Blended finance

A true catalyst for change?

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Knowledge update

Many development practitioners consider blended concessional finance (BCF)[1] essential to closing the finance gap and achieving the Sustainable Development Goals. Increasing volumes of blended finance and accompanying instrument innovation from development finance institutions (DFIs) reflect the theoretical promise of the blended finance approach. Yet, numerous questions about its actual effectiveness remain. This update, part of the Impact Horizon series, summarises the current state of the emerging literature on BCF and takes stock of what we know to date and what we need to study further about BCF's catalytic impact for client countries.

[1] This note uses the terms blended concessional finance and blended finance interchangeably.

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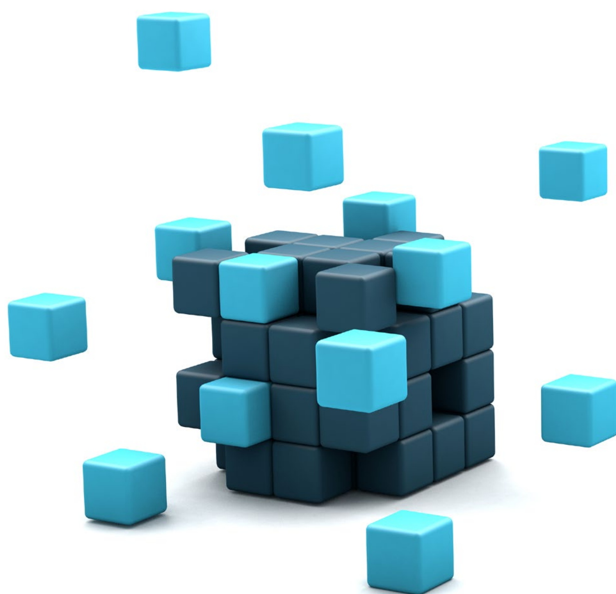
1. Preliminaries

It is important to highlight that the BCF literature has not yet converged on robust empirical findings. Among other things, this is because (i) BCF instruments are relatively new and rather diverse, (ii) BCF data are often not available to public researchers and may not be comparable between institutions, for instance, because of different approaches to defining the boundaries of blended finance, to calculating grant equivalents (or a lack thereof) and to measuring mobilisation, and (iii) there are fundamental methodological challenges involved in attributing positive development impact to the use of concessional elements, such as identifying appropriate counterfactuals or empirically falsifiable hypotheses. Consequently, most publications on blended finance are in the grey literature, making a structured literature review on the topic elusive. This introduction to the literature on BCF, therefore, may only portray a selective view of relevant publications and is by no means exhaustive.



2. The economic rationale for blended finance

The most coherent part of the BCF literature discusses the theoretical reasoning for using blended finance with respect to the welfare effects it induces and the opportunity cost of subsidisation. The latest contribution to this strand is a recent working paper exploring the catalytic impact of blended finance.[2] This study provides a concise history of the theoretical arguments in favour of blending and presents the latest thinking in terms of prompting knowledge spillovers, improving production networks and mobilising institutional investors. Notable earlier contributions on theoretical foundations include work by the European Bank for Reconstruction and Development (EBRD),[3] which provides guidance on economic analysis for the appropriate use of subsidies, with a special focus on technical cooperation. Similarly, the International Finance Corporation (IFC)[4] has published guidance on how to better unpack the composite rationale for blending in terms of concessionality, additionality and impact, with reference to fundamental economic concepts such as efficiency and equity distortions.

In the bigger picture, a discussion about the use case for BCF naturally links to seminal work on why the private sector should be subsidised at all,[5,6] and must be embedded in a strategic view of the mandate for DFIs,[7] as well as the question of how to navigate the trade-offs between risk, return and impact.[8] The fundamental premise of impact investing in this regard is that there is no such trade-off or – in a weaker form – that the current perception of the trade-off involved is biased and could be improved. Putting the effectiveness of blended finance instruments under empirical scrutiny, therefore, also informs the debate on the fundamental assumptions underpinning the strategic approach of DFIs.

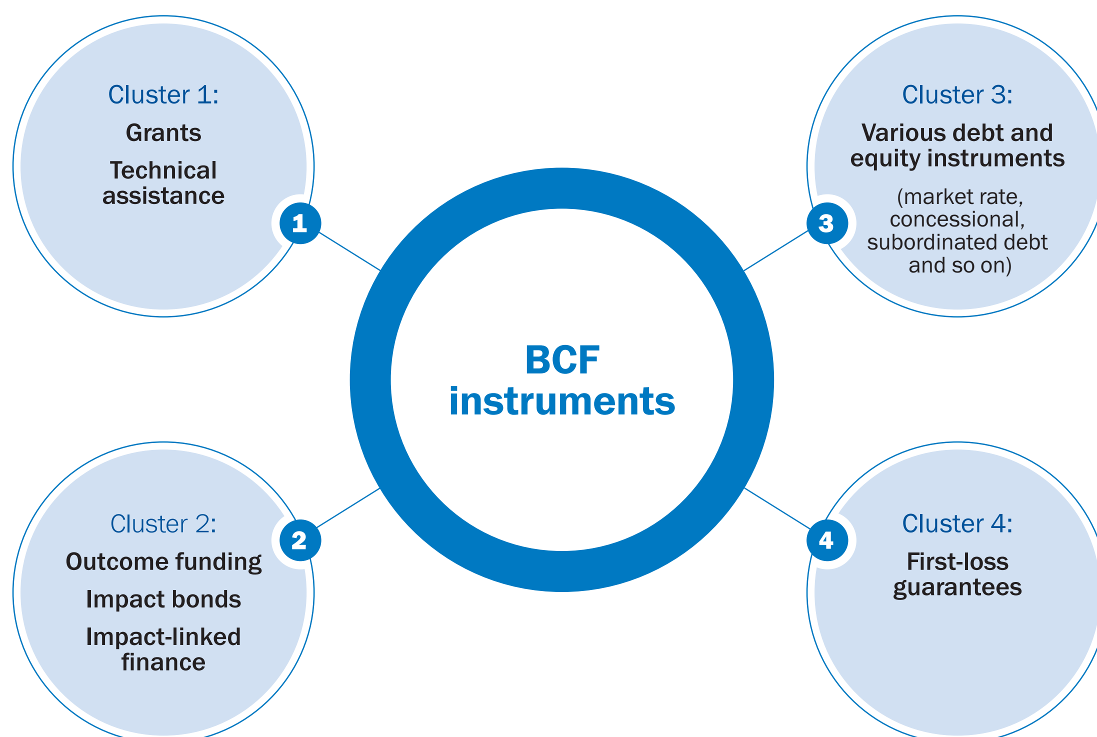
[2] See Pegon (2022).
[3] See Buiter and Schankerman (2002).
[4] See Mutambatsere and Schellekens (2020).
[5] See Kenny (2019).
[6] See Carter (2015).
[7] See Carter (2021).
[8] See Carter (2022).

3. The case for using various blending instruments

A second key contribution of the literature is a better understanding of when to use which type of BCF instrument. Here, the Initiative for Blended Finance at the University of Zurich has published a report[9] that adds value beyond a basic review of the literature by interviewing a representative group of practitioners. Doing so allows the authors to categorise BCF instruments into four clusters and discuss their respective use case. For an overview of the characteristics of these clusters, their recommended use as well as strengths and weaknesses, please see the Appendix.

The identification of clusters enables the authors to link them with relevant differentiators for when to use the set of instruments. These include, among other things, the purpose of the transaction in terms of its primary motivation and the impact problem to be addressed, as well as the investee context in terms of target market maturity, growth trajectory and intervention maturity. Lastly, two recent publications by the Organisation for Economic Co-operation and Development (OECD) provide in-depth discussions of the mechanisms underpinning the rationale for the fourth cluster. The first report[10] argues that guarantees have proven to be the most effective instrument for mobilising private finance, as they are uniquely suited to mitigate commercial, credit and political risks. Guarantees can bring financial additionality by changing the risk-return profile of investments while alleviating credit restrictions for underserved borrowers. At the same time, guarantees increase the complexity of transactions, require specialised staff skills and are restricted by accounting rules that require DFIs to take the full potential loss onto their balance sheets. The second OECD report[11] discusses risk transfer mechanisms (RTMs) in the context of blended finance more generally. The concept of RTMs includes guarantees, but also securitisation, co-lending/syndication and risk-sharing facilities. The authors argue that DFIs are well positioned to use RTMs to release credit risk from their own balance sheets to finance more projects and to better leverage the large footprint that commercial financial institutions have on the ground by increasing willingness to absorb parts of their credit risk.

Figure 1: Initiative for Blended Finance categorisation of BCF instruments



Source: Kwon et al. (2022).

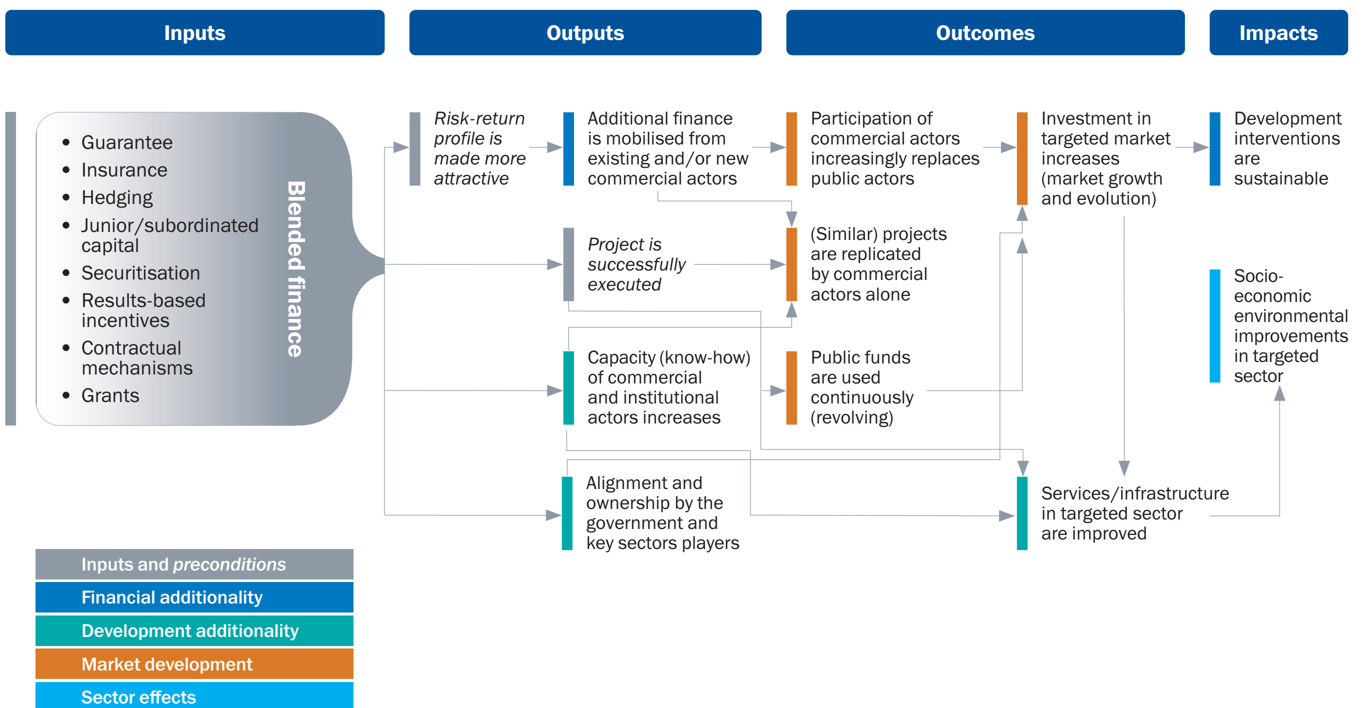
[9] See Kwon et al. (2022).
[10] See Garbacz, Vilalta and Moller (2021).
[11] See OECD (2021a).

4. Challenges to evaluating the impact of blended finance

Building on this outline of the economic rationale for blended finance and its applications, the following section reviews how these theoretically sound BCF instruments perform in practice. Before discussing the available evidence, it is necessary to understand the key challenges to clearly identifying the effects of blended finance. A helpful tool for conceptualising the underlying questions is a stylised theory of change for BCF interventions, as shown in Figure 2.

The main challenge in evaluating BCF projects is the inherent difficulty in randomly assigning elements of blended finance to a specific project. This arises for several reasons, including fuzzy criteria with respect to the eligibility for concessionality and the tautological dimension of defining BCF as only applicable when it is effective. Furthermore, there are ethical concerns about wasting public resources by knowingly supporting the "wrong" projects or withdrawing resources from the "right" projects. The absence of an established approach to identifying appropriate counterfactuals limits the ability to undertake robust quantitative causal inference. Even finding relevant comparators for investigating effects descriptively is challenging for BCF projects in light of their diverse instruments, geographies and thematic focuses. In addition to setting up a sound methodological approach, the interpretation of findings involves the typical caveats of applied research. For instance, it is difficult to ascertain whether individual negative findings as to the effectiveness of BCF instruments falsify the theoretical arguments in favour of blending or whether they suggest the incorrect implementation of the instrument. Likewise, some blended finance interventions may need critical mass to bring about the intended effect, or it may be too early for such an effect to materialise. Lastly, the usual trade-off between the internal and external validity of the research method applies. A couple of recent OECD working papers explore in depth such methodological challenges for evaluation,[12] summarising suitable approaches and methods for evaluation.[13] The latter discusses such evaluation methods across the large matrix of instruments available, front-end versus downstream results, and

Figure 2: Theory of change for blended finance interventions



Source: Sánchez Torrente et al. (2020).

[12] See Andersen et al. (2019).
[13] See Habbel et al. (2021).

different dimensions of intended impact. The proposed quantitative and qualitative approaches include theory-based methods, counterfactual methods, cost-benefit analysis and social return on investment. An indicative overview table on these approaches can be found in the Appendix to this note. While the OECD paper gives important guidance on evaluating the effectiveness of BCF-supported projects, it falls short of answering the key underlying causal question about attributing the identified effect to the use of concessional elements.

5. The current state of evidence on the effectiveness of blended finance

The most systematic overview of current knowledge on blended finance comes from an evidence gap map compiled by the German Institute for Development Evaluation.[14] Four years after its publication, only little additional evidence on blended finance instruments has become available. Thus, this extensive literature search from 2020 remains broadly representative today, but only identifies 33 papers that met the inclusion criteria at the time, most of them programme evaluation reports. The available publications are not sufficient to form a consensus view on the effectiveness of blended finance. Due to the methodological challenges described earlier, most of the identified studies limit their scope to investigating whether BCF interventions can be linked to positive effects rather than answering the question of whether such effects can be causally attributed to the concessional element of the intervention.

Box 1: **Evidence on results-based finance**

Given that literature on the effectiveness of RBF constitutes the largest subset of evidence on blended finance instruments, this box discusses the findings of relevant studies. The Blended Finance Task Force[15] defines RBF as “instruments that provide incentives and disincentives to achieve desired outcomes or results (tie at least a portion of payments to achievement), including social impact bonds and performance-based contracts. This type of financing is aimed at rewarding innovation and successful implementation of a project.”

Even though studies on RBF present the largest subset of evidence on the effectiveness of BCF, it is not obvious how to synthesise their findings. This is because it is not clear whether RBF approaches can be expected to work equally well in any sector or whether more rigorous types of evidence should be given more weight when aggregating findings. The current state of the literature certainly lacks a sufficient number of studies to estimate quantitative meta-effect sizes. Considering effects more qualitatively, a systematic review[16] of the evidence with regard to RBF in the health sector (the largest evidence base on RBF in terms of a specific sector) concludes that there are many positive effects, but that the results are simultaneously mixed, creating many different grey areas, as some interventions have not produced the expected results or have generated negative effects. A particularly positive example of evaluation[17] of a health intervention by the Inter-American Development Bank in Ecuador finds that the results-based conditionality roughly doubled aid effectiveness. In contrast, performance-based financing (PBF) programmes, a specific subset of RBF initiatives, are distinguished by a focus on monetary incentives to healthcare providers to achieve agreed performance measures under certain conditions. Here a distinctly negative review[18] of the literature questions the view that PBF in the health sector is an effective, efficient and equitable approach to improving the performance of health systems in low-income and middle-income countries. In summary, these two examples illustrate the divergent views in the literature which, on balance across sectors, are not sufficient to disprove the effectiveness of blended finance, but strongly underpin the need for a cautious operational approach to implementing BCF instruments.

[14] See Sánchez Torrente et al. (2020).
[15] Blended Finance Taskforce (2018), “Better finance, better world”, Consultation Paper
[16] See Mathonnat and Pélissier (2017).
[17] See Bernal, Celhay and Martinez (2018).
[18] See Paul et al. (2018).

Interestingly, the authors note that the distribution of blended finance investments across instruments does not correspond to the evidence found. According to market data from Convergence, concessional capital (here: junior/subordinated capital) was used in 43 per cent of blended finance interventions in 2020, followed by technical assistance funds (25 per cent), guarantees/risk insurance (22 per cent), grants (9 per cent) and results-based financing (1 per cent). The distribution of investments, therefore, runs almost contrary to the distribution of the available evidence: results-based finance (RBF) is studied by far the most, but is used in only 1 per cent of interventions, while concessional finance is used most frequently, but backed up by very little evidence.

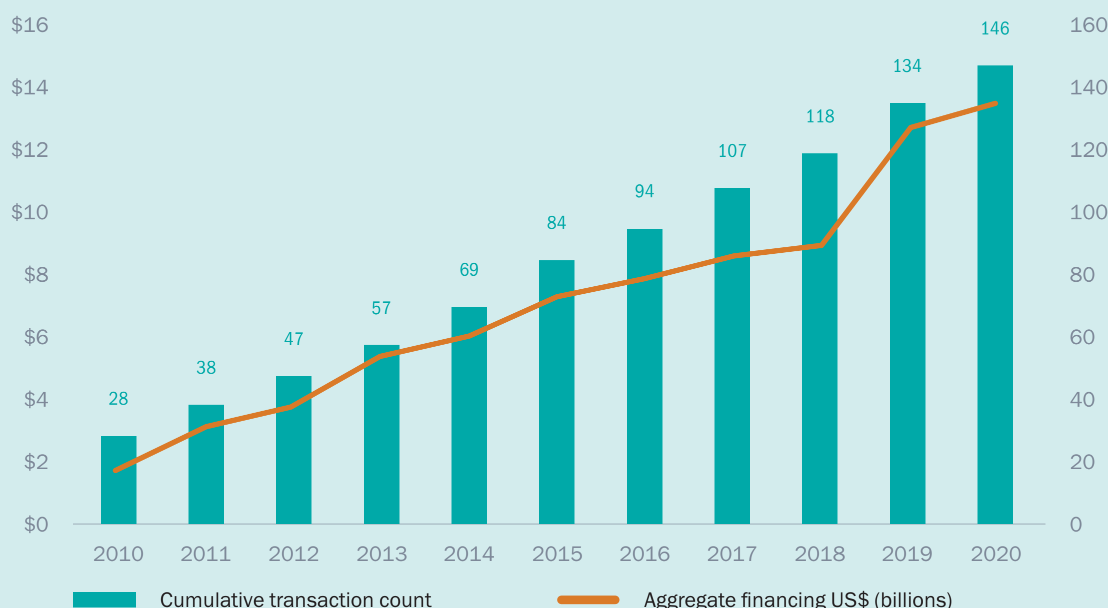
Other publications from institutions that use BCF instruments complement the findings from the more academic literature. A review by the European Union[19] of how effective blended finance is in delivering development results discusses many concerns similar to those captured in this note. The authors conclude that the current state of evidence casts doubt on whether the sizeable rollout of blended finance is currently justified. In contrast, a cluster evaluation[20] of project performance assessment reports from the IFC's blended finance portfolio mostly finds encouraging results and is in line with the positive outlook of a series of EM Compass Notes[21] on the IFC's approach to BCF and the lessons learned. Despite its global mandate, however, these insights mainly stem from a strong regional focus of the IFC's blended finance operations in African countries.

Box 2: Thematic deep-dive into blended finance in agribusiness

As an outlook beyond the main literature, this box presents insights from a selection of blended finance publications with a focus on agribusiness. Doing so exemplifies the kind of thematic insights into the constraints and opportunities of BCF that are available in the literature, but to varying degrees depending into the topic. Data briefs on agriculture and food systems by Convergence[22] suggest that the cumulative number of deals in this thematic area grew steadily between 2010 and 2020. The number of transactions per year, however, remained constant at about 10. A working paper by the Smallholder and Agri-SME Finance and Investment Network (SAFIN)[23] puts these numbers into perspective, at about 10 percent of the overall number of recorded blended finance deals, and into the context of a decline in relative spending on agriculture in terms of government expenditure and development assistance flows.

[19] See Van Waeyenberge et al. (2020).
[20] See World Bank (2020).
[21] See International Finance Corporation (2021).
[22] See https://www.convergence.finance/resource for convergence data briefs (and other relevant BCF publications)
[23] See Havemann (2019).

Figure 3: Market size and growth of blended finance for agriculture



Source: Apampa et al. (2021)

In light of the disproportionate relevance of the agricultural sector to many developing economies, as well as its key function in tackling climate change, it seems surprising that investors have not used BCF tools in this sector more widely. Havemann et al. (2022)[24] suggest that the challenges for blended finance in agribusiness align with many of the risks for investments in emerging and developing markets, whereas the fragmented and informal structure of agricultural markets, as well as their unique exposure to weather shocks, pose an additional challenge. The authors also highlight the context-specific conditions under which different financing mechanisms can contribute to addressing the identified barriers.

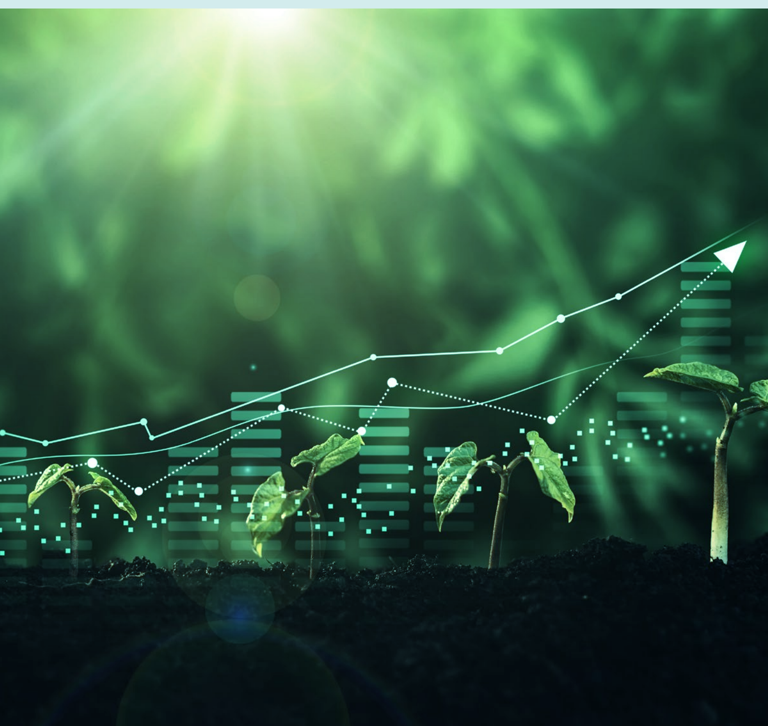
Figure 4: Risk and non-risk challenges impeding agricultural financing

Project-specific risk	Project-specific non-risk challenges	Country risk issues
Business risks from the underlying business model, including new untested business models, or transition risks related to sustainability or failure to integrate environmental, social and governance (ESG) considerations	**Informality of company:** Large majority of companies operate informally, not reporting 100 per cent of revenues	**Macroeconomic risk:** Global emerging markets risk, national fiscal, inflation, and so on
Financial risk: Ability and willingness of borrower to repay obligations	**Lack of conventional security for lender:** Lenders lend against security, with preferred security being clear-title land and buildings – often not available for agriculture	**International, national and local political agriculture risks:** Agricultural trade, sanctions
Agronomy risk: Reduced or unpredictable harvest (quality/quantity) due to agronomic practices, that is, production and technical risks	**Small borrowing amounts:** Large majority of required borrowing amounts are likely less than US$ 100,000 (possibly less than US$ 20,000)	**Currency risk:** Decline in the value of an investment due to adverse currency movements
Natural hazards: Unpredictable weather events, earthquakes, landslides	**Lack of domestic financial resources for agriculture:** Domestic credit is under-supplied, and then only small amounts allocated to agriculture	**Political risk:** Transfer, conversion, political insurrection, civil disturbance
Commodity price risk: Adverse movements of commodity prices		
Interest rate risk: Decrease in ability of company to make debt service payments due to changes in global and local interest rates		

Source: Apampa et al. (2021)

[24] See Havemann, Negra and Werneck (2022).

Reassuringly, a recent OECD report[25] on making blended finance work for agri-small and medium-sized enterprises (agri-SMEs) showcases encouraging lessons learned from selected case studies. The authors suggest that BCF can, indeed, facilitate the mobilisation of commercial finance, improve financial inclusion and stimulate the creation of new markets and value chains around agri-SMEs. This message aligns with that of Apampa et al. (2021), who outline how to scale up critical finance for sustainable food systems through blended finance. Their vision for enabling such transformation encompasses three stages, in line with the economic rationale for blended finance, where BCF instruments: (i) increase finance and investments for bankable projects and improve near bankable projects to become bankable; (ii) the financed entities that build up a successful and robust track record will then have a demonstration effect. In turn, the perceived risk by private investors of the whole sustainable food systems will decrease and, as a result, overall investments in this segment will increase, attracting larger pools of capital and institutional investors; and (iii) over time, the importance of commercial finance will increase as the role of concessional finance decreases. In conclusion, the authors propose a concrete action plan that calls for a concerted effort by development actors to achieve a critical mass of BCF instruments and truly leverage their potential to sustainably transform the agricultural sector.



6. Conclusion

Taking stock of the different strands of the literature on blended finance shows that the discussion on its theoretical foundations is the most mature part of the literature. Many empirical publications, in contrast, emphasise the challenges of evaluating the effectiveness of BCF instruments in practice. A large gap of evidence, especially with respect to the causal mechanism of blended finance interventions, exists across sectors and geographies and reflects these difficulties. This shortcoming severely limits practitioners' ability to make evidence-based decisions on the use of blended finance. Therefore, there is an urgent need to operationalise the well-developed theoretical arguments in favour of blended finance through rigorous impact analytics. Such a push for better institutional learning on blended finance should also consider the limitations on robust knowledge that can be generated due to the nature of BCF instruments.

DFIs have a special responsibility to contribute to the much-needed push for better evaluation of blended finance approaches due to their unique access to a large amount of confidential and consistent data on the use of blended finance in their portfolios. Particularly as the jury on the effectiveness of blending is still out, practitioners must mitigate the associated risks of exploring innovative finance by choosing instruments carefully and aligning them with their economic rationale. To this end, the literature cited in this note provides initial guidance on how to link different types of instrument to their use case and how to interpret their validity against the backdrop of the overall body of evidence. Further deep-dive assessments are required at the country or sectoral level to understand the BCF catalytic impact in transition countries.

[25] See OECD (2021b).

7. Appendix

Figure 5: Overview of different BCF instrument clusters

Cluster	Characteristics	Uses	Strengths and weaknesses
Grants/technical assistance	• Same source of capital, development and philanthropic actors • No financial return expectation	• Supporting instruments, intended to help achieve impact goals • Important when entering new markets	• Requires less financial knowledge • Needs to strike a balance between accountability and flexibility • Historically criticised for lack of effectiveness
Outcome funding	• Links impact creation directly to financial rewards • Allows stakeholders with different interests to be aligned • Addresses an impact-specific need with measurable targets • Establishes new market rules and does not accept market rules	• Directly creates impact and strengthens the relationship between impact and the financial payment • Demonstrates the effects of the instrument • Can be combined with grants and technical assistance	• Creates knowledge sharing of an impact sector or region among stakeholders • Clear impact measurement and reporting • Tends to be smaller in size and higher in complexity – needs to answer the question of scalability and replicability • Requires appropriate and material financial reward to be effective • Can invite public scrutiny when misunderstood as subsidising the private sector
Market-rate debt and equity, subordinated debt, concessional debt and equity	• Clear distinction between debt and equity capital • Equity takes a higher risk, higher return and ownership; debt takes a lower risk, lower return and no ownership • Subordination is about risk – taking a junior position and a lower priority for repayment • Concessionality is about lower return and/or longer time horizons • Capital providers can be both subordinate and concessional, but are not necessarily so	• Varying motivations depending on debt vs. equity, market-rate vs. subordinate vs. concessional capital • Chosen for being an established instrument • Important to align risk and return expectations by using clearer terminology	• Established instruments easily understood by the private sector and other stakeholders • Requires financial knowledge • Impact not explicitly built into the structure • Financial and impact additionality is contested
First-loss and guarantee	• Chosen for de-risking a transaction and crowding in capital • First-loss capital is distinctively different from subordinated capital in terms of return expectation	• De-risk the transaction and crowd in futher capital • More suitable for later-stage investments	• Familiar to the financial market and larger institutional investors • Requires a large asset size and financial knowledge • Requires striking a balance between achieving impact goals and crowding in

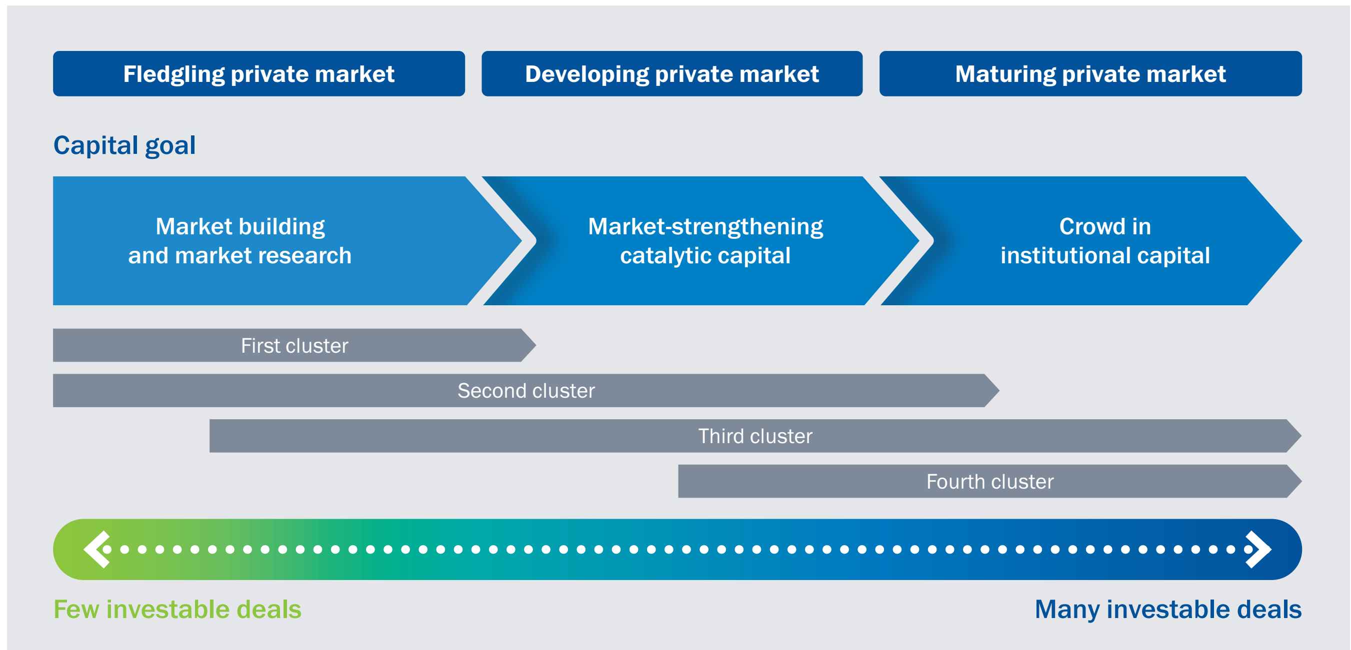
Source: Kwon et al. (2022).

Figure 6: Methods and indicators for evaluating BFC instruments and mechanisms

Evaluation issue	Indicators	Quantitative methods	Qualitative methods
Underlying mechanisms and causal links			Theory-based methods (contribution analysis, realist evaluation, process tracing, qualitative comparative analysis)
Front-end results			
Financial sustainability and development orientation	• Profit/yield; interest income • Costs (such as operating costs) • Repayment/default rates; non-performing loans • Internal rate of return/net present value • Debt-to-equity ratio • Dividends; redemption conditions • Credit history • Revolving use of funds	Cost-benefit analysis Social return on investment Value-for-money analysis	**Document analysis of:** • Development objectives and goals • Alignment with the SDGs and other official development strategies • Flexibility of the instrument/ mechanism • Management and governance
Mobilisation	• Leverage ratios: - in absolute terms - as a ratio to official capital invested - for local and foreign capital - for class A and B shares • Cost of the subsidy • Pricing of the financial return offered to investors		
Factors that drive mobilisation			Comparative case studies Qualitative comparative analysis
Additionality	**Financial additionality:** • Additional capital raised since financing • Capital amount offered vs. available in the market • Local currency financing • Loan tenors/grace periods **Development additionality:** • ESG performance improvements • Financing terms (such as interest rate, maturity)	Counterfactual approaches (quasi-experimental or experimental)	Theory-based methods Document analysis of market information
Concessionality	• Size of the grant element of the loan		
Exits	• Internal rate of return for investors • Environmental and social mission of the investment • Social and development agenda of the new owner	Cost-benefit analysis Counterfactual approaches	Theory-based methods
Downstream results		Counterfactual approaches	Theory-based methods

Source: Kwon et al. (2022).

Figure 7: Use case of BCF instruments by market maturity



Source: Kwon et al. (2022).

Figure 8: Methods and indicators for evaluating BFC instruments and mechanisms

Maturity of project/intervention

IDEATION

PILOT

DEMONSTRATE

SCALE

Role of blended finance

Establish business case for new products and business models

Provide capital for pioneering project in under-invested market

Build track record of investment to demonstrate potential for scale

Crowd in new investment to help build scale and create a more efficient market

Mostly concessional

Type of blended financial capital

Mostly commercial

Source: Habbel et al. (2021).

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