation, every project should plan and incorporate such processes into their strategy. LTWP Project can be an inspiration for good practices as well as a source of lessons learnt.

3A.2. Promoting country ownership

29. Development finance providers are encouraged to ensure that blended transactions respect national ownership and national development strategies as stated in the Kampala Principles (GPEDC, 2019^[3]). Including national actors at all stages of the project, as appropriate, and ensuring their position as co-owners can contribute to the success of the blended finance deals and enable the long-term sustainability of investments. The importance of this step is highlighted in numerous international frameworks:

Box 4. International statements on country ownership

“We will enhance inclusive and sustainable urbanization and strengthen economic, social and environmental links between urban, peri-urban and rural areas by strengthening national and regional development planning, within the context of national sustainable development strategies” (AAAA, 2015^[12]).

“Local engagement and ownership in blended finance should be pursued as it will contribute to sustainable impact” (THK, 2018^[11]).

“Encourage official development assistance and financial flows, including foreign direct investment, to States where the need is greatest, in particular least developed countries, African countries, small island developing States and landlocked developing countries, in accordance with their national plans and programmes” (UN SDG 10.B, 2015^[35]).

“Partnerships for development can only succeed if they are led by developing countries, implementing approaches that are tailored to country-specific situations and needs” (4th HLF on Aid Effectiveness, Busan, 2011^[36]).

Kampala Principle 1: Inclusive Country Ownership. Strengthening co-ordination, alignment and capacity building at the country level (GPEDC, 2019^[3])

30. National ownership is beneficial to create a respectful and equal relationship in development co-operation. In order to facilitate such processes, policy framework should be explicit about the role expected of the private sector in delivering national and sectoral development priorities (GPEDC, 2019^[3]). In practice, blended finance deals can actually emerge from broader policy considerations and policy work initiated by central or local governments (UNCDF, 2018^[6]). As an example, case studies in the agriculture sector have shown that public actors in developing countries tend to be interested in using development finance for catalysing private investments (OECD, 2020^[37]). This could in turn increase chances of obtaining more concessional finance along with more local currency financing. Finally, getting the buy-in from political actors could prove beneficial, especially for large projects where the state can be a partner in the blended finance project.

31. However, in some instances governments may potentially be only involved in later stages of the project, if at all, thus missing key phases of deal structuring. As an example, the aforementioned review by GPEDC of 919 projects involving development partners and the private sector across four countries – Bangladesh, Egypt, El Salvador and Uganda - over 2017-18 points out that only 13% of the projects listed national governments as partners (GPEDC, 2019^[3]). In such cases, the lack of prior consultation with beneficiary government can increase the risks of failure when implementing specific projects (CFI, 2020^[38]). Insufficient dialogue between development finance providers and national public representatives may also lead to information and capacity asymmetries between those actors resulting in, for example, inaccurate risk assessment (UNCDF, 2018^[6]). This may in turn give rise to over-subsidizing of private sector and hence undermining financial additionality or reducing the mobilisation of private finance, thus reducing development additionality. Lastly, there is a danger of blended finance being a back door to tied aid (UNCDF, 2018^[6]). For these reasons, open discussion with governments as well as transparency and accountability are key features when designing blended finance deals. Wherever possible, consultation and co-ordination mechanisms should be encouraged with local governments. As an example, the earlier mentioned report from the Trade Union Development Cooperation Network (ITUC-TUDCN) and the CSOs Partnership for Development Effectiveness (CPDE) (ITUC, 2016^[20]) shows that compliance with the principle of ownership is one of the biggest challenges identified. The paper highlights the fact that many DFIs have a preference for donor-country companies and developing countries do not have access to

decision-making procedures. Finally, only in a handful of cases, consultation with developing country governments is explicitly required.

32. It should be noted that national public actors are often sensitive to foreign partners understanding their history and development agendas (C. Markowitz, 2017^[21]). An example from South Africa shows that the government can be reluctant to partner with any foreign financiers who do not comprehend the importance of social development and local employment projects to remedy inequalities resulting from apartheid (C. Markowitz, 2017^[21]). Overall, beneficiary countries can share views on local needs and challenges and help shape blended finance deals, with higher chances of sustainability and therefore long-lasting impacts. Finally, as the dialogue between blended finance actors and partner countries improve, trust is built alongside, which is a pre-condition for effective blended finance models.

33. Nonetheless, securing country ownership may be challenging in cases where developing country governments fail to effectively meet their duties as partners due to various external problems such as corruption, inefficient administration and too high fragmentation of constituted institutions (Bilal, 2019^[9]). In those cases, alternative solutions could be sought including improving transparency and introducing coordination mechanisms among blended finance actors to coordinate policy reforms. Finally, building capacity at government level can also relate to the fact of increasing the financial expertise of national authorities and help raise their ability to access capital.

3A.3. Understanding local circumstances for desirable intervention

Why it is important to take local context into consideration when designing a blended finance transaction

34. Many blended finance projects stem from client-driven and deal-oriented approach (Bilal, 2019^[9]). This may sometimes create a risk that deal designers will follow a standardised strategy without sufficiently considering local context circumstances and dynamics. As an example, *Blended Finance for Agriculture* case studies indicate that institutional and product design elements of projects were often found incompatible with local context (OECD/SAFIN, forthcoming^[39]). It is rare that off-the-shelf solutions apply to many different contexts. On the other hand, donors should bear in mind that there is a trade-off between customization and achieving scale. Too much focus on tailor-made solutions for local contexts can undermine an ability to quickly scale up and transfer projects from a local level to a regional or national level. It also may sacrifice a more systemic approach to change among investors increasingly looking at developing country investments.

35. In line with the Kampala Principles for Effective Private Sector Engagement in Development Cooperation (GPEDC, 2019^[3]) local actors should be part of both design and implementation efforts, as well as monitoring and evaluation of development interventions. A comprehensive local context assessment is necessary for structuring blended finance intervention, for example when deciding on the level of concessional finance to enhance the risk/return ratio or aligning incentives with projects participants. Knowledge of local context is also salient in the process of identifying measures to overcome barriers to local market development. This could help assessing whether and to what extent blending instruments should be used. In addition, it is also important to shift focus towards systemic changes instead of solely considering the benefits of individual transactions.

36.

Designing the right type of deal requires to take into account several local dimensions. This helps inform the choice of instruments

37. The selection of the most suitable blended finance instrument depends on sector and type of transaction as much as it does on local circumstances. Understanding where the market is failing and what the constraints are for private investments enables the design of the right transaction with appropriate instruments. For example, in case of high political or currency risk perceptions, guarantees may be an

appropriate solution. In LDCs, technical assistance accompanying other instruments is often a useful solution to address knowledge gaps (UNCDF, 2018_[6]). Those contexts may also require higher levels of concessionality due to more difficult investment environments. On the other hand, if the main impediment in an infrastructure project are low expected returns, concessional loans are likely to be a better solution.

38. Furthermore, blended finance operations need to respond to local realities and issues such as local political economy dynamics, and regulations need to be carefully considered. First, local political economy dynamics refer to an understanding of power relations, market and institutional structures, drivers of change and domestic constraints (Bilal, 2019_[9]). It could also include assessing vested interest such as government's incentives for engagement into a project which may sometimes be ideological. Second, understanding local regulations could facilitate project implementation, and identifying regulatory gaps could contribute to improve the enabling environment, as discussed in part 3C.2.

39. In some instances however, development finance providers may decide to go beyond the local regulatory requirement, for example on environmental and social topics. In order to ensure that ESG standards improve project's impact, solutions such as country-specific 'E&S safeguards plan' can sometimes be considered (C. Markowitz, 2017_[21]).

3A.4. Understanding the local context is necessary for additionality

Why additionality assessments need to be done taking into account the local context

40. Development actors widely stress the importance of additionality in blended finance (UN, 2015_[40]) (THK, 2018_[11]) (UNFCCC, 2015_[41]) (IFC, 2018_[42]) (IFC, n.d._[43]) (OECD, 2020_[44]). In-depth understanding of local needs and conditions is crucial for designing and implementing projects with high financial and development additionality. Currently, however, there is no one standardized way of conceptualizing and measuring additionality. A recent report "Blended Finance and Evaluation: An Assessment of Core Concepts" prepared by Aide à la Décision Économique (ADE) in collaboration with Just Economics, identifies three distinct ways of conceptualizing additionality. Yet, it also recognizes that there are many more variants used by blended finance actors (ADE, Forthcoming_[45]). It is commonly agreed that a comprehensive understanding of local market structure, political environment and sector characteristics helps to identify market failures and opportunities and hence increases the likelihood of additionality. Such characteristics are subject to change over time, and additionality assessments should therefore not remain a onetime event.

Box 5. Additionality – definitions

Additionality: “In the context of reporting on private sector instruments in DAC statistics, [the OECD-DAC Secretariat proposes that] an official transaction be considered additional either because of its ‘financial additionality’ or ‘value additionality’ or both. Such a transaction is financially additional if it is extended to an entity that cannot obtain finance from local or international private capital markets with similar terms or quantities without official support, or if it mobilizes investment from the private sector that would not have been otherwise invested. It is additional in value if the public sector offers to recipient entities or mobilizes, alongside its investment, non-financial value that the private sector is not offering and which will lead to better development outcomes e.g. by providing or catalysing knowledge and expertise, promoting social or environmental standards or fostering good corporate governance” (OECD, 2016^[46]).

Development additionality: In addition to financial and value additionality, the literature on additionality often refers to development additionality. This term refers to the development impacts that arise as a result of investment that otherwise would not have occurred. In this case, one of the main rationales for partnership is that it facilitates faster, larger or better development impacts than the public or private sector would be able to achieve working alone. Source: (OECD, 2016^[47])

Importance of local context for development additionality

41. Development additionality is intrinsically linked with supporting the delivery of the 2030 Agenda for Sustainable Development. Understanding actual needs for blended finance projects in specific geographical, social, economic and political conditions, as well as examining risks for their success, is indispensable for assessing development additionality. Such assessment is especially important in Least Developed Countries and regions as it attunes blended finance to address the ‘leaving no one behind’ commitment. Currently, it is estimated that only 5% of private finance mobilised by official development finance interventions reaches LDCs (OECD, 2020^[48]). This is because investments in least developed and fragile countries are often hampered by political and financial risks of investments, costly and time-consuming pipeline development, high transaction costs relative to project size, as well as untested business models and little market data (UNCDF, 2018^[6]). Acknowledging the fact that investing in such environments is likely to entail high development additionality is a pre-condition for designing appropriate incentives and instruments for investments. Focusing on underinvested sectors and locations may also increase chances of blended finance to reduce social inequalities.

42. Moreover, in order to meet development additionality objectives, blended finance actors may seek to adjust their intervention to local conditions and may consider the local needs for ‘patient capital’ as well as for space for experimentation in certain contexts (Dutch MFA, 2019^[49]). As a result, being flexible in realising proof of concepts and implementing new models tailored to specific circumstances and market gaps in a given ecosystem could be beneficial. In addition, it should be noted that archetypes copied from other blended finance models may serve as an inspiration for project preparation and project scoping but may require further adjustments to local contexts.

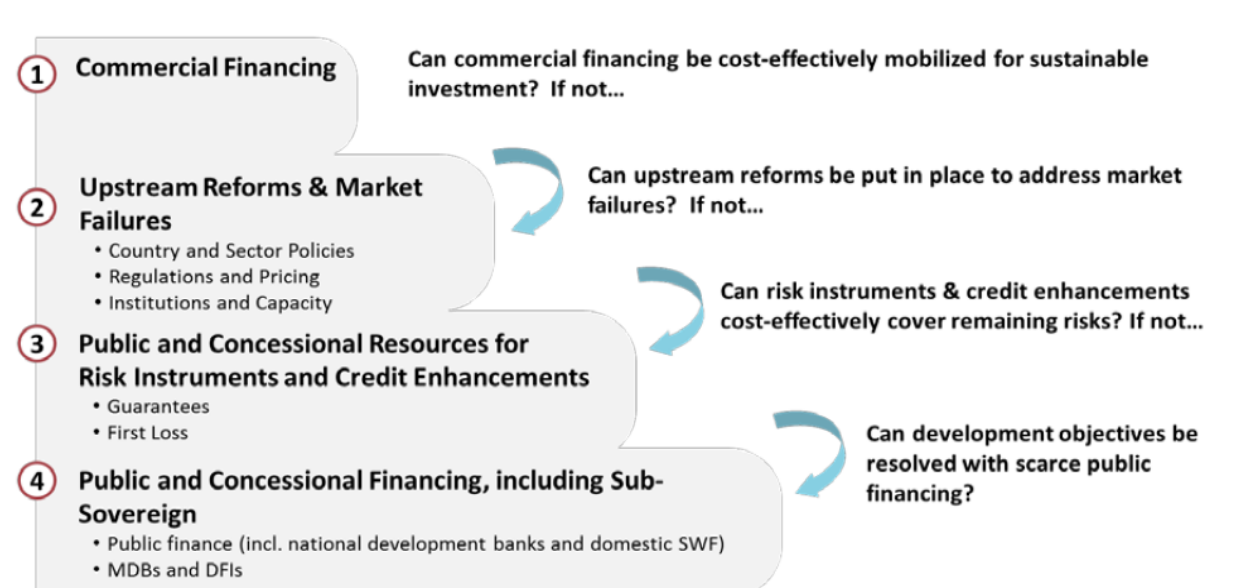
Although difficult investment environments may make blended transactions more challenging, they hold potential of high development additionality while reaching underinvested sectors and locations, as well as underserved populations.

Importance of local context for financial additionality

43. A transaction is said to be financially additional if it is extended to an entity that cannot obtain finance from local or international private capital markets with similar terms or quantities without official

support, or if it mobilises investment from the private sector that would not have been otherwise invested. It should be remembered though that concessionality does not guarantee additionality and it may actually lead to crowding out commercial finance. In order to ensure minimum level of concessionality in conditions where commercial finance is available in the market, a cascade approach was developed by the World Bank Group (World Bank Group, 2017^[50]). It lays out a sequenced approach to determining the type of development finance required in a given market and understanding of local conditions is necessary for its application (OECD, 2020^[44]). In practice, however, incentives structures of DFIs and MDBs need to be aligned to such an approach and a good level of collaboration between DFIs is necessary.

Figure 1. World Bank cascade approach



Source: (World Bank Group, 2017^[50])

44. Difficulty of determining financial additionality of blended finance intervention depends primarily on assessing the local financial market and the type of financial instrument to be used. For example, it is important to examine in advance whether local capital markets already provide financing to a specific sector and at what terms (maturity, interest rate/tenor, return and collateral requirements, grace period).

3A.5. Need for representation and effective communication on the ground

45. Having a representation on the ground is often said to help identifying opportunities, supporting project preparation and establishing fruitful partnerships with financial, national and other local actors. Multiple organisational designs are however possible, and the consequences of using each of them depends on a variety of settings e.g. regulations, investment strategy, mandate, balance sheet and fiduciary risk. Below are a few examples of organisational settings:

1. *Local offices in the country of transaction* – Such organisational settings are often linked to a greater understanding of local needs and challenges and may help to establish partnerships without any intermediaries. However, it may sometimes be too costly in regions where few other initiatives are run by the same organisation.
2. *Having investment officers in home office but frequently travelling to developing countries* – this structure also gives an advantage of direct contacts with local stakeholders while being a cheaper

and more flexible arrangement. Nonetheless it rarely fully replaces a long-term presence on the ground.

3. *Partnering with local organisations* – such setting provides an opportunity for understanding local conditions but challenges may arise when objectives, vision or ways of working differ between various stakeholders. Local organisations may also have other priorities and hence opt for different blended finance opportunities.
4. *Teaming up with other development finance institutions that have a stronger local presence* - such an approach allows to combine contributions and local networks of other institutions. However, research from EBRD indicates that the full potential of such cooperation may not be achieved when there is limited engagement and cooperation between organisations. It is due to their transaction-driven approach and therefore competitive relation (EBRD, 2018^[51]).

46. It should be noted that no organisational setting should be seen as more suitable in all circumstances but rather that the decisions to choose one setting over another depends on various criteria including the regulatory environment or risk management considerations. In addition, peer learning should be encouraged, at the regional/local level.

Creating fruitful partnerships

47. Co-operative and well-co-ordinated representatives on the ground are, among others, responsible for establishing fruitful local partnerships. The Kampala Principles in particular, highlight that inclusive dialogue and consultation should aim at reaching agreement on priorities and identifying solutions to shared challenges (GPEDC, 2019^[3]). Research from C. Markowitz indicates, however, that for some MDBs, working together harmoniously on the ground with other actors was one of the greatest challenges. As a solution, MDBs often highlight the importance of sustained dialogue throughout project implementation. This may require allocating special resources on building consensus, but it may prove beneficial in the later phases of the project. Such consensus and dialogue may take the form of annual/bi-annual 'trust building' workshops held before the conceptualisation of blended finance project (C. Markowitz, 2017^[21]). Regardless of the strategy chosen, turning relationships into partnerships should be one of the project priorities. It should also be noted that different local contexts may require various ways of establishing partnerships.

48. Comprehensive frameworks based on past blended finance experiences may serve as a valuable starting point. In addition, combining local financing solutions with an aggregation approach through e.g. fund-of-funds may be a way to overcome a trade-off between scale and locally-embedded approaches (OECD, 2020^[52]).

49. In order to anchor blended finance in local context and deliver a more transformational impact on local markets, blended finance actors should look beyond single projects and, where possible, coordinate their operations. A clustering of blended finance transactions (as opposed to focusing on project-level activities) may allow blended finance actors to achieve more systemic results on a given market. It can also allow for a more effective and structured engagement with local stakeholders. The added value of clustering blended finance transitions is also linked with a possibility of identifying, selecting and scaling successful models of blended finance in a given portfolio thus accelerating positive advances in a given market.

Box 6 EU Blending Facilities

The European Commission established a number of regional and, more recently, thematic investment facilities grouped under the EU Blending Facilities frameworks. These facilities, including for example Asia Investment Facility (AIF) or Latin America Investment Facility (LAIF), aim at mobilising finance for projects in particular geographies and sectors that struggle to raise the required funding on the markets. Although the financial institutions (FIs) which work within these frameworks identify and select projects on the basis of their own assessment criteria, the process of project development involves collaboration with the European Commission, both within the technical bodies and at EU delegation level. The clustering of projects within a specific EU Blending Facility is based on the EU programming process and policy priorities approved by partner countries. It also builds on strategic discussions held within each Blending Facility (by strategic board or steering committee) and on the analysis of the facility-wide portfolio and the pipeline of projects. In this sense, the EU Blending Facilities promote cooperation and coordination between the EU and relevant financial institutions and other stakeholders, thereby moving beyond individual project-level activities.

3B Ensure consistency of blended finance with the aim of local financial market development

The emergence of efficient local financial markets will be essential to sustainable financing for development. Hence, Blended Finance should seek opportunities to work with local financial actors, where possible, and should avoid approaches that crowd out local financial institutions. Capacity building with local financial institutions also provides an opportunity to shift focus towards systemic change, instead of individual transactions.

Box 7 Cases of strengthening the local dimension of DFIs interventions

DFIs can strengthen the local dimension of their interventions in several ways. One approach consists in improving the capacity of the local institutions the DFIs are working with.

This is the case for instance with the Corporate Governance Development Framework (CGDF) adopted by 34 DFIs. This is part of an effort by DFIs to promote good governance by their clients. The CGDF provides a common methodology and toolkit to undertake a governance diagnostic of the DFIs' clients. This may lead to the adoption of an action plan and technical assistance to help enhance their corporate governance as well as their environmental and social practices, if necessary. Besides the due diligence and know-your-customer principles applied by the DFIs, the framework can help strengthen good governance not only of DFIs clients, but also the clients of the financial intermediaries DFIs are working with (see Chesnais, 2019, An example of commitment to good governance: DFIs and corporate governance support, Private Sector & Development, Proparco).

DFIs can also directly contribute to reform or develop new local financial institutions. This is the case for instance of the German KfW Development Bank and its participation to the establishment of the new development bank in Tunisia, the Banque des régions (BdR) - the Bank of Regions. The BdR, set up by the Tunisian government, aims to provide access to finance and support to micro, small and medium-sized enterprises (MSMEs) in the regions of Tunisia, a segment of the market underfinanced, notably due to weak performances by current public institutions, which will be absorbed by the BdR. KfW provides technical assistance, including in the form of knowledge transfer and support to the establishment of strong governance structure and principles (independent from the state). KfW will then provide a substantial line of credit to the BdR. By doing so, KfW contributes not only to the financing of MSMEs in Tunisia through its line of credits, an activity common to many DFIs, but it also helps with the creation of a stronger public financial institution, with sound governance structure and operational practices, therefore also enhancing the credibility and sustainability of the BdR for longer-term impact.

DFIs interventions can also have a strong demonstration effect, with a lasting impact on their clients. This is the case for instance of the IFC senior debt facility to CRDB Bank, a lead financial institution in Tanzania, to support notably SMEs owned by women, since 2014. Complementing a 2011 DANIDA guarantee and grant facility Women Access to Finance Initiative (WAFI) aimed at enabling women to contribute to economic growth through SME loans (see CRDB Annual Report 2018, p.224 & p228), the IFC support was instrumental in demonstrating the business case of lending to women entrepreneurs. CRDB has then also strengthened its position on the market for women with its Malkia account, designed to help women save for investment, business, healthcare and education needs. IFC continues to play a lead role in fostering women empowerment in the banking sector in Tanzania. Working with five major banks (including CRDB) and two insurance companies through its Finance2Equal programme, IFC promotes gender equality by helping them to support and serve women better, through case studies, peer learning and firm-level measures, including by helping women to get quality jobs in financial institutions.

3B.1. Engagement and capacity building with local financial institutions

50. Blended finance interventions aim to withdraw concessional financing once the project can survive and thrive in a local financial market. Hence, engagement with local financial institutions is not only an added value in terms of accommodating local perspectives but it also constitutes an opportunity for local capacity building and subsequently may contribute to a long-term economic development of local markets. However, it also brings its own challenges.

Challenges encountered in developing local financial markets

51. Many financial institutions in developing economies face both challenges of structural inefficiencies and capacity constraints. Many of the challenges arise at macro level with insufficient national capital resulting from low domestic savings, absence of a liquid stock and bond market, ineffective banking and capital market regulation (such as excessive collateral requirements), and high interest rates on government bonds in local currency that make interest rates for non-government borrowers prohibitively expensive (OECD, 2020^[44]). This in turn contributes to higher cost of capital and limited choice of financial institutions for local SMEs. Nonetheless, some of these constraints and inefficiencies may be addressed through capacity building. Local financial actors such as domestic pension funds, local banks or sovereign wealth funds, may also face knowledge gaps on the most effective instruments to be used to mobilise additional finance. Finally, capacity building, such as building investment knowledge locally through peer-to-peer exchanges, can help shape relevant regulatory reforms and foster the growth of the financial sectors in developing economies.

Box 8. Capacity building with local banks on the need to support “missing middle SMEs”

The so-called “missing middle enterprises” in LDCs usually need credit between \$50,000 to \$1 million (UNCDF, 2018^[6]). While in well-developed financial markets it would typically be provided by local banks, in emerging markets and developing economies (EMDEs) it is often not the case.

Due to structural and capacity gaps local financial institutions may sometimes perceive credits to SMEs as too risky and too expensive, according to the same research by UNCDF. However, SMEs play a critical role in emerging economies, with a contribution of up to 40% of GDP (IFC, 2017^[53]). They are also estimated to provide two-thirds of all formal jobs in developing countries in Africa, Asia and Latin America, and 80% in low income countries, mainly in Sub-Saharan Africa (ILO, GIZ, 2013^[54]). It is therefore important to overcome those challenges in order to diversify economic activity and hence contribute to creation of sustainable local economies.

Lack of collateral, high transaction costs relative to project size, as well as untested business models and little market data are some of the key barriers often cited by local banks and which prevent them from lending more to local SMEs.

Providing guarantees to local banks to support on-lending to SMEs and collaborating with them in blended finance transactions contributes to build capacity as well as local financial markets (GPEDC, 2019^[3]). Such transactions also help provide financial capacity for local banks to support local SMEs financing needs. This solution is particularly effective in contexts where perceived risks are much higher than real risks.

Development finance providers can also support local banks by providing credit lines and associated technical facilities. Financial institutions may benefit from technical assistance targeting improvements in conducting cost benefit analysis, assessing project bankability, building track record and structuring deals with reasonable exit strategy (BSDC, 2018^[4]). Apart from local banks, other institutions such as MFIs can benefit from technical assistance provided along the blended finance intervention.

More effective partnerships with local financial institutions can help raise awareness on better suited financial products, such as longer-term loans and lower interest rates. Overall, blended finance instruments may contribute to creating a favourable environment for SMEs and hereby increasing their positive impact on the local economy. Increased capacity of local financial institutions can contribute to sustainability of local investments and long-term efficiency of whole markets.

Why and how local institutions' engagement with blended finance projects may be a win-win

52. Local financial institutions are natural partners for development finance providers and their participation should be maximised (GPEDC, 2019^[3]). Some DFIs, such as KfW (KfW, n.d.^[55]), explicitly state their strategy on engagement with local financial institutions. Such institutions, including national development banks, sovereign wealth funds and local pension funds bring unique understanding of local context and can be better at managing countries' regulatory, political and market risks, thus contributing to risk premia reduction. In addition, local financial institutions may facilitate the arrangement of blended finance transactions and support the creation of a pipeline of bankable projects. Some local entities are also well positioned to incubate, anchor and lead the arrangement of blended finance solutions at the national level (OECD, 2020^[52]). It should be noted that local pension funds, which typically don't invest in early stages projects can help refinance projects at lower interests rates. Finally, local financial institutions also help mobilise local finance and can thus provide local currency financing which is of a significant importance, as discussed in section 3B.2. Moreover, involvement of local business angels may contribute to lowering transaction costs and increasing project credibility (Dutch MFA, 2019^[49]).

Box 9. Finance in Motion - Building partnerships with local financial intermediaries

Investing through financial intermediaries can contribute to leverage local infrastructure, as well as support the continuous strengthening of the local financial sector. Such an approach works towards scale and long-lasting positive change, and it has been promoted by several institutions including Finance in Motion, a global impact asset manager developing and advising blended finance funds.

To best reach their target groups and support financial sector development, the funds advised by Finance in Motion typically channel investments through a range of local financial intermediaries – from microfinance institutions and commercial banks to factoring and leasing companies. These on-the-ground partners then lend the money to, for example, small business owners, according to specific eligibility criteria which reflect the impact mission of the respective fund. In addition, close geographical proximity to the funds' stakeholders allows for a tailored approach that responds to the specific needs and opportunities of local partners.

As an example, the Green for Growth Fund (GGF), initiated by the KfW Development Bank and the European Investment Bank and advised by Finance in Motion, aims to support local financial institutions in developing green loan products. In practice, through a technical assistance project, GGF has supported a microfinance institution in Kosovo in extending a dedicated energy efficiency lending product to urban and rural households that have a high energy efficiency potential. Financial product development was accompanied by an extensive marketing campaign to build a market for the product. Overall, such strategies can increase awareness and uptake of energy and resource efficiency and renewable energy solutions in the local financial sector and among the public, and contribute to a broader impact beyond the fund's investment activities.

Source: (Finance in Motion, 2020)^[56]

Unfortunately engagement of local financial institution can be challenging

53. Even though some bilateral and multilateral development banks already extensively engage with local financial institutions, especially regional development banks, this might present some challenges. The main reason is related to limited information and high perceived risks, especially around working with public financial institutions. In addition, local private financial actors may in turn have different approaches and priorities when it comes to SDGs funding. As a result, more flexibility may sometimes be required when working with local financial institutions.

54. Lack of understanding of blended finance by local financial institutions is another challenge encountered when working with those actors (OECD, 2020)^[37]. Case studies from *Blended Finance for Agriculture* suggest that local financial institutions can play a very important role in blended finance projects despite not being aware of the concept and its opportunities (OECD, 2020)^[37]. Better communication and awareness building could facilitate fruitful collaborations that would otherwise not happened, and in the long run further enhance local economic development.

3B.2. Crowding in domestic finance

55. Involvement of local investors such as pension funds, investment funds, national development banks and individual investors in blended finance operations provides opportunities for crowding in domestic finance in strategic sectors aligned with national development plans. As an example, the Senegalese Strategic Investment Fund (FONSIS) was launched to help facilitate local private-sector

investments. Apart from leveraging additional capital for development purposes, it also has the potential of generating beneficial spill-over effects for local markets. As acknowledged by the G20, “greater effort should be made to include local intermediaries and local pools of institutional capital in projects” (G20, 2017_[111]). Blended finance actors may use different tools to crowd-in domestic capital and tap into local expertise in blended finance transactions. They may do so by opening new opportunities for co-investment, for example in first-of-a-kind investments in sectors so far underserved by domestic finance. Development finance institutions can also use their capital to de-risk deals to attract local capital to blended finance projects, e.g. by guarantees or subordinated capital tranches. Crowding-in may be also achieved by general support activities to local institutions, for example by improving industry standards, which may trigger an investment response from local investors.

Why it is important to crowd in domestic finance

Both domestic and foreign investors add unique value to blended finance and they are important sources for development capital. While foreign investors may often contribute with technology transfers and bring in know-how and expertise (OECD, 2014_[57]), domestic investors account for domestic resource mobilisation, provide local expertise and insight into local context. A study by Dutch MFA indicates that engaging local co-investors increases the likelihood of success of venture capital funds (Dutch MFA, 2019_[49]). Their presence is also likely to improve risk allocation of investments, especially as they provide financing in local currency (ref. section 3B.3).

56. Beneficiary countries themselves are, after high-income countries, the second largest source of private finance mobilised in LDCs (UNCDF, 2018_[6]). They complement external financing and serve as a vehicle for mobilising further domestic finance (UNCDF, 2018_[6]). The role of domestic capital is likely to increase in the coming years due to the capital flight caused by Covid-19 crisis. Therefore, blended finance projects may have to partially shift towards local financing. Domestic capital may be particularly needed in the reconstruction phase, which is likely to last much longer than the health crisis itself.

Challenges and opportunities when leveraging domestic capital

57. Crowding-in domestic finance provides additional funding and thus may increase the scale of development interventions. However, ways of leveraging domestic capital into blended finance transactions, especially in less developed markets, could be improved (UNCDF, 2018_[6]).

58. Sustainable development financing has to be anchored in domestic financial systems and rely on local investors who can bring in additional resources. Yet, a growth of overseas investments from developing countries in recent decades (S. Bano, 2015_[58]) (Herzer, 2011_[59]) signals a threat of excessive outflow of capital from local markets. Blended finance actors should strive to develop effective strategies for tapping into local resources and channelling them into development-oriented local investments. An important source of capital in developing markets increasingly originates from domestic institutional investors. For instance, assets managed by African sovereign wealth funds are steadily growing (PWC, 2020_[60]). Another example are domestic pension funds, which deserve particular attention. Their assets under management in twelve African markets is expected to rise from 670 billion USD in 2012 to about 1.8 trillion USD by 2020 (AfDB, 2018_[61]). All African pension funds are estimated to hold USD 350 billion of assets under management outside of the continent (Lee, 2017_[62]). Well-designed and supported blended finance transactions may counteract such outflow of local capital. The most straightforward reason for pension funds’ disengagement in local markets is high risk, which these institutions by nature try to avoid. There are also other potential constraints for leveraging domestic capital from pension funds, such as local regulations. Pension funds’ operations may require regulatory reforms regarding their mandate before engaging in a blended finance transactions. Overall, by investing in local markets and not overseas, institutional investors can encourage local players to invest more domestically and bring private resources for domestic growth.

59. National and sub-regional development banks are particularly well positioned for crowding in domestic-finance, as highlighted in THK Roadmap for Blended Finance (THK, 2018^[11]). They are also an important provider of medium-to-high-risk funding for development objectives at terms that allow them to maintain their financial sustainability (OECD, 2020^[52]). A unique role of National Development Banks (NDBs) stems from their explicit development mandates given by their respective governments. They focus on long-term financing and promotion of the country's economic development, and they understand the risks and barriers that local commercial institutions are confronted with when financing underserved market segments. (OECD, Forthcoming^[63]). NDBs also have a strong track record of providing counter-cyclical finance (WB Group, 2012^[64]); (IATF, 2016^[65]). In light of these characteristics, NDBs can make significant impact on the ground as both domestic finance providers and "project structurers" (IDB, 2013^[66]). It is important to note, however, that many NDBs should still improve their risk management capacity, reduce their reliance on governmental budget transfers and in some cases reduce undue political interference (WB Group, 2012^[64]). Moreover, some MDBs/DFIs are reluctant to engage with NDBs given that they may be perceived as potential competitors in small local markets (Bilal, 2019^[9]). To tap into opportunities linked with partnering with NDBs and to scale up the prospects of mobilising domestic resources, blended finance actors could consider, along delivery of blended finance operations, contributing to the development of NDBs' institutional capacity (Bilal, 2019^[9]). In light of the ensuing economic crisis caused by the COVID-19 pandemic, NDBs' countercyclical role in terms of development financing could be crucial to supporting the economic recovery (Griffith-Jones, Marodon and Ocampo, 2020^[67])

60. Another challenge related to blended finance projects is the potential gap between the requirements from foreign investors (specifically, institutional investors) and local investors or donors. While foreign investors may look for investments of certain size with minimum liquidity, local investors, donors or public sponsors may consider small sized investments. As a result, in order to scale up financing, aggregated structures of small projects could be further explored. In addition, the use of equity crowd-funding campaigns may contribute to foster local engagement from individual investors.

Box 10. The Trade and Development Bank's experience in leveraging domestic capital from institutional investors

The Trade and Development Bank (TDB) is a multilateral, treaty-based financial institution offering both Infrastructure and Trade finance. As part of a reform, in 2013, the Bank embarked on a new plan where diversification was a key theme, which provided an opportunity for the Bank to blend public and private funding on both the asset and liability side.

The Bank decided to introduce a new class of shares aimed at institutional shareholders. With the introduction of those shares (Class B) which delivers cash dividends, the Bank embarked on finding suitable investment partners through private placements. The institutional investors were attracted not only by the financial returns but also by the reforms the Bank had undertaken to strengthen their investment. For example, while not formally regulated by any given central bank, the Bank adopted and continues to benchmark itself against global best practices.

TDB's strategy to diversify its shareholder base through the introduction of Class B shares has resulted in a strong increase in the institutional shareholding of the Bank over the past few years (from 5.8% in 2010 to 24.5% in December 2019). As a result of the increased investment from central banks and institutional investors, the governance of the Bank continues to improve while it maintains its privileged multilateral status. TDB has also been able to achieve a capital base that blends both public and private funds, local and global. Class B shareholders include several African pension funds and insurance companies as well as non-regional institutional shareholders.

Source: interviews and unpublished material kindly provided by staff of the Trade and Development Bank.

3B.3. Local currency financing

61. Local currency financing is a key factor contributing to local financial market development. Both of those processes are mutually reinforcing and can be supported through blended finance interventions. The importance of this principle is highlighted in numerous international frameworks (see Box 11 below):

Box 11. International statements on local currency financing

“We call on the multilateral development banks to work more closely with domestic financial markets, and in local currencies wherever possible, in order to build local markets.” (G7, 2018^[10])

“Denominating projects in local currency should be encouraged wherever appropriate, with financial exchange hedging support where it is not” (G20, 2017^[11])

“We will also promote lending from financial institutions and development banks, along with risk mitigation mechanisms, such as the Multilateral Investment Guarantee Agency, while managing currency risk” (AAAA, 2015^[12])

What discourages investors from investing in local currencies?

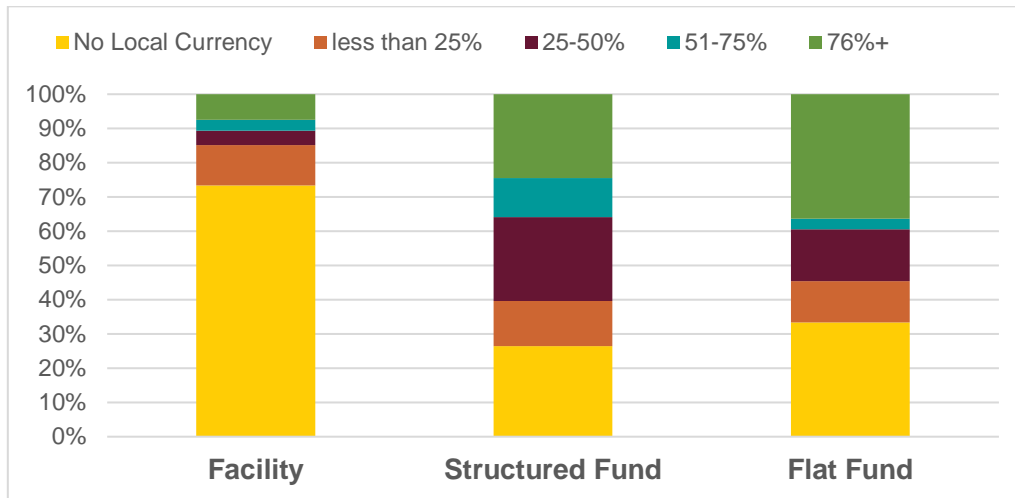
62. Local currency risks are in many countries one of the key factor pushing international investors away from emerging markets. Research from Moody’s indicates that currency risk has been a single largest reason for defaults in EMDEs (39.2-43.5%) between 1983 and 2016 (Davison, 2018^[68]). The same study points out that almost all of the defaults resulted from currency transfers and local currency devaluation. Currency risks exist in both free-floating and pegged currencies systems. Devaluation of local currency means decreased potential profits for investors and difficulties in exit for international equity investors.

63. As a result, international investors usually favour transactions in hard currencies, which may be highly disadvantageous for local partners. This is because companies which borrowed money in hard currencies are also obliged to pay back in the same currencies thus taking all the risk on themselves. Meanwhile, limited amounts of capital in local currency can make long term funding particularly difficult. Apart from passing risks onto borrowers it may also lead to bad investment decisions. This is particularly problematic when borrowers focus only on the short-term benefits of lower interest rates and do not pay enough attention to longer-term risks of higher repayments (with principal repayments included) due to currency depreciation over the time of repayment (TCX, 2018^[69]). Furthermore, investments in local currency contribute to financial stability and local capital market development which in turn, as a spill over, encourages further local currency investments.

Unfortunately local currency financing is not the norm

64. Hard-currency lending is still the prevailing norm for development institutions (TCX, 2018^[69]). When it comes to blended finance funds and facilities, as many as 69% of facilities and 25% of funds has no investment in local currency in their portfolio and only 7% of facilities and 25% of funds has more than ¼ of their investment in such currency (OECD, 2018^[70]) (see Figure 2 below).

Figure 2. Average percent of investment portfolio based in local currency



Note: Based on 94 facilities and 86 funds

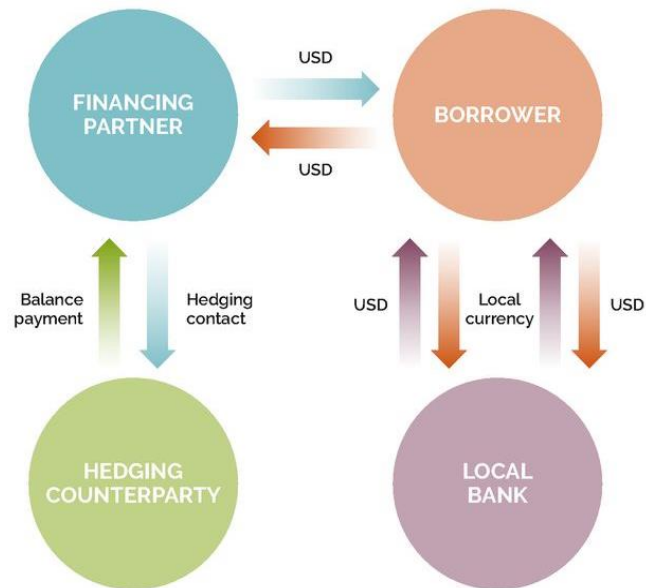
Source: https://www.oecd-ilibrary.org/development/blended-finance-funds-and-facilities_806991a2-en

Ways to mitigate local currency risks

65. Underdeveloped financial markets and public institutions have little possibility of mitigating foreign currency risks (TCX, 2018^[69]). However, while crowding-in local capital in local currency is critical for local markets sustainability, there is still little evidence on how and with what instruments it can be done most effectively. Possible mechanisms to mitigate local currency risks include cross-currency swaps, credit/risk-sharing guarantees or foreign-exchange forward contracts protecting its clients against long-term risk, as shown in Figure 3. It does so by diversifying currencies, which means that loss in one currency is offset by gains in the others thus balancing the portfolio risk.

66. Moreover, many developing countries have high savings rates relative to developed countries (BSDC, 2018^[4]) and could use those resources to avoid hard currency debt. If a given transaction has already taken place in hard-currency, more flexibility may be a solution. Therefore prolonging concessional lending could be considered in case of significant currency fluctuations, even though such lending would normally be expected to have set timeframes.

Figure 3. How a local currency-index loan works



Source: TCX (2017) M-Kopa connects low income homes to affordable solar energy – fast, <https://www.climatefinancelab.org/wp-content/uploads/2017/03/M-Kopa-Description.pdf> (accessed 1 June 2020)

Box 12. Local currency guarantee by the European Commission

Demand for local currency financing in many developing countries is far greater than supply. Loans are often denominated in hard currency. But by borrowing in hard currency the unhedged foreign exchange rate risk can cause serious problems to borrowers in the event of severe currency depreciation. Hedging solutions are often not readily available or are expensive.

Under the EFSD Guarantee, managed by the European Commission in the framework of the External Investment Plan, the EU aims to make local currency financing more accessible for investors, and in the long run to strengthen local currency capital markets in the EU Neighbourhood and Sub-Saharan Africa. Out of 28 guarantees initially approved under the EFSD Guarantee there has been several programmes targeting local currency financing, including Local Currency Lending in Sub-Saharan Africa (managed jointly by KfW Group and AfDB), as well as African Local Currency Bond Guarantee Programme (KfW Group).

Source: <https://ec.europa.eu/commission/sites/beta-political/files/en28guaranteesjan20.pdf>

3C Use blended finance alongside efforts to promote a sound enabling environment

A sound enabling environment is a vital condition for mobilising private investment. Blended Finance can be a means of achieving development impact in challenging environments, but it can also be an important complement to reform efforts, and should seek to be supportive of them where relevant.

3C.1. Demonstration effects and market creation

67. As highlighted under the THK Roadmap, “blended finance should help to accelerate inclusive sustainable market development, including the local financial market” (THK, 2018_[11]). Blended finance provides an opportunity to contribute to local economic transformation and improve investments climate.

Blended finance and flourishing investment climate

68. The relation between blended finance and a sound investment climate is mutually reinforcing and supplementary. A perfect investment environment would not require a blended finance intervention in the first place. At the same time, blended finance can help create new capital markets and support already existing ones. It does so by providing capital to projects in difficult environment but also by facilitating further reforms and changing perception of risks.

69. As noted in a *THK Roadmap for Blended Finance* document, “flourishing investment climate enables a better quality and quantity of blended finance” (THK, 2018_[11]). The relation, however, is not as straightforward. Research by Munemo suggests that foreign direct investment can have crowding-in effect, nonetheless it can also have a crowding-out effect as competition for local businesses grows. Which of those two effects will be stronger depends to a large extent on the level of development of local financial system (Munemo, 2017_[71]).

70. How blended finance can develop new markets

71. The World Bank Group is one of the international bodies which identified and addressed the need for broad transformational market changes through its Maximising Finance for Development Approach (MFD). This cross-WBG approach complements the IFC’s Creating Markets strategy (IFC, n.d._[72]) and

focuses on improving investment climate, building capacity, as well as strengthening regulatory and policy frameworks in local markets and (WB Group, n.d.^[73]). The EU has also developed a comprehensive approach to improving investment climate in its partner countries with the External Investment Plan (EIP). It integrates three pillars: the mobilisation of financial resources (Pillar 1), technical assistance (Pillar 2), and improvement of conducive investment environment (Pillar 3). The core objective of Pillar 3 is to remove constraints to private investment in developing markets, starting with in-depth analysis of the needs and impediments of local markets. This is followed by public-private dialogue coupled with prioritised interventions to support reforms, as well as capacity building of public and private sector (European Commission, 2019^[74]). Another holistic approach to improving investment climate in local markets is taken by the EBRD with its dedicated strategy to address systemic changes in the local environment and foster change towards “open market-oriented economy” (EBRD, n.d.^[75]). The “transition impact” dimension is part of the EBRD country strategies. It is also taken into consideration in the EBRD project selection process, as well as evaluation of the overall bank’s engagement in a local market (Bilal, 2019^[9]). All of these approaches link deal-oriented blended finance project engagements with wider transformative objectives on local markets creation.

3C.2. Fostering policy reforms addressing obstacles faced by private investors in the local context

72. A favourable investment climate is essential in attracting and retaining foreign and domestic investments. Through blended finance, development actors should ideally help to overcome investment barriers in local markets, especially barriers to commercial sustainability (GPEDC, 2019^[3]). As MDBs and DFIs are principally transaction-driven institutions (Bilal, 2019^[9]), they could play an important role in strengthening their systemic and holistic understanding of local markets, as well as incentives and mechanisms to engage in broader transformational changes. Building conducive local environment by blended finance can be achieved by a variety of tools. Blended finance transactions could be supplemented by capacity development and advisory services to national and local authorities, which are aimed at enhancing economic and governance reforms. Other tools may include facilitation of private-public dialogue, building the capacity of private sector representatives, and contributing to local discussions on policy and regulatory reforms (European Commission, 2019^[74]). Such activities can be scaled up by improving coordination and leveraging experience among blended finance actors (DFI Joint Report, 2018^[76]).

Conclusion

73. This Detailed Background Guidance lays out guidance for DAC Blended Finance Actors for OECD Blended Finance Principle 3 based on emerging good practice from a review of selected case studies. Principle 3 pertains to tailoring blended finance solutions to local contexts and tackle issues around a) supporting local development priorities, b) ensuring consistency of blended finance with the aim of local financial market development and c) using blended finance alongside efforts to promote a sound enabling environment.

74. This paper aimed to demonstrate the benefit of implementing differentiated approaches for future blended finance transactions in order to maximise their impact. It attempted to emphasise the need for taking into account national development plans which has recently been gaining importance in response to the 2030 Agenda. As an example, the *Integrated national financing frameworks* tool has been developed by the UN Task Force in order to support financing national priorities, and blended finance transactions could be conceived in its context (UN Task Force for Financing for Development, 2019^[77]). The paper also sought to reflect on the importance of ensuring appropriate stakeholder consultation, particularly for large infrastructure projects. The paper also focused on triggering a conversation on the need for blended

finance to shift focus towards creating more systemic transformational changes by creating new markets. In particular, it highlights the benefit of mobilising local investors such as sovereign wealth funds and local pension funds to provide local currency finance to projects that generate revenues in local currency, thereby eliminating foreign exchange risk, and providing long-term finance. Finally, the paper also recognises some of the critical challenges of blended finance, including the importance for local governments to fostering a conducive environment by implementing structural reforms in order to catalyse further investment locally.

75. Overall, the OECD DAC Blended Finance Principles result from a truly collaborative effort by the wide range of stakeholders active in the blended finance landscape. Public consultation have been undertaken to allow interested stakeholders to provide feedback and ensure that all voices are heard and experiences are taken into account. As the principles are being widely discussed, the OECD aims to ensure that the guidance provided are being adhered to over the coming years. To support this objective, each detailed background note, including on Principle 3, provides a checklist to ensure effective implementation (see Figure 4 below).

Figure 4. Checklist to implement Principle 3

3.A Does the project support local development initiatives?

- ✓ Does the project include an **effective stakeholder consultation** process throughout the investment cycle?
- ✓ Is the project developed in line with **national development strategies** and including **national actors** at all stages of the project, as **co-owners**?
- ✓ Are **additionality assessments** conducted based on **local considerations**, including a comprehensive understanding of local market structure, political environment and sector characteristics to help to identify local market failures?
- ✓ Is the **organizational setting** suitable to ensure regular communication and good **oversight** of the project on the ground?
- ✓ Is the project benefiting from **local monitoring** thanks to **effective local partnerships**? Are local partnerships helping to originate **new relevant deals** in line with local priorities?

3.B Does the project support local market development?

- ✓ Does the project contribute to increase **capacity of local financial institutions**?
- ✓ Does the project seek to **involve local investors**? Does it actively seek to provide opportunities for crowding in **domestic finance** in strategic sectors aligned with national development plans?
- ✓ Does the project promote **local currency financing** as a key factor contributing to local financial market development?

3.C Does the project support promotion of sound enabling environment?

- ✓ Is the project designed to offer a **demonstration effect** and more broadly contribute to attract further investment?
- ✓ How is the project contributing more broadly to a **favorable investment climate** that is essential in attracting and retaining foreign and domestic investments?

Source: Authors

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