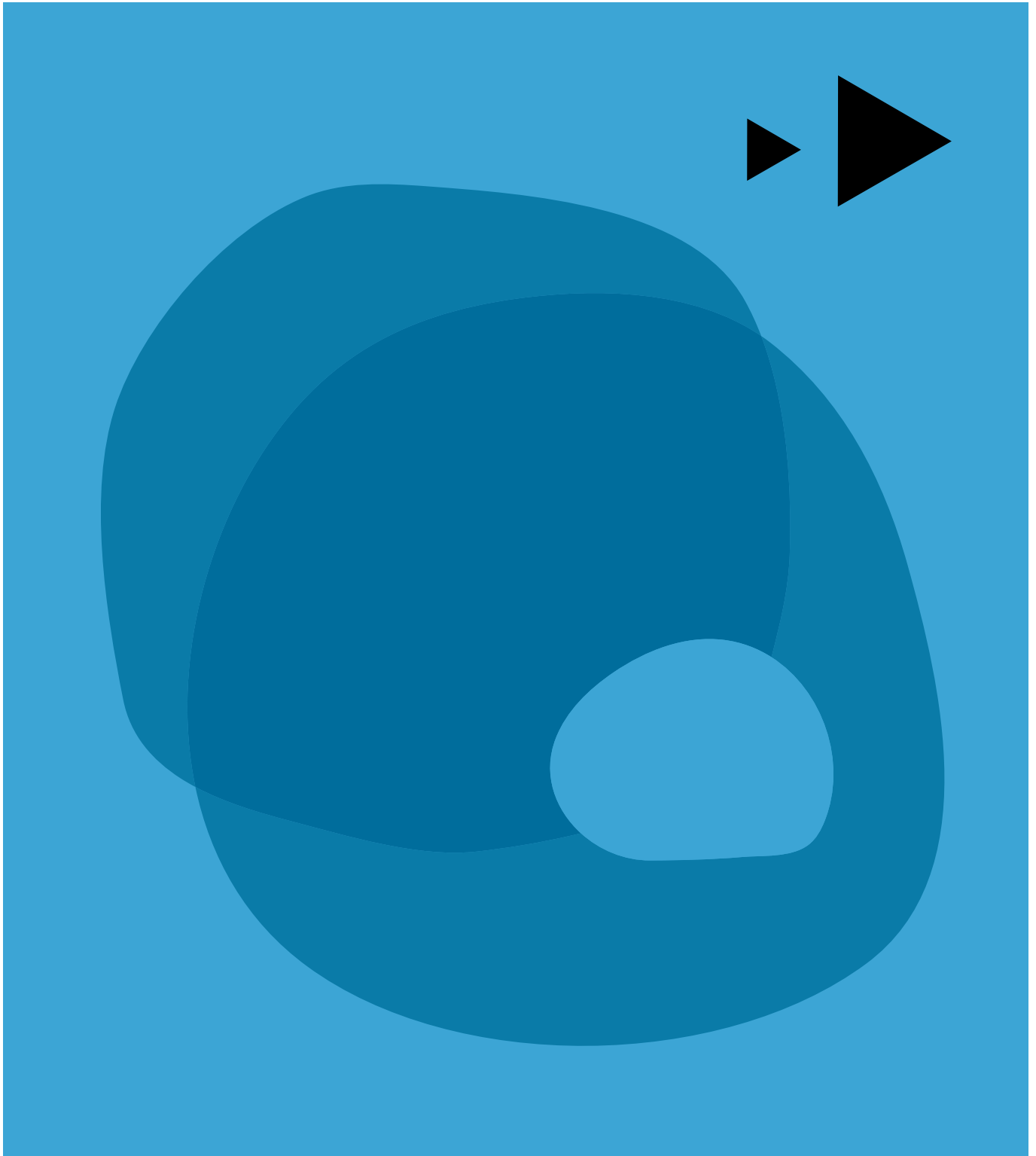


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# How Can Development Cooperation Mobilise Private Investment in Developing Countries to Achieve the Sustainable Development Goals?



# How Can Development Cooperation Mobilise Private Investment in Developing Countries to Achieve the Sustainable Development Goals?

Report from the Rethinking Development project, Norad

Paul Wade

January 2022

*This is the fourth in a series of reports under the Rethinking Development project. The report is based on two reports commissioned by Norad in 2021, a research report from Convergence, an international resource centre for blended finance, and a consultancy report from Partners for Development. It is also based on interviews with Norwegian and international resource persons and on international literature in the field. The conclusions are those of the author.*

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Dear Reader

The world is facing enormous challenges, and Norwegian development cooperation has an ambitious mandate. Our aim is to help ensure that the UN Sustainable Development Goals (SDGs) are reached by 2030, and we will do this as effectively as possible with the limited funds at our disposal. Norad's development cooperation has undergone several changes in recent years. We have adopted a new strategy and, in line with this, our organisation is now structured around the SDGs. We have also been given more responsibility, and now manage about half of the long-term development funding. Following the reform of Norwegian development cooperation, the Ministry of Foreign Affairs now plays a more overarching role than before, which means that the primary responsibility for finding effective solutions for the use of development funds rests with Norad. We therefore need to work actively and continuously to gather knowledge and discuss the important choices and dilemmas pertaining to development cooperation. This requires both a retrospective and forward-looking approach: we must examine and understand what works best so that we can replicate it in other contexts. However, we also need to ask more fundamental questions about the framework conditions for development cooperation and consider what trends will be important in the years ahead.

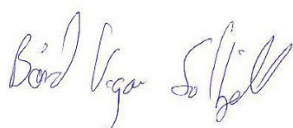
It is against this backdrop that I initiated the Rethinking Development project in the autumn of 2020. So far, we have taken an in-depth look at four thematic areas, the importance of which we believe will increase as we head towards 2030. The project has examined the fight to combat poverty while also providing global public goods, how development assistance can help reduce global warming, how we can mobilise investments from the private sector, and what is needed for successful institutional cooperation.

The four thematic areas are very different, but they are similar in the sense that they all look at development cooperation as part of a larger picture, and aim to address dilemmas that are creating increasingly precarious situations. This report looks at how development aid can best be used to achieve large-scale mobilisation of investments from the private sector for developing countries to achieve the SDGs through, for example, job creation, poverty reduction, climate change mitigation and adaptation, and food security.

This report proposes the use of blended finance in development cooperation. This means combining the use of government development funds and private commercial capital to enable such investment. Norway can play an important part in the mobilisation of investments from the private sector for developing countries to reduce their investment gap. To achieve this, it is essential to build a unified and coordinated partnership between Norwegian players, with a particular focus on a close and good relationship between Norad and Norfund.

In this series of four reports, we have received input from the private sector, civil society and experts in Norad, the Ministry of Foreign Affairs and other government ministries, as well as national and international specialist groups. We would now like to invite you to read the report and participate in the discussion. If we are to meet the daunting task of achieving the SDGs, we need to develop new ideas and solutions. These ideas could also stem from new sources that are not already familiar with the work of the development cooperation. Perhaps someone reading this report has a solution that has not been thought of. As we head towards 2030, it is essential that development cooperation efforts encompass other funding sources and actors as opposed to just those internally in Norad.

We hope you enjoy reading this report.



Bård Vegar Solhjell

## Summary

There are trillions of dollars worth of profitable sustainable investment opportunities in developing countries, but these are largely untapped. Forecasts show that opportunities for investments of at least USD 1.3 trillion per year until 2030 will be in areas where private sector investment is a natural fit. This constitutes about only **0.5 per cent** of all of the capital available in the international capital markets. It is nonetheless a vast amount compared with the amount of private capital that has reached low- and middle-income countries in recent years. In other words, if the world is to succeed in achieving the SDGs, it must identify new ways of attracting private capital to low- and middle-income countries on a large scale.

The purpose of this report is to provide a foundation for discussion and analysis of how Norwegian development cooperation, also known as Official Development Assistance (ODA), can help raise more private capital for the work of delivering on the SDGs. The report presents different models for the interplay of development aid and private capital and assesses which approaches are suitable for large-scale mobilisation of private capital for developing countries. Finally, the report recommends concrete measures and programmes that can accelerate the pace of investment.

The report shows that a combination of blended finance instruments, sewn together cohesively and in partnership with other key players, such as development finance institutions (DFIs) like Norfund, can be very effective, both in terms of mobilising international capital for developing countries and mobilising more domestic capital for local businesses.

The United National Conference on Trade and Development (UNCTAD) has calculated that if the world is to achieve the SDGs, there is an uncovered financing gap of about USD 2.5 trillion annually in investments for low- and middle-income countries. New estimates show that this gap increased by another USD 700 billion per year during the COVID-19 pandemic. Global development funds amount to USD 161 billion, which is far from sufficient.

Even though the COVID-19 pandemic led to a temporary decline in investment in developing countries, we are seeing some trends that provide grounds for optimism in the long term. The international financial markets are experiencing major change, which may have a favourable effect on developing countries. In recent years, investors have shown a rapidly growing appetite for investment in companies that make a positive contribution to sustainability.

Sustainable investment strategies have resulted in investment of hundreds of billions of USD per year over a short period of time. There is a large number of potentially profitable investment projects in developing countries which fit these strategies. However, a number of bottlenecks are preventing the flow of investment to developing countries.

This is where good development assistance policy has a role to play: international private capital can be attracted if the correct measures are implemented, and good project proposals are drafted.

**This report reviews a number of the reasons why it has been so difficult to attract sufficient private capital to low and middle-income countries, and makes recommendations on how to mobilise more private capital.**

The report addresses two key limitations on private investment in developing countries:

1. developing countries' access to international capital;
2. private companies' access to capital from the domestic financial sector within developing countries.

In relation to Item 1), the main challenge regarding investment in developing countries is that the risk is perceived as being too great, compared with the expected return. This can be due to weaknesses in the framework conditions for the business sector or factors related to investors' lack of knowledge about the markets. Investments that would be profitable if the financing costs were 'normal' thus are not profitable enough when weighed against the perceived risk.

This challenge needs to be addressed to increase private investment flows to developing countries. Developing countries must take action to reduce perceived risk, among other things, by improving the framework conditions for the business sector with the help of development cooperation, if relevant. These are indirect measures, and will take time. This is why **direct measures** in the form of public policy instruments are important in order to offer funding on better terms than those that are available through ordinary market mechanisms. This is called *concessional finance*. The combination of concessional finance (e.g. development funds) and commercial finance is called **blended finance**. This type of financing can improve the relationship between perceived risk and return, it has a rapid effect and it can trigger private investors' investment decisions in developing countries. One example of blended finance is the use of risk mitigation instruments like guarantees and first loss facilities, both of which can reduce the perceived risk.

In relation to Item 2), there are also many sustainability projects in developing countries that are commercially viable but which do not receive financing due to a lack of available capital in the local financial sector. Lack of capital is a serious obstacle to economic development and job creation in low-income countries. Blended finance solutions improve access to capital that is available to banks or other domestic financial institutions. More investments can thus receive finance.

The two limitations outlined are the result of, among other things, weaknesses in the framework conditions for efforts and investments in the private sector – a lack of or inadequate regulation, limited enforcement of legislation, a poor physical and digital infrastructure, a lack of 'ecosystems' of necessary services, a lack of predictable local and regional demand, etc. These challenges need to be addressed – through direct investment and, especially, capacity building, supporting political reform and developing strong institutions. These are priority areas in Norwegian ODA, but are not the focus of this report, which examines the steps we can take in the short-term and in partnership with other financial players in more complementary roles to help the private sector manage these risks and immediately begin the work of building trust and functioning markets in developing countries.

Partnerships with other financial players are necessary. In international development cooperation, different categories of financial players help mobilise private investment in developing countries. Aid agencies provide grant aid, e.g. grants in the form of concessional capital. DFIs like Norfund offer non-concessional capital near market terms, expected capital preservation and a positive return that is close to the market rate. The different financial players can complement each other and put a package together that makes it possible to realise much of the investment with considerable contributions from private, commercial capital.

The report proposes several new instruments and identifies four main models for blended finance in which use of these instruments has major potential for mobilising large-scale private investment, specifically for low- and lower- middle-income countries. These models are often preferred by private investors, and they are fairly simple to execute.

The first three approaches combine commercial capital from private investors, capital near market terms from DFIs or multilateral development banks (MDBs), and funds from aid agencies. The capital is channelled into a fund with risk mitigation from the latter, as well as some from DFIs/MDBs. The fourth approach provides a guarantee that covers part of the private capital risk.

The blended finance models that are outlined in the report have been tested in other countries. They have resulted in over 100 blended finance transactions (each one worth over USD 50 million) during the past few years, where capital has been mobilised for low-income countries and lower-middle-income countries, including countries that receive Norwegian ODA. The transactions have mobilised about NOK 200 billion in total, NOK 50 billion of which was capital financed using development aid. The private investments have been directed to most of the SDGs and sectors, including sectors prioritised by Norwegian ODA. Complementary development assistance is often given to early-stage and project development, as well as technical assistance (TA) and capacity building both before, during and after investment.

The report shows that a combination of the instruments proposed, sewn together cohesively and in partnership with other key players, such as DFIs like Norfund, can be very effective. The main types of instruments or tools are:

- Risk mitigation
  - first loss facilities – grants for loss provision;
  - development guarantees;
  - currency (exchange rate) risk protection – support donor programmes that protect investors from currency risk using financial instruments.
- Instrument for financing local businesses in local currency – support donor programmes that help develop and issue bonds in local currency. This improves local investors' access to financing in the local currency.
- Project development and TA.

These instruments can be combined in programmes in partnership with other players which make complementary contributions. A key aspect of blended finance is to **build partnerships in order to exploit synergies** and have a greater impact. Development cooperation can use one or more of its instruments in combination with other partners, such as DFIs. The different parties can use complementary measures to achieve considerably more together than is possible separately.

The following example illustrates this: development funds, capital from DFIs (like Norfund or Swedfund) and institutional investors join forces in, for example, an investment fund that lends money to a very large number of businesses in developing countries. The development funds, which can take the form of a development guarantee or grant for a first loss facility, absorb some of the losses on loans and thus mitigate some of the risk related to the capital invested by the DFI and institutional investors. The DFI invests near market terms, and institutional investors invest on market terms. Institutional investors have some preferential rights to payment streams in relation to the DFI, which implicitly reduces the risk for institutional investors.

The risk mitigation in such an approach allows institutional investors to invest in accordance with their mandate. This is achieved by spreading risk through diversification of the portfolio between a wide range of underlying investment vehicles (loans) with different levels of risk, and by charging first losses on loans in the portfolio to the development cooperation capital, then the DFI, before charging any further losses to institutional investors. With an adapted structure and portfolio, the likelihood of expected losses will be reduced to a level that makes it attractive for the DFI and institutional investors to invest.

This is one of several examples – many of which are presented in this report – of how development cooperation can mobilise large amounts of private capital for developing countries. The report also proposes a role for Norfund. A dialogue with Norfund on coordination and cooperation will therefore be important. Norfund and Norad can create a win-win situation by coordinating their efforts, making it attractive for Norwegian and international institutional investors to contribute commercial capital to some of the blended finance transactions proposed. Extensive use of blended finance will allow the development cooperation to work with the business sector and, if used wisely, the aid will be able to mobilise more capital towards achieving the global SDGs.

## Scope of the report

This report discusses how development cooperation can minimise the investment gap in developing countries to enable them to achieve the SDGs, whilst also supporting improved framework conditions for the business sector in these countries. The main focus is on how to best deploy a given amount of development aid to mobilise as much private investment in developing countries as possible. While mobilising large amounts of private capital for developing countries is necessary to achieve the SDGs, it is not enough.

Investments must also be made in such a way that they are effective in terms of development, reduce poverty and/or help progress towards other SDGs. In other words, the same development and additionality requirements apply to use of development funds in blended finance as for all other development assistance. The recommendations in the report are contingent on the premise that the funds are spent on this basis, and are subject to sufficient safeguards to achieve this.

This field has already been covered extensively in the literature and in international policy work on development cooperation. The OECD DAC, the UNDP, international DFIs and MDBs have drafted and adopted principles and standards to ensure that development funds used in blended finance contribute to development.<sup>1</sup> This is a large field, and could have filled a separate report. We will therefore not discuss it in further detail here, but set the premises that recommended measures are implemented in accordance with these principles and standards.

In other words, this report focuses on which measures can mobilise private capital on a large scale for developing countries, primarily by attracting institutional investors like pension funds, insurance companies and international banks. Other than citing existing regulations, standards and principles, this report does not discuss the regulations and measures beyond the mobilisation of private capital to broaden the impact on development. Its focus is restricted to the necessary premise of catalysing increased private investment in developing countries using development funds in blended finance. The focus is on a more overarching thematic level, where a selection of generic structures are discussed. Any implementation or practical execution would require further examination of the generic structures adapted to the relevant context, and would include safeguards in accordance with the principles and standards for blended finance that have been established internationally in development cooperation.

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<sup>1</sup> Principles for blended finance from the OECD DAC and DFIs: [OECD-Blended-Finance-Principles.pdf](#); [DFI-Blended-Concessional-Finance-for-Private-Sector-Operations\\_Summary-R....pdf \(edfi.eu\)](#). The OECD DAC has also published guidance for blended finance transactions in accordance with the principles of the DAC: [https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC\(2020\)42/FINAL&docLanguage=En](https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC(2020)42/FINAL&docLanguage=En)); OECD-UNDP impact standards for financing sustainable development: <https://www.oecd-ilibrary.org/docserver/744f982e-en.pdf?expires=1640548779&id=id&accname=guest&checksum=83EAED634A5E1B3B7CADCC5EA9E8D71D>



## Chapter 1

# Developing countries' need for finance to achieve the SDGs

1. International development cooperation is intended to help developing countries achieve the SDGs. This requires major SDG-related investment in developing countries, which was acknowledged by the global community at the International Conference on Financing for Development in 2015 in Addis Ababa. In its World Investment Reports,<sup>2</sup> UNCTAD has calculated developing countries' need for SDG investment and the remaining financing gap.<sup>3</sup> In its 2014 analysis, UNCTAD calculated that developing countries' total annual investment need was about USD 3.9 trillion, two-thirds of which was for infrastructure. The total realised investment volume in developing countries was USD 1.4 trillion per year. This resulted in an annual investment gap of USD 2.5 trillion for the SDGs. Before the COVID-19 pandemic, there was already a sustained investment gap, and this has increased as a result of the pandemic.

2. Creating enough jobs for a fast-growing population of working age is also a structural challenge for developing countries. In 2018, the African Development Bank (AfDB) reported that 10–12 million new jobs need to be created every year in sub-Saharan Africa to employ young people entering the labour market. Among workers in the region, 90 per cent are in the private sector, primarily in the informal sector and small and medium-sized enterprises (SMEs). The public sector, whose finances are under great pressure, is unable to absorb the young people entering the workforce, so the growth in employment must come from the local business sector and, to a great extent, SMEs. Companies need financing if they are to grow and create new jobs. Access to credit for the private sector in developing countries is very limited, which is particularly problematic for SMEs and is an obstacle to faster economic growth.

3. In addition to greater access to international financing, developing countries also need better access to credit and other financing for the business sector from the country's financial sector domestically.<sup>4</sup> This is examined in Chapter 4.

4. Developing countries are unable to finance all of the investment necessary to achieve the SDGs, a situation that existed before the COVID-19 pandemic. They face two enormous challenges. On the one hand, the effects of the pandemic must be dealt with, and the 'Build Forward Better' approach must be secured during the next couple of years. Furthermore, steps must be taken to close the structural SDG investment gap through a considerable increase in investment until 2030. A large part of these two agendas overlap, and the discussion in this report is relevant to both of them.

5. In light of the effects of the pandemic and the decline in some capital flows to developing countries during the past couple of years, the OECD's estimate of the investment gap for developing countries has increased from USD 2.5 trillion to USD 3.2 trillion per year. This is the sum of the investment needed in every sector in developing countries (health, education, water supply, renewable energy, agriculture, fishing, transport, manufacturing, etc.), and covers all of the SDGs.

6. Financing to help close the investment gap can come from different sources. Developing countries can mobilise domestic resources through tax revenue and private savings, which are placed for investment via the domestic financial sector. Figure 1 provides an aggregate representation of the different sources that financed this investment volume in developing countries. In general, international financing comes from: (1) the public sector, in the form of development funds, loans and other public financing; (2) the private sector, in the form of foreign direct investment (FDI) in companies, portfolio investments (purchase of shares, bonds etc.) and private transfers (e.g. money sent by relatives working abroad).

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<sup>2</sup> UNCTAD: World Investment Report 2014 and later editions.

<sup>3</sup> Mainly covers available reports (OECD, UNCTAD, Convergence etc.) which are cited here, data until the end of 2019, i.e. before the COVID-19 pandemic. The financing gap for developing countries has subsequently widened.

<sup>4</sup> Important elements that are discussed later in the report are the lack of bankable projects and a lack of venture capital.

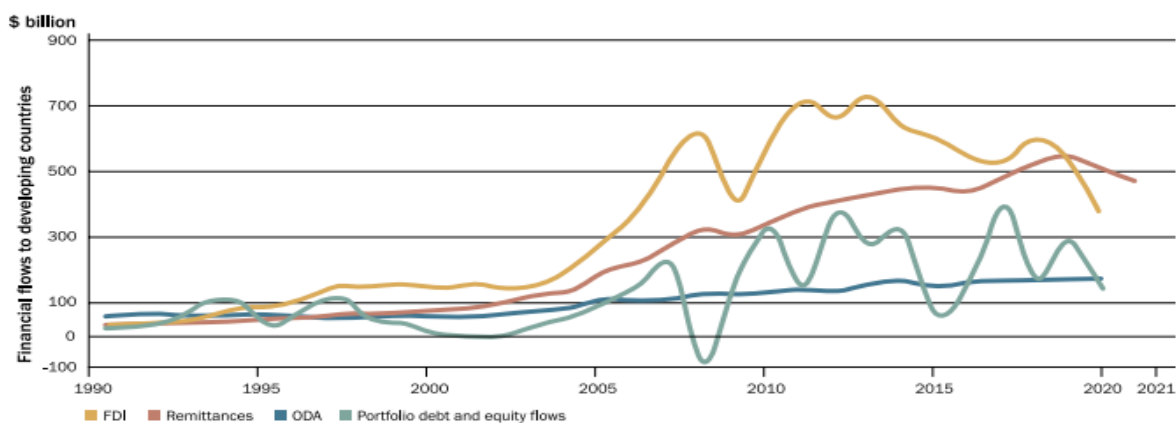
7. For several years (pre-pandemic), the sum of SDG funding in developing countries from all sources (Figure 1) amounted to about USD 1.4 trillion per year. It will not be possible to close the remaining gap of USD 2.5–3.2 trillion per year merely by increasing some of these sources. Norwegian ODA has been at a fairly stable USD 150 billion per year for many years, i.e. about 5 per cent of the total financing gap, and there is political pressure in many donor countries to reduce this amount. The investment volume from the private sector in relation to the SDGs in developing countries needs to be increased.

**Figure 1. Sources of financing for the SDGs in developing countries**

	Domestic	International
Public	Tax revenues	Grants, loans, other public funding
Private	Private savings (financial sector as intermediary)	Foreign direct investment (FDI), portfolio investments, transfers

Source: Simplified version based on Table 3 of the report 'OECD Global Outlook on Financing for Sustainable Development 2021'.

**Figure 2. Capital flows to low and middle-income countries, 1990–2020**



Source: World Bank-KNOMAD staff estimates, World Development Indicators, IMF Balance of Payments Statistics

8. Figure 2 shows a growth trend in selected cash flows to developing countries over the past few decades where FDI and private money transfers in particular have risen sharply (pre-pandemic). Portfolio investments have also shown an increasing trend during the period, but with large fluctuations.

9. An important part of the strategy to mobilise adequate financial resources for sustainable investment in developing countries is therefore to mobilise more private capital internationally and domestically. This means mobilising more international private capital from international capital markets (portfolio investments) and FDI, on the one hand, and more domestic private capital in developing countries on the other.

10. A key element of this strategy to mobilise more private capital is **blended finance**, which entails bringing development-oriented finance from development cooperation and commercial capital together in a blended finance structure. This is discussed in further detail below, and is the primary focus of this report.

11. Table 1<sup>5</sup> breaks down the pre-pandemic investment gap for developing countries by economic sector and by potential capital contributions from the private and public sectors. In 2014, UNCTAD calculated the

<sup>5</sup> The table has been reproduced from UNCTAD's 2014 World Investment Report.

size of the investment volumes that developing countries might attract from private investors for different sectors per year in the years ahead.<sup>6</sup> The total potential investments before the pandemic were calculated at USD 1.3 trillion per year for private sector investment and USD 1.2 trillion for public sector investment, which would have closed the pre-pandemic financing gap. According to UNCTAD's calculations, the sectors with the greatest potential for private investment are the power sector (USD 370 billion), agriculture and food security (USD 225 billion), transport (USD 165 billion), climate change mitigation (USD 135 billion), and telecommunications (USD 130 billion)<sup>7</sup>.

**Table 1: Sector Investment Gaps in Developing Countries – USD billions**

Sector	Investment description	Current investment	Total investment required	Investment gap	Potential contribution from private sector	Potential contribution from public sector
Power	Generation, transmission and distribution of electricity	260	630-950	370-690	370	160
Transport	Roads, airports, ports and rail	300	350-770	50-470	165	95
Telecommunications	Infrastructure (fixed lines, mobile and internet)	160	230-400	70-240	130	25
Water and sanitation	Provision of water and sanitation to industry and households	150	410	260	100	160
Agriculture and food security	Agriculture, research, rural development, etc.	220	480	260	225	35
Climate change mitigation	Relevant infra, renewable energy generation, R&D of climate friendly technologies, etc..	170	550-850	380-680	135	395
Climate change adaptation	Cope with impact of climate change in agriculture, infra, water management, coastal zones etc..	20	80-120	60-100	25	55
Eco-systems including biodiversity	Conservation and safeguarding ecosystems, marine resource management, sustainable forestry, etc...		70-210		70	
Health	Infra investment, e.g. new hospitals	70	210	140	75	65
Education	Infra investment, e.g. new schools	80	330	250	35	215
TOTAL		1400	3900	2500	1330	1170

Sources: UNCTAD, World Investment Report, 2014, Chapter IV; UNCTAD, SDG Investment Trends Monitor – September 2019.

### **In which areas is it most likely or easiest to mobilise private investment, and in which areas is public investment more likely?**

12. There is potential for attracting private investment in areas where the activities can generate revenues that justify the investment cost. This can be in collaboration with the public sector or development cooperation. The sectors are ranked from greatest to least private investment potential as follows: energy, agriculture, transport, climate mitigation, telecommunications, water and sanitation, health, ecosystems/biodiversity and education (UNCTAD's empirical analysis, Table 1).

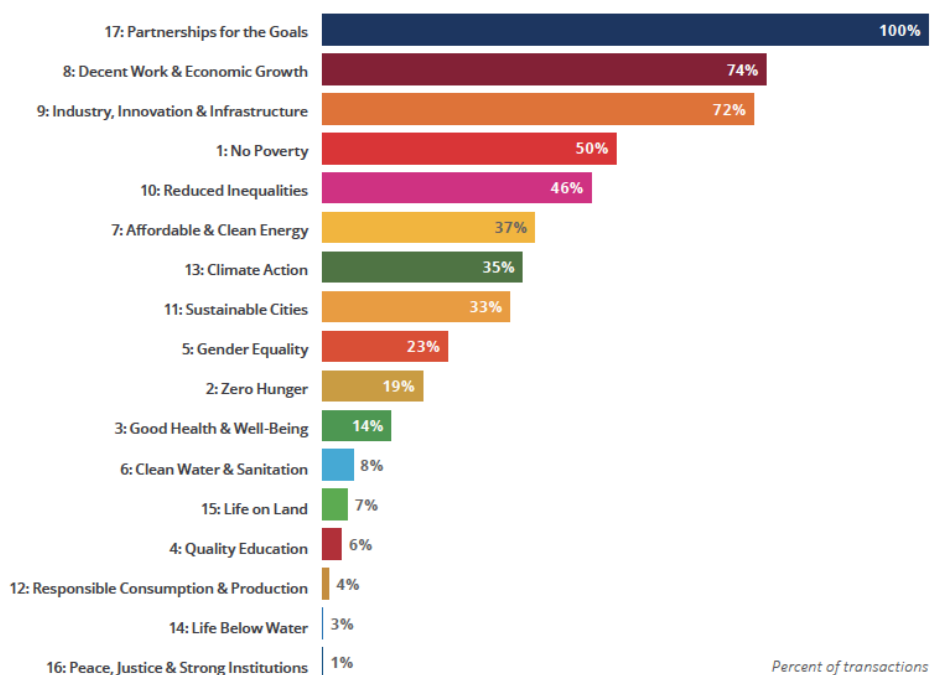
13. Figure 3 shows the breakdown within different SDGs of over 600 investments in developing countries in recent years that have been financed using a combination of development aid and private capital, i.e.

<sup>6</sup> UNCTAD estimated the potential contribution from private investment to different sectors as follows: it assumed that, in the most favourable scenario, developing countries could increase the proportion of total investments represented by private sector investment in the respective sectors to the same level as in industrialised nations within 15 years (2015–2030). UNCTAD then calculated the increase in private sector investments every year. This is the potential investment contribution from the private sector to close the SDG investment gap by 2030.

<sup>7</sup> The sectors that have been identified as having the greatest need for public investment are climate change (USD 395 billion), education (USD 215 billion) and water, sanitation and hygiene (WASH – USD 160 billion).

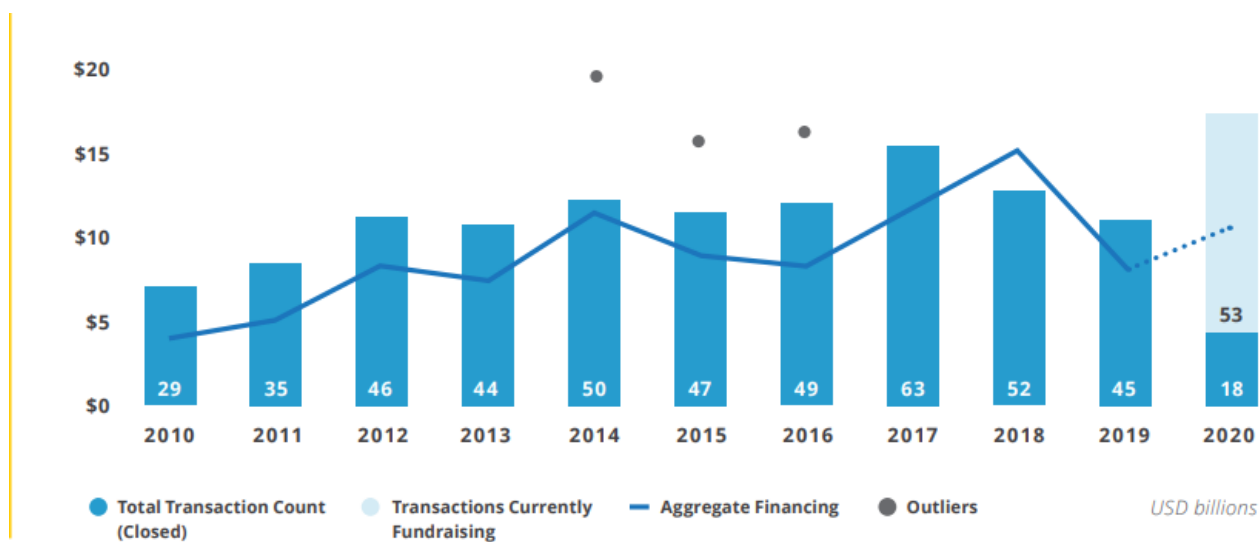
blended finance transactions. Even though several transactions target financial sector SDGs, many of them also target social sectors, and the number has risen sharply in the last few years.

**Figure 3. Alignment between blended finance transactions and the SDGs (2014–2019)**



Source: Convergence, Blended Finance Historic Deals Database.

**Figure 4. Total annual blended finance flows to developing countries, 2010–2020**



Source: OECD, Global Outlook on Financing for Sustainable Development 2021.

14. Figure 4 shows that the mobilisation of private capital to developing countries through blended finance tripled in the period 2010–2018, from USD 5 billion to USD 15 billion per year. Like FDI, the volume has declined slightly in the last two years, especially since the outbreak of the pandemic.

## How much of the private capital available in international capital markets do developing countries actually need?

15. This need for capital represents a minute proportion (less than 0.5 per cent) of the total funds available in international capital markets. Globally, these amounted to USD 379 trillion in 2019, and they are growing on average by over USD 15 trillion per year. In 2019, USD 307 trillion was invested in high-income countries, USD 57 trillion in China and USD 15 trillion (less than 5 per cent) in developing countries. In other words, less than 5 per cent of global private capital is invested in developing countries. The chances of increasing this proportion are good – with the right measures: if a mere 0.4 per cent of private capital in the international financial markets was deployed to investment in developing countries, this would close the part of the investment gap for the SDGs in which it is natural for the private sector to invest. This will be a crucial step towards closing the investment gap.

16. Despite the capital surplus and interest rates in Western markets having been close to zero for several years, relatively little commercial capital has flowed to poor countries historically. This reflects a number of challenges and barriers that make it difficult to attract private capital for investment in emerging markets in developing countries. Some of the main challenges in **attracting private investment to developing countries** are listed below.<sup>8</sup>

- a. Project risk – the actual or perceived risk associated with the financial aspects of a project in a developing country is considered too high in relation to the expected return.
- b. Country risk, including commercial and political (actual/perceived). The risk is more indirect, albeit important to investors' decisions: it may include regulation, macroeconomic stability and prospects for economic growth, exchange risk uncertainty, political stability, legal safeguards, etc.
- c. Investors point out that there is a very limited selection or a limited supply of bankable investment projects in developing countries. Project ideas are often not developed to a level where they can be assessed on their merits by, for example, banks or investors for possible financing.
- d. Many international private investors' knowledge and understanding of, the investment options in often unknown markets (developing countries) is poor. This leads them to overestimate the project and country risk, and underestimate the scope of bankable projects.
- e. Poor regulatory and financial infrastructure. The local investment climate is often challenging, with a lack of regulation and property rights and poor legal systems, as well as poorly designed and executed policy and regulation reforms, making these markets fairly inefficient. Local financial markets in developing countries are particularly weak. There are no standardised asset classes for investing in poor countries that potential institutional investors (e.g. securities funds, pension funds and insurance companies) can apply when allocating assets. However, these cannot be found in developing countries, precluding investment in developing countries by such investors.
- f. Institutional investors have limited mandates and incentives to make investments in sectors or markets in developing countries that would have a major development effect.
- g. Physical infrastructure like roads, power, broadband, telephony, ports/airports and transportation.

17. Some of these challenges involve improving the national framework conditions in the developing country. In addition to the need for active steps from the authorities, this is often supplemented with measures within traditional development cooperation, policy advisory services and capacity building.<sup>9</sup> These challenges are often deeply rooted and structural, and long-term efforts will be needed to overcome them. The causal chain between measures to improve national framework conditions and a company's decision to invest at the grassroots level is fairly long and indirect. However, some of the challenges listed are of such a nature that adapted measures can already start to have a more direct impact on and influence investors' decisions in the short term. It is therefore necessary to have a package of measures that collectively address the aforementioned challenges. This report examines measures within a narrow area of development

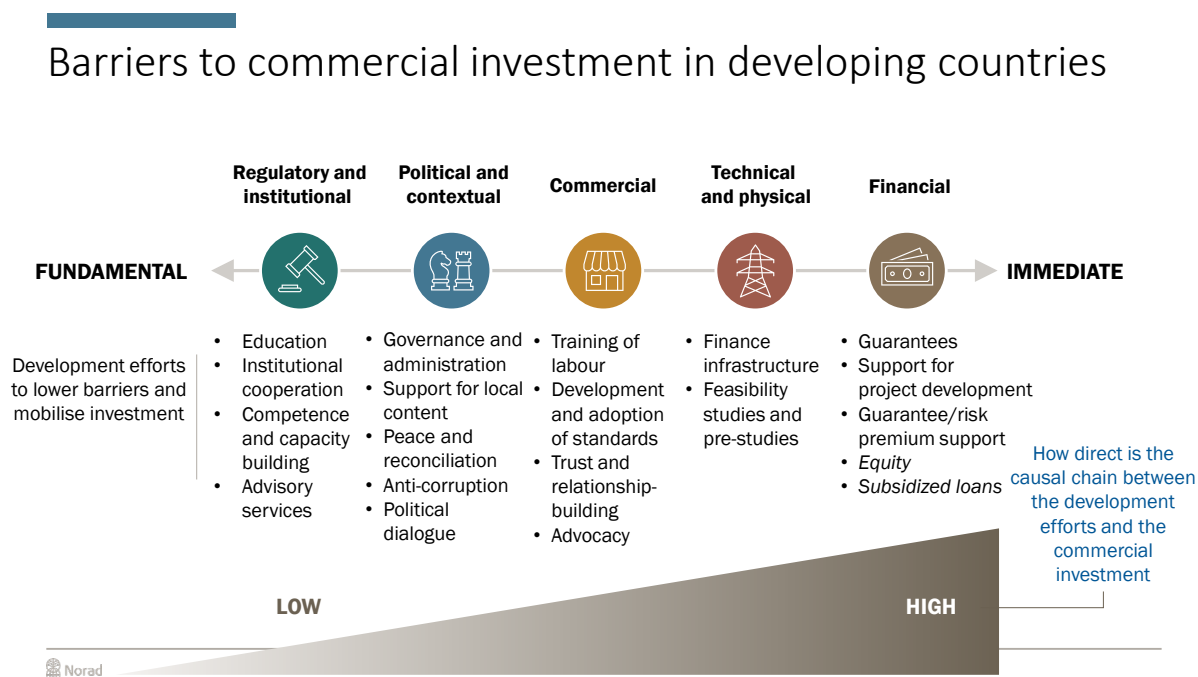
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<sup>8</sup> Source: UNCDF, 'Blended finance in the Least Developed Countries', 2018.

<sup>9</sup> ODA makes a large contribution here through the Knowledge Bank.

cooperation that can help attract more investment capital to developing countries – primarily by addressing a), b), e) and f) of Item 17. However, this is only part of a bigger picture where other complementary measures from the authorities and in other parts of development cooperation are also necessary. Figure 5 illustrates barriers to commercial investment in developing countries and types of development efforts.

Figure 5.



Source: V. Vikjord, Norad, 2021.

18. It is also worth noting some potentially good news for developing countries and international development cooperation: international financial markets are currently experiencing a sustainability revolution, which is probably one of the most important and favourable trends for developing countries in the past 50 years. Investors' fast-growing appetite for 'socially responsible' investment strategies<sup>10</sup> has boosted investment in sustainability projects, primarily in wealthier countries, but with some activity in certain regions in developing countries. There are a vast number of potential investment projects in developing countries that target many SDGs and sectors and would suit the purpose of these investment strategies. International private capital could be attracted if the correct measures are implemented and good project proposals are drafted.

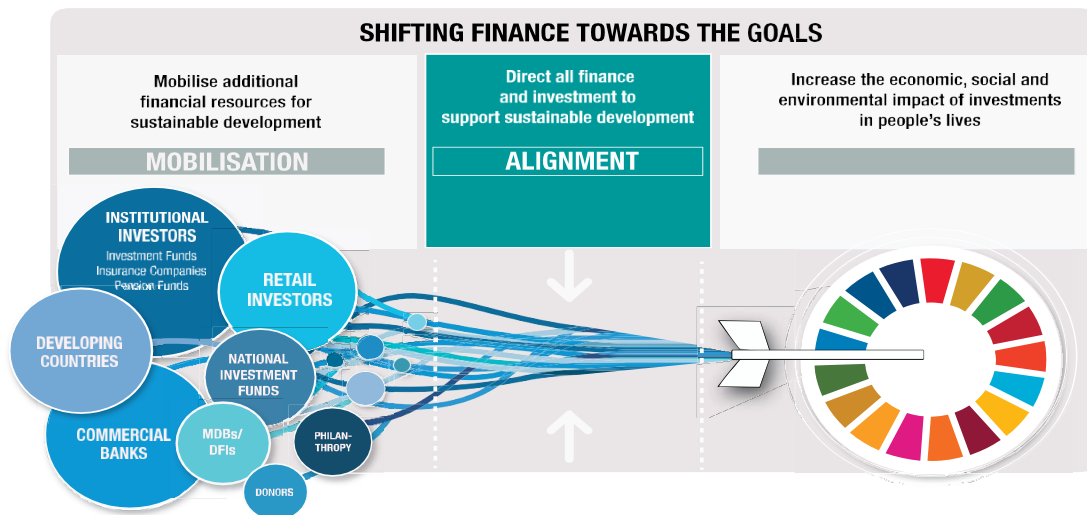
19. The OECD<sup>11</sup> describes the international agenda that was initiated after the international agreement on the SDGs in 2015, which seeks to also mobilise financial resources from the private sector for sustainable development. Figure 5 provides a graphical summary of this mobilisation agenda, where the main point is to persuade the different sources of capital – commercial investors, aid agencies, national and international DFIs and private foundations – to focus their efforts and channel their capital towards the same objective: investment in sustainability in developing countries. This requires the right incentives for each player.<sup>12</sup>

<sup>10</sup> Prime examples of such purpose-oriented investment strategies include 'Responsible Investment, Sustainable Finance, ESG (Environment, Social and Governance oriented) Investment, Impact Investment, Green Finance and Transition Finance'.

<sup>11</sup> The OECD's annual/biennial report 'OECD Global Report on Financing for Sustainable Development'.

<sup>12</sup> The size of the 'bubbles' on the left shows the relative size of the different sources of funding.

**Figure 6. Mobilisation of capital to reduce the investment gap to achieve the SDGs**



Source: OECD Global Outlook on Financing for Sustainable Development 2020

While there is potential for attracting more private investment to developing countries, the players in the international development cooperation system have not fully exploited these opportunities.

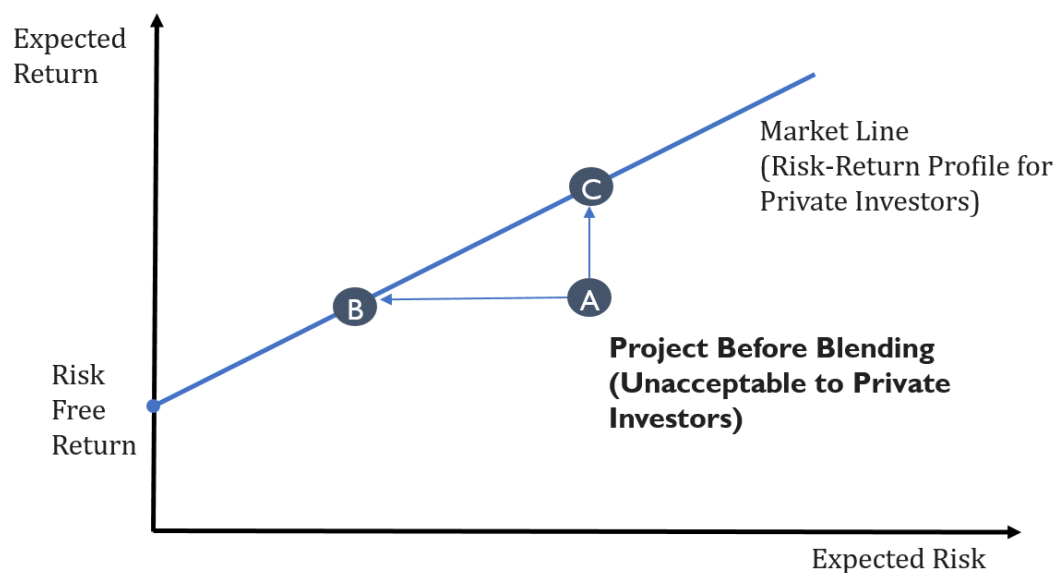
## Chapter 2

### Development cooperation which mobilises private investment to poor countries – blended finance

20. How can more private investment be attracted to developing countries? Does development cooperation have a useful role to play here? Which approach can effectively mobilise much more private capital to developing countries? What is Norway doing today, and what should we continue to do in the future? To answer this in more detail, we will start by examining private investors' assessment of risk and expected return on investment in developing countries for a more exhaustive discussion of these questions.<sup>13</sup>

21. Private investors generally make their investment decisions by weighing the perceived risk against the expected return on the investment. Private investors consider it a high risk to invest in developing countries, particularly when the gap between the risk and expected return is large compared with investments in high-income countries. For investment projects with elevated risk, investors require a higher expected return to offset the increased risk.<sup>14</sup> This is shown schematically in Figure 7, where market line B–C shows the combinations of return and associated risk that investors can achieve elsewhere in the market, and will therefore require when assessing new investments, e.g. in developing countries. The following description applies to investment assessments made by domestic investors in developing countries as well as international investors.

Figure 7.



22. Return on investment in many developing countries is often expected to be lower, given the perceived risk, or may be higher, given the expected return (both scenarios are illustrated in point A in the figure) than the alternative investments in international capital markets (lines B–C).<sup>15</sup> This shows how investors assess the risk associated with poorer framework conditions for business in a country, e.g. related to the level of governance in accordance with legislation and rules, management in companies, macroeconomic and political vulnerability and poor infrastructure. This also reflects project-specific risks and barriers, e.g. high transaction costs for a relatively small investment. It is worth noting that an important part of the uncertainty investors face is caused by a lack of good data. There is little data on the results of previous and similar investments in individual sectors, such as data

<sup>13</sup> This section, including Figure 7, is based on the UNCDF's report, 'Blended finance in the Least Developed Countries', 2018.

<sup>14</sup> For example, when investment is financed through a loan, this involves elevated risk, more expensive loan guarantees and higher interest costs. This cost is assessed against the potential return. In general, the return is lower in high-income markets, but a high return in low-income markets is often consumed by higher financing costs.

<sup>15</sup> This also means that the expected return in a developing country is often higher than in industrialised markets, albeit not enough to justify investment, given the high risk.



on e.g. credit history/debt service, etc. The international capital markets are also excessively wary of investment in developing countries: international investors typically assess the risk in a developing country as higher than domestic investors and overstate the risk of such investments. In other words, there is a gap between perceived and actual risk. If this gap can be narrowed, the required rate of return can be reduced, and more investments will be made.

23. Investors may also face greater uncertainty in such markets. In addition, banks and institutional investors, like securities funds, pension funds and insurance companies, may be constrained by rules and regulations which prevent them from investing in such markets, due to a lack of support. The general rule regarding investment in developing countries is that if a project is considered high-risk, its design is at an early stage or it is poorly structured, the cost of private financing will often be too high for the company to invest.

24. The use of public instruments like concessional finance,<sup>16</sup> together with commercial (private) capital – called blended finance – can influence the relationship between risk and return, and thus trigger a private investment decision, e.g. for a sustainability investment in a developing country. The rest of this report takes a closer look at blended finance and its use in development cooperation.

25. Text box 1 elaborates on the definition of blended finance used in this report: blended finance is the strategic use of concessional finance to trigger private or commercial investment in sustainable investment in developing countries. Concessional finance can come from public and private sources (philanthropy), both domestically and internationally.

26. Caution must be taken when using development aid for blended finance, and it must only be used in accordance with established principles for effective development cooperation.<sup>17</sup> Two critical principles are: 1. development additionality must govern the use of development aid for a measure, i.e. the investment must have a direct, positive development effect in accordance with the SDGs, and must be socioeconomically viable; 2. the use of development aid for a measure must entail

#### **Text box 1.**

In 2018, OECD DAC members agreed on the OECD's definition of blended finance as 'the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries.' (Source: OECD, Making Blended Finance Work for the Sustainable Development Goals, 2018.)

#### **The OECD's definition has three important components:**

1. 'Development finance' is the breadth of public development finance, i.e. development funds that are committed by OECD DAC members every year, as well as investments (loans or equity) made every year by international finance institutions, MDBs and DFIs;
2. 'Mobilisation' implies an intention to mobilise additional capital which would not flow to developing countries otherwise; and
3. 'Additional finance' includes financing and investments that otherwise would not flow to SDG projects in developing countries – this can be public, philanthropic or private investment, but primarily private investment.

The definition covers 'development finance' which is either provided on market terms (commercial), near market terms (often DFIs and MDBs) or below market terms (concessional finance, e.g. development cooperation).

Convergence, the primary global resource centre for blended finance, considers this broad OECD definition to be problematic, as it combines standard MDB and DFI activities on market or near market terms with concessional development aid funding. For example, it mentions the confusion caused by the ODI's Blended Finance Report from April 2019 using a data set that consisted of 92% traditional DFI funding (i.e. on market or near market terms), and only 8% concessional development funds.

Our report is principally based on data from Convergence's global database for blended finance transactions. Convergence uses a subset of the broad OECD definition: It looks at the core of blended finance, where concessional capital (i.e. well below market terms) is used to mobilise private investment.

<sup>16</sup> Concessional finance (and the associated term 'concessionality') is about funding on better terms than those available through regular market mechanisms. For example, grants (which are not to be repaid, unlike loans), lower interest rates on loans, unusually long maturities, interest-only period, etc.

<sup>17</sup> The OECD DAC has adopted 5 principles for blended finance (link: <https://www.oecd.org/dac/financing-sustainable-development/blended-finance-principles/guidance-and-principles/>). They are the result of many years of discussion among donor countries about what is needed to ensure that their use in blended finance constitutes efficient and correct use of development aid. All of the recommendations regarding use of blended finance in ODA in this report are based on full compliance with the five OECD DAC principles for good practices in blended finance.

financial additionality, i.e. the project would not have been funded solely by commercial sources without concessional support.

27. In such cases, use of development aid for blended finance can be justified as an effective instrument. Examples can be that private investment helps build markets in or for developing countries. These can be markets that in the long term will be commercially sustainable in themselves or the investment creates other positive external effects, such as beneficial social, environmental or other societal effects beyond the financial component and incentives for private businesses. Using blended finance has shown that it is fully possible to attract private capital for such SDG investments in developing countries. In short, the main point for donors who design blended finance programmes is to distinguish between (i) markets where commercial capital is available and concessional capital can be harmful and (ii) markets where concessional capital may be a useful tool for accelerating development.

28. It is important to only view blended finance as part of the public and private finance alternatives that are available to developing countries. Solely using public funds as financing is the best option for some projects and sectoral initiatives. Examples of this are different forms of basic infrastructure, access to free education or measures to strengthen the framework conditions for the business sector. Other projects can be exclusively financed by private or commercial investment. In such cases, it will not be relevant for the public sector to provide concessional finance. There are nonetheless cases of SDG investments where the risk-return profile does not make them clearly commercially bankable for private investors. The use of concessional finance can improve the risk-return profile enough for a project to be commercially viable, at the same time that it is greatly beneficial to society. As shown above, UNCTAD has calculated that over half of the investment gap for the SDGs in developing countries is within this category, and this is the focus of this report.

## How does the use of development aid for blended finance work in practice?

29. Blended finance instruments have two main functions: 1. to share risk, i.e. reduce some of the risk for commercial investors; 2. to provide cheaper financing in order to increase the expected return for commercial investors. In practice, risk mitigation reduces the credit risk of commercial investors, and thus lowers loan costs.

30. The most common blended finance instruments are:<sup>18</sup>

- grants;
- concessional loans (either at low interest rates, with flexible collateral requirements or long maturities);
- refundable grants, equity and shares in mutual funds with a required rate of return lower than the market, including first loss provisions (e.g. with the contribution of grants);
- guarantees related to credit and other types of risk, subsidies for guarantee premiums;
- interest rate and currency risk hedging, and TA.

31. Figure 8 shows the effect of blended finance. As described in connection with Figure 3, investments to the right of or below the market line are poorer investment alternatives than the others in the market (the market line). In this example, it will not be rational for a commercial investor to invest in a project with a risk-return combination like the one seen in point A. However, proceeding with the investment can still be socioeconomically viable and boost development.

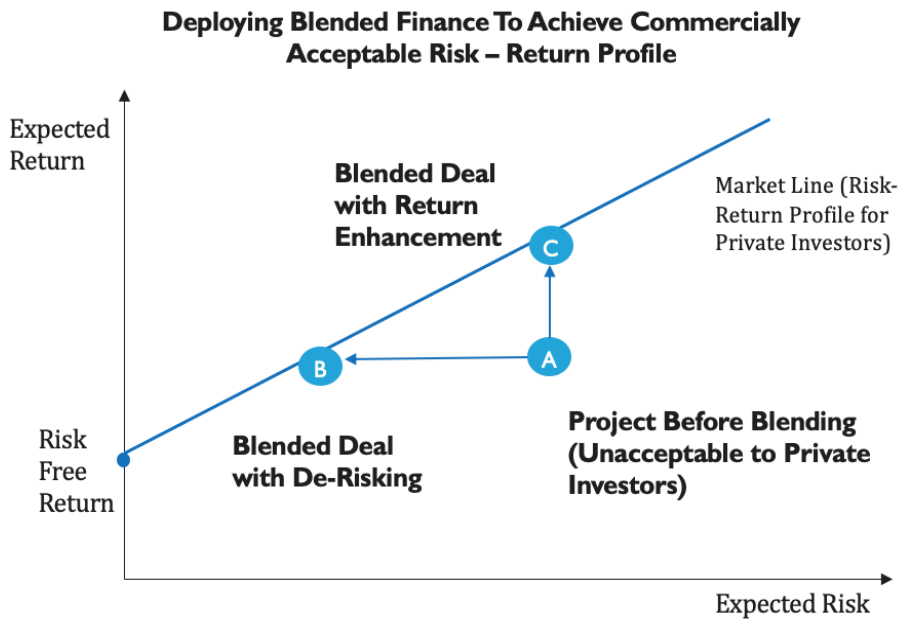
32. Blended finance can change the combination of risk and return and take the projects to a point along line BC. In the case of risk mitigation in the form of a (partial) guarantee or first loss provision, this incentive will bring the investment to point B on the market efficiency line. In other words, the perceived risk for investors will be reduced and lower their required rate of return from C to B. For subsidies that raise the expected return, the investment is brought to point C. In both cases, this will make the project attractive enough to trigger commercial

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<sup>18</sup> Source: UNCDF, 'Blended finance in the Least Developed Countries', 2018.

investment. Data from the world's largest database of blended finance transactions<sup>19</sup> shows that in 2020–2021, most blended finance solutions move a project from point A to B, i.e. mitigate the risk on the project.

Figure 8.



Source: UNCDF, 'Blended finance in the Least Developed Countries', 2018.

33. Commercial players' requirements for investments are well documented in empirical data. For example, the Investor Survey 2020 from the Global Impact Investor Network (GIIN) contains a good analysis of investors' decision-making. (1) Among private investors, 80 per cent report that they would only invest if they considered the terms of the investment opportunity to be as good as or better than others in the market. Only a very small minority of investors are willing to invest when the risk-return ratio in the market is poor. (2) To mobilise investors for a new class of investment vehicles (e.g. build a new market, such as bonds in a developing country) where experience is limited, investors expect a higher return than usual until they become more used to this type of investment vehicle. Blended finance can help build new markets for investment vehicles in developing countries and thus provide better access to funding for businesses and households in these countries.

34. There is another factor that applies to many developing countries: many sustainability projects which are commercially bankable do not receive funding due to a lack of available capital in the financial sector. Blended finance solutions improve access to capital which is available to banks or other financial institutions, and thus increase the number of sustainability projects that can receive funding.

35. There is an international development cooperation architecture that focuses on mobilisation of private investments and development of the private sector in developing countries. This covers a large number of organisations in different niches, primarily:

- MDBs (like the World Bank) and DFIs (like IFC and Norfund);
- OECD/DAC member states' aid agencies, ministries of foreign affairs, and/or ministries of development cooperation;
- private, philanthropic organisations.

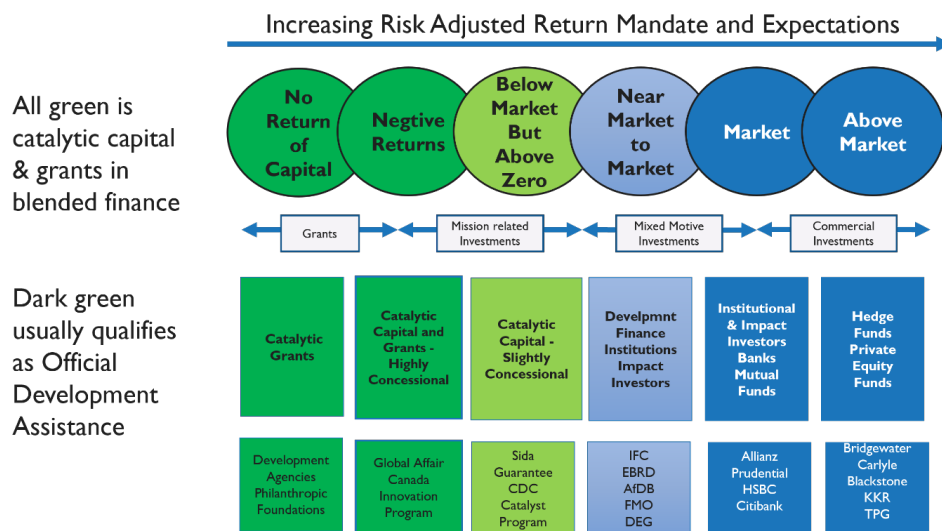
36. The different players support mobilisation of private investment in developing countries in different ways and with varying required rates of return for the capital, weighed against risk. This is reflected in their different mandates, how they receive their funding (for further financial intermediation) and internal incentive structures. Figure 9 shows this with a stylised overview of funds used in mechanisms for development finance with the

<sup>19</sup> Convergence's database of over 600 blended finance transactions. Convergence is an international network for blended finance and the global leading resource centre in the field. It was established by the G-20, the World Economic Forum and the OECD after the International Conference on Financing for Development in 2015 in Addis Ababa.

private sector, where the players are placed on an axis with an increasing risk-adjusted required rate of return (declining level of concessionality) from left to right. Public sources of such funding are shown in green and light blue.

Figure 9.

## SPECTRUM OF FUNDING AND CAPITAL TO FINANCE SDG PROJECTS IN DEVELOPING COUNTRIES



Source: Convergence, Blended finance research working paper, 2021.

- **Fully-concessional** (e.g. wholly negative internal rate of return = grant). No repayment of funds/capital contributions: mainly government (foreign and development cooperation) ministries and aid agencies (like OECD/DAC members) and private, philanthropic foundations. They offer grants and TA without setting any conditions or expecting repayment.
- **Highly-concessional** (e.g. negative internal rate of return). Expected loss of capital: mainly government ministries, aid agencies and private philanthropic foundations. They contribute risk capital with the expectation that they will lose some of the capital.
- **Semi-concessional** (e.g. positive internal rate of return, but below market terms). Expected capital preservation: mainly government ministries, aid agencies and private philanthropic foundations. They contribute risk capital with the expectation that the capital will be preserved and may generate a moderate positive return.
- **Non-concessional** (e.g. positive internal rate of return, near market level). Expected preservation of capital and a positive return on market or near market terms: principally MDBs and DFIs that inject or lend capital to businesses in the private sector. They contribute risk capital with the expectation that the capital will be preserved and generate a return on or near commercial market terms.

The different DFIs can use their instruments to supplement each other and put a package together that allows realisation of the investment with a considerable contribution of private capital from commercial players. Commercial investors and players find themselves at the far end of the scale (blue) and expect a return on invested capital that is at least as good as that which can be achieved elsewhere in the market.

## Chapter 3

### Blended finance for developing countries

#### – an empirical overview of the most effective measures

37. A number of challenges need to be addressed to mobilise investment funds for developing countries and successful investment. Development initiatives are often needed in several or all of the areas described below in order to put together a successful package. This chapter looks at international experiences in the different areas in which development cooperation can be very effective, and is structured as follows.
38. Section I shows aggregated historical data on 108 fairly large (over USD 50 million) blended finance transactions in developing countries (least developed countries (LDCs)), low-income countries and lower-middle-income countries). These are the types of countries which receive Norwegian ODA.
39. Section II looks at risk reduction and mitigation for commercial investors in the form of a capital setup or structure that is part of the blended finance transaction.
- Designed to bring in large institutional investors – large-scale mobilisation.
  - Medium-sized transactions, like capital from impact investors<sup>20</sup> and other commercial investors. Capital structures like those in section II.a are also used for medium-sized transactions. This category also includes other blended finance instruments, such as bonds, which often focus on specific SDGs.
40. Section III looks at risk reduction by using instruments to reduce currency risk. Section IV looks at risk reduction in the form of capacity building and TA both before and after financial investment and at support measures during the design phase of blended finance transactions.

#### I. Empirical data on large blended finance transactions that target developing countries

41. Convergence has analysed which structures for blended finance transactions are best suited for large-scale mobilisation of private capital for developing countries. The findings are the result of an analysis of information from market players in blended finance transactions, what has worked well for donors, and all transactions registered in a historical blended finance database.<sup>21</sup> The analysis identified a set of blended finance transactions which was particularly effective for large-scale mobilisation, albeit most suitable for aid agencies. This section presents empirical data on frequency and capital volume in transactions in such structures which have focused on developing countries.
42. The data as at 1 May 2021 comes from Convergence's historical deals database for blended finance transactions dating back to 2010. Blended finance took off after the International Conference on Financing for Development in 2015 in Addis Ababa.
43. The database shows 424 blended finance transactions since 2010 involving development aid. These blended finance transactions for developing countries have covered most sectors. Typical sectors include

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<sup>20</sup> Impact investment is a capital investment which is intended to have a favourable impact on nature, the environment, climate, social matters or forms of governance instead of a direct financial return, even though it can also be financially profitable. Impact investment includes non-profit and for-profit investments, such as microloans or investments in social measures. This type of investment gives investors blended value – a combination of a financial return and social results. This makes it possible to finance measures that otherwise would not have received financial support from e.g. the authorities or traditional banks.

<sup>21</sup> Data and analysis from Convergence. 1. Interviews during the past six months with 78 private players in international capital market (investors and capital managers) about their thoughts on aspects associated with investing in low- and lower middle-income countries, including investor preferences. 2. The Global Impact Investing Network's annual survey (responses from 294 investors which manage over USD 400 billion). 3. Global Investors for Sustainable Development Alliance (GISD), an alliance established by the UN Secretary General (based on the Swedish model – SISD), and with whom there is regular consultation – covers 30 global institutional investors who manage over USD 16 billion). 4. Analysis of all transactions in Convergence's historical transaction database of over 630 blended finance transactions since 2010.

renewable energy, other infrastructure, agriculture, transport, climate change mitigation, telecommunications, financial services, water and sanitation, health, housing construction and property, manufacturing, commerce and education. Nature-based solutions (sea and land) for ecosystems have also emerged in recent years. The blended finance transactions have funded sustainable investment for most of the SDGs.

44. These blended finance transactions have released a considerable amount of commercial capital through catalytic use of development funds. A total of USD 101 billion has been mobilised. The concessional capital was USD 27 billion. In other words, every development dollar mobilised on average USD 2.74 in commercial capital. This is called the mobilisation ratio, and it was 2.74 in this case.<sup>22</sup> The concessional capital was financed through development cooperation in the form of grants or financial instruments (like junior (subordinated) loans and junior equity),<sup>23</sup> which can have the same effect as a first loss facility. The average amount for these 424 blended finance transactions was USD 238 million. The financial markets consider such transactions to be medium-sized.

45. Since one of the objectives of this report is to find the best way for Norwegian ODA to help mobilise commercial capital on a large scale, in the following we will look at data for a subset of blended finance structures which are funds, i.e. an investment portfolio. Funds have proven to be particularly effective here. The data set focuses on the precedence for large-scale mobilisation of capital for LDCs, low-income countries and lower- middle-income countries.

46. The search in the blended finance database has therefore been limited to transactions:

- (i) in LDCs, low-income countries and lower-middle-income countries;
- (ii) where catalytic concessional capital was financed in the form of grants (or a corresponding implicitly lower required rate of return on loans or equity);
- (iii) where the structure for the blended finance transaction is a fund;
- (iv) blended finance transactions of at least USD 50 million.

47. Altogether 108 such transactions have been identified. These mobilised a total of USD 23.6 billion (about NOK 200 billion), USD 5.9 billion of which (about NOK 50 billion) was concessional capital financed through development assistance and NOK 150 billion mobilised as commercial capital. This means that the development funds mobilised three times as much in commercial capital. Eleven OECD/DAC donor countries provided concessional capital for these transactions (in addition to other private donors).

48. The average transaction in this subset was worth USD 218 million. Transactions often consist of concessional capital from several donors. Aid agencies made 140 contributions to these 108 transactions.

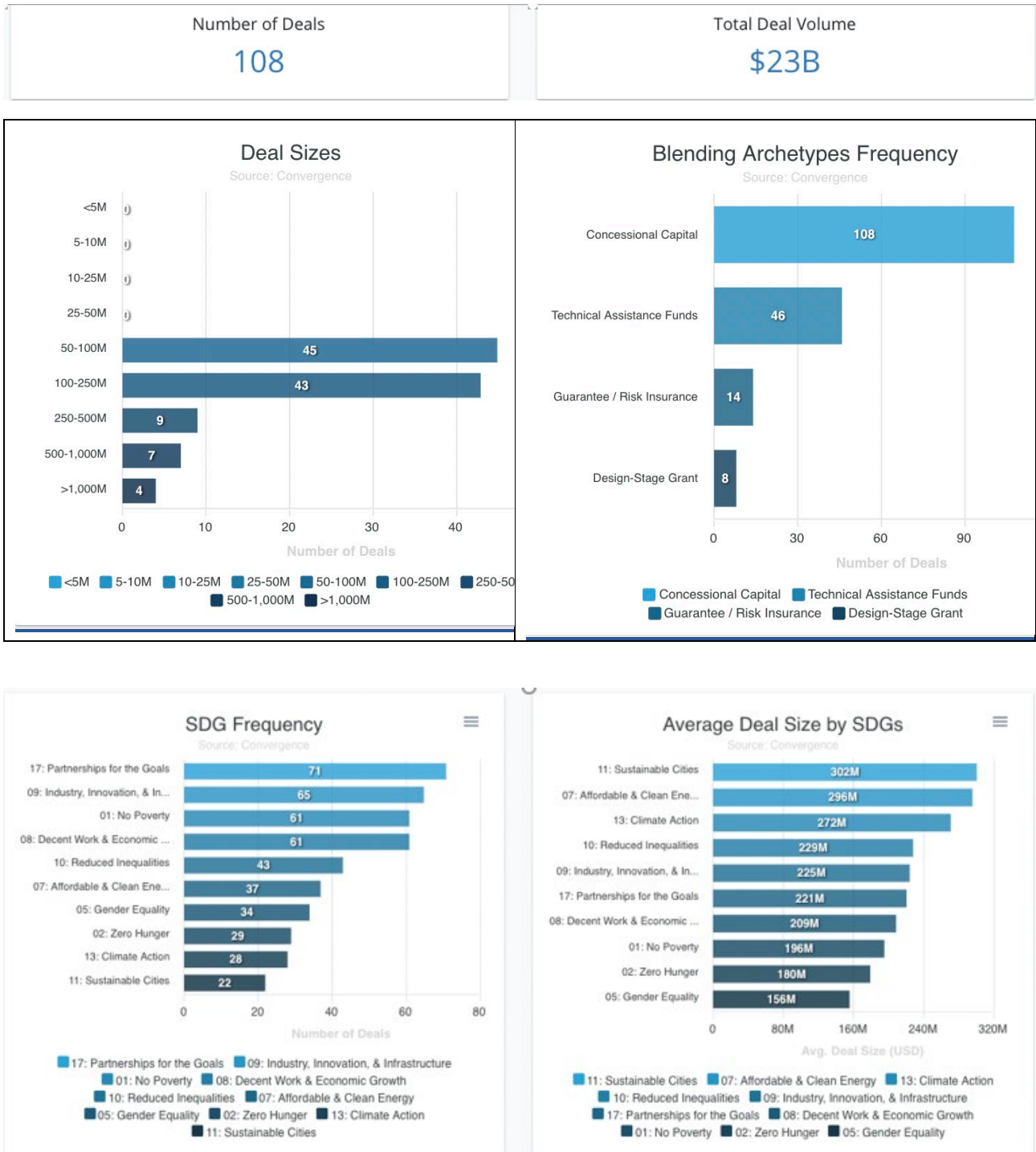
49. The figures below show the distribution of transactions by SDG and main type of support scheme (called 'blending archetypes' in the figure – concessional capital, capacity building, guarantees and grants for designing the transaction).

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<sup>22</sup> Convergence's estimates for the mobilisation ratio have increased to about 4.0 on average during the past 5 years.

<sup>23</sup> Junior capital (junior loans or junior equity) means that the owners of such capital have subordinated access to revenue streams from the investment (e.g. interest income or profit) and will not receive their share until the tiers of capital that have preferential rights, i.e. first senior capital (tier 3) and then mezzanine tier capital (tier 2) have been paid for their shares.

Figure 10.



Source: Convergence, Blended finance research working paper, 2021.



Table 2 provides a summary of the largest transactions above USD 400 million in this set.

**Table 2: Blended finance transactions over USD 400 million – fund with concessional capital**

Blended finance transaction	Sponsor	Total (USD million)	Purpose of financing	Financial contribution from OECD DAC member countries
Emerging Africa Infrastructure Fund	PIDG	1.034	Loans for African infrastructure projects	UK, Netherlands, Switzerland, Sweden and Australia
Room2Run	AfDB	1.000	Loans for financial institutions, infrastructure projects and companies	European Commission
Climate Investor One	Climate Fund Managers	850	Equity for green infrastructure projects	Canada, UK, Netherlands, USAID and Sweden
Danish SDG Fund	IFU	800	Equity for SDG companies and projects	Denmark
Microfinance Enhancement Facility	KfW	678	Loans for microfinance institutions for lending to micro, SMEs	Germany, Sweden and Austria
Global Climate Partnership Fund	KfW	667	Loans for microfinance institutions for lending to micro, SMEs	Germany, Denmark and UK
Meridiam Infrastructure Africa Fund	Meridiam	612	Equity for green infrastructure projects	France
Green for Growth Fund	EIB	520	Loans and equity for green projects and companies	Germany, Luxembourg and the European Commission
IFC Catalyst Fund	IFC	418	Equity in private equity funds and companies with green projects	Canada, UK and Japan

Source: Convergence's historical deals database for blended finance, May 2021.

## II: Risk mitigation for commercial investors when designing a capital structure

### II.a Four blended finance structures where development cooperation can mobilise private capital on a large scale.

50. The four structures that are preferred by private investors and thus used most frequently in the market are presented here, based on the findings from the analysis above. Their primary objective is to mobilise private capital on a large scale for SDG investments in developing countries where the investments meet the OECD DAC principles for blended finance and international standards associated with sustainable investments through financial instruments like bonds, etc. The four structures presented here have already been used in hundreds of cases and in many countries. Concrete examples of blended finance are discussed below in connection with the relevant structure. Blended finance transactions that target large-scale mobilisation of institutional investors often require coordinated input from several donors. These structures provide a wealth of opportunities for medium-sized transactions with other types of investors where it is often adequate for a single donor to participate.

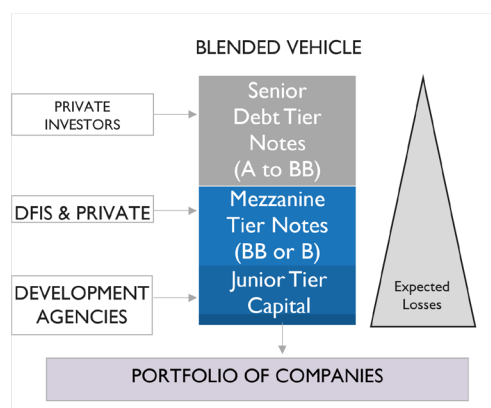
#### **Blended finance structure 1:**

51. This structure blends capital lent by private investors (i.e. they invest in debt instruments) and concessional capital from aid agencies in a fund. The fund offers loans to bankable projects in developing countries where the risk is considered to be relatively high compared with higher income countries.



Figure 11.

**STRUCTURE 1:  
BLENDED FINANCE VEHICLE PREFERRED BY DEBT INVESTORS**



Source: Convergence, Blended finance research working paper, 2021.

52. A blended finance fund with three tiers of capital is established, where the tiers are distinguished from each other by their different preferential rights to payment streams and different distribution of risk in connection with losses. **Tier 1** (junior tier, bottom of the figure): development aid, e.g. for a first loss facility, which mitigates some of the risk for tiers 2 and 3 (see Text box 2).<sup>24</sup> **Tier 2** (mezzanine tier): capital from MDBs and/or DFIs (like Norfund, Swedfund etc.) as well as from (private) impact investors. This capital is near market terms, but mitigates some of the risk for tier 3. **Tier 3** (senior capital): commercial capital with risk mitigation from other sources of capital.<sup>25</sup> In addition to private investors, like IFC, the AfDB, Islamic Development Bank, Trade and Development Bank East Africa.

53. The structure is normally a fund with an experienced fund manager. The fund invests in a portfolio of loans whose credit rating is between BB- and B- (see Appendix 1 for the credit rating scale). To bring institutional investors onto tier 3, the securities they invest in must have investment

**Textbox 2. First loss facility**

A first loss facility is a support measure where the ultimate effect is that the risk of loss is reduced for investors that inject commercial capital (e.g. in a fund with a portfolio of many project investments or loans to businesses). Some of the losses on the investments in the portfolio are covered through the support measure. In other words, the first loss facility reduces the risk of loss for commercial investors. It works as follows: financial support is given (e.g. a grant from a donor) in the form of funds placed in a reserve account for provisions for losses associated with the portfolio of individual investments (e.g. loans for projects or companies) in the fund. This reserve account will cover the first losses in the portfolio, e.g. up to 5% of the total capital. The losses on the portfolio investments will not affect commercial investors until the total losses are greater than 5% of the fund's total investments. This has become an effective way of improving a portfolio's creditworthiness in relation to commercial investors, and thus attracting commercial capital. If the total losses in the fund's portfolio are less than 5% at the end of the life of the fund (e.g. 12 years), the remaining funds in the reserve account or the first loss facility will typically be transferred to an identified ODA measure.

<sup>24</sup> Norad provided grants to two first loss facilities based on proposed resolution X in 2020 – the United Nations Capital Development Fund's BUILD SME investment fund and the credit scheme from Equity Bank (Kenya) for farmers and small and medium-sized enterprises.

<sup>25</sup> Senior capital (loans or equity) means that the owners of such capital have a first claim on revenue streams from the investment (e.g. interest income or profit) and are paid their share before the other capital tiers (mezzanine tier capital (tier 2) and junior capital (tier 1)) are paid their shares of whatever is left after any losses. The risk mitigation in the example above reduces the transaction costs for commercial investors on tier 3. As they are protected from (some) loss, the loans are cheaper, and the premiums on the loan guarantees are lower.

grade rating.<sup>26</sup> This is achieved using two measures to set the direction of the fund. (1) Spreading risk by diversifying the portfolio among numerous underlying investment vehicles (loans) with different levels of risk, and (2) where the other types of capital (tiers 1 and 2) are subordinate to tier 3, i.e. that any losses on loans in the portfolio are first charged (up to a certain level) to the lower capital tiers before tier 3. On the whole, this reduces the likelihood of loss for investors on tier 3.

54. The spreading of risk (1) as a result of diversification of the loan portfolio improves the credit rating of the total loan portfolio by 1–2 notches, and subordinating tiers 1 and 2 in relation to tier 3 improves the credit rating of the securities in tier 3 by a further 1–6 notches. Overall, the credit rating of securities in tier 3 is improved by up to 6–8 notches compared with their starting-point: the subordinated loans that have an average risk and credit rating of B. As the credit rating scale in Appendix 1 shows, a 6-notch upgrade raises a credit rating from B to BBB for tier 3 securities, i.e. investment grade. Securities in the mezzanine tier (tier 2) will then receive the rating 'good quality, non-investment grade' (e.g. BB).

55. This is attractive enough to bring investors to both tiers 2 and 3. It is crucial that this capital structure gives the securities at the senior capital tier an investment grade rating. This makes it possible for a large universe of investors to invest in these – institutional investors which only have authority to invest in investment grade securities, according to their mandate and capital market regulation.

Examples of such blended finance transactions are provided below.

#### **Japan ASEAN Women Empowerment Fund (BF1)<sup>27</sup>**

56. The Japan ASEAN Women Empowerment Fund (JAWEF) is a three-tiered fund with blended finance structure 1. The fund provides loans to microfinance institutions, which in turn grant loans to female entrepreneurs in South and Southeast Asia, including in a number of countries that are below investment grade, such as Cambodia, Laos, India, Sri Lanka, Pakistan, Myanmar and Vietnam. It uses capital from all three tiers: a first loss facility (junior capital tier) and capital in the mezzanine tier to mobilise private investors to the senior capital tier. Most of the concessional finance comes from the Japanese authorities. The fund has accumulated USD 241 million in capital, with USD 1 million in tier 1 capital. The tier 2 capital is USD 120 million, which was injected by the Japanese DFI JBIC and the Japanese International Cooperation Agency (JICA). The tier 3 capital is USD 120 million, which is from private investors. It was possible to mobilise a large proportion of capital from private sources by combining two elements: only a small proportion of highly-concessional capital as a contribution to the first loss facility and public catalytic capital in the mezzanine tier near market terms, i.e. little concessionality.

57. JAWEF has reached 150 000 microentrepreneurs after 3 years of operation, and 91 per cent of the borrowers are women. The fund has increased its capital and expanded its loan volume. The fund has a strong track record in promoting access to financial services for female microentrepreneurs, and is helping narrow the global credit gap of USD 1.7 trillion faced by companies owned/led by women.

#### **Aceli Africa catalytic market incentive facility<sup>28</sup>**

58. **Aceli Africa** is a version of blended finance structure 1. This is a financing facility which uses market incentives to catalyse lending from local commercial banks and microfinance institutions in Eastern Africa, and some international finance institutions for SMEs in agriculture.

59. Concessional capital from aid agencies is used to mobilise local lenders in African countries to grant loans to SMEs in agriculture. Concessional capital covers some of the risk for lenders and helps compensate

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<sup>26</sup> *Investment grade* means that credit rating agencies assess the risk of defaulting on the loan as relatively low. In other words, the investment is fairly safe

<sup>27</sup> Source: Blue Orchard Impact Investment Managers, 2019.

<sup>28</sup> Source: Partners for Development, 'Rethinking Norwegian Official Development Assistance towards 2030 - more effective ODA to engage with and mobilise the private sector', May 2021.

for a lack of incentives for lenders to provide loans to the agriculture sector. Such incentive problems are seen in many African nations.<sup>29</sup> Aceli Africa provides microfinance institutions with financial incentives to issue loans that have a high development effect and further financial incentives to achieve good results in priority areas (food security and nutrition, credit for women, and climate-smart agriculture). The facility also offers TA to borrowers.

60. Aceli Africa started its operations in 2020 with USD 31 million in concessional capital. So far, 70 loans with a total value of USD 11 million have been catalysed to SMEs by spending less than USD 1 million of concessional capital. This means that more than 13 times the development funds have been mobilised in private capital. First-time borrowers have received 47 per cent of the loans. SMEs have received 59 per cent, meeting the 2X Challenge criteria for equality and financing for women,<sup>30</sup> and 51 per cent has gone to SMEs that contribute to food security and nutrition in Africa.

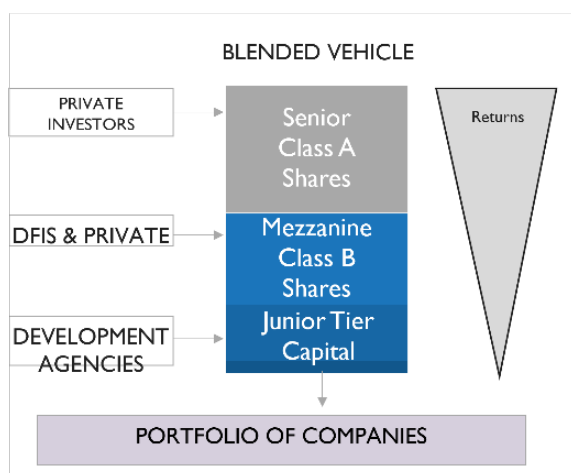
61. The facility further consists of several capital contributions from donors with a view to a total of USD 75 million in concessional capital. In accordance with the results achieved so far, Aceli seeks to mobilise USD 700 million in loans from private financial institutions over a 5-year period. Each development dollar is expected to generate at least USD 3 in increased revenues for smallholders and SMEs.

### Blended finance structure 2:

62. This structure is similar to the first one, but the portfolio is for equity investments (shares) from private investors which are combined with concessional funds from aid agencies. The fund then invests equity for commercially sustainable projects in developing countries (with a relatively high level of risk).

Figure 12.

### STRUCTURE 2: BLENDED FINANCE VEHICLE PREFERRED BY EQUITY INVESTORS



Source: Convergence, Blended finance research working paper, 2021.

### In general:

63. A blended finance fund with three tiers of capital will be established. A corresponding distribution of risk between capital tiers/investor types and donors as in structure 1. Tier 1 (junior tier, bottom of the figure):

<sup>29</sup> This includes much higher unit costs associated with credit assessment and loan drafting, as well as a higher risk of defaulting on loans.

<sup>30</sup> The 2X criteria are a global gender finance initiative to raise considerably more capital for female entrepreneurs. The 2X criteria are internationally harmonised and integrated in the Global Impact Investing Network's (GIIN) framework for impact management and metrics.

grants (e.g. for a first loss facility), which mitigate some of the risk for tiers 2 and 3. Tier 2: capital from MDBs and/or DFIs (like Norfund, Swedfund etc.), as well as private impact investors – this capital is near market terms, but mitigates some of the risk for tier 3. Tier 3 (senior capital) is commercial capital with risk mitigation from the other sources of capital, in addition to private investors like IFC, the AfDB, Islamic Development Bank, and the Eastern and Southern African Trade & Development Bank.

64. The structure is normally a fund with an experienced fund manager. The fund invests in a portfolio of shares in companies. If companies in which investments have been made perform well, the surplus will yield profits which will go to the fund. This surplus will then be distributed between the different capital tiers, in accordance with an agreed priority sequence.

65. A typical priority sequence for surplus could be as follows:

1. The first distribution to tier 3 capital (top tier) at the internal rate of return is 0–5 per cent.
2. The second distribution to tier 2 capital (mezzanine tier) at the internal rate of return is 0 per cent.
3. The third distribution to donor-financed tier 1 capital up to the total grant amount for any remaining surplus. The donor has given instructions in the original fund agreement about where to place any amount remaining– which is usually a follow-up development initiative (e.g. a TA fund).
4. The fourth distribution is to different capital tiers through negotiation.

66. The priority sequence for the surplus results in the following for commercial investors:

- (i) reduces the probability of loss;
- (ii) increases the probability of achieving a return that is similar to that found elsewhere in the market;
- (iii) increases the likelihood of a relatively good return.

A certain prioritisation of commercial investors with tier 3 capital is necessary to mobilise sufficient private capital, but the process of building a market for international portfolio investments in developing countries is more of an art than a science in terms of making an exact calculation of the optimal amount of development funds and risk distribution. The final distribution of risk between the parties is settled during negotiations.

67. The donors have already participated in a large number of blended finance transactions with these structures, where development funds have mobilised a multitude of private capital.

Examples of blended finance transactions corresponding to structure 2 are provided below.

### **Danish SDG Investment Fund <sup>31</sup>**

68. The Danish SDG Investment Fund invests in projects in developing countries where the objective is to help achieve the SDGs, especially goals 1, 2, 6, 7 and 9. The fund's total capital is almost DKK 5 billion. Tier 3 capital: Danish pension funds and private investors – a total of almost DKK 3 billion. Tier 2 capital: the Danish Investment Fund for Developing Countries (IFU), the counterpart to Norfund, DKK 1.1 billion. Tier 1 capital: DKK 900 million, DKK 100 million of which is capital contributions from the Danish government and DKK 800 million is a guarantee from the Danish government for a loan of a similar size to that from Danmarks Nationalbank.

69. In addition to the DKK 2 billion in public funding having mobilised DKK 3 billion in private capital, the fund will mobilise more private capital for specific investments in developing countries. Fund manager IFU expects total investment to be DKK 30 billion once the fund has been fully invested. This means a considerable catalytic effect of the DKK 2 billion in public funding.

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<sup>31</sup> Source: <https://www.ifu.dk/en/danish-sdg-investment-fund-2/>

## Climate Investor One<sup>32</sup>

70. Climate Investor One, with total capital of USD 1.65 billion, is a version of blended finance structure 2. It has qualities that make it particularly suitable for supporting an investment project through several stages, from design development (short term) to the fixed investment (e.g. construction, medium term), to the operations stage, which has a long duration. The structure manages this using a suitable blend of commercial and concessional capital, which is adapted to the players' needs at each of the three stages.

71. The fund was established in 2015 by the Netherlands Development Finance Company, FMO and the company Phoenix InfraWorks to finance renewable energy projects in emerging markets. A joint venture has been established for fund management – Climate Fund Managers.

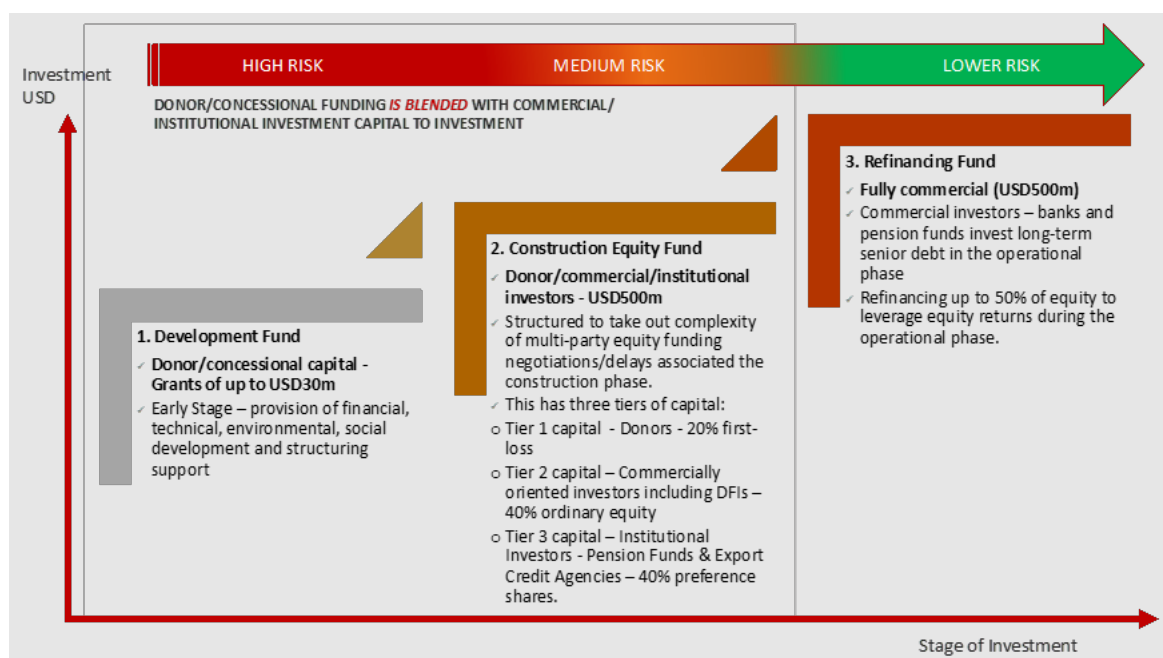
72. This is actually a package of three funds:

(i) A USD 50 million project development fund that is financed through development cooperation and which provides funding to project development activities, e.g. by power plants.

(ii) A Construction Equity Fund of USD 800 million with a similar design to blended finance structure 2. Twenty per cent of the total assets are tier 1 capital that is aid-financed, and which has been set aside to cover losses during the construction stage. Forty per cent of the assets are tier 2 capital from commercial investors, in addition to some national development institutions. Forty per cent of the assets are tier 3 capital from institutional investors like pension funds.

(iii) A refinancing fund of USD 800 million. The fund does not have any concessional capital, only commercial capital raised via banks and pension funds. After a few years of operation, usually 2–3 years, projects are normally in full operation. Potential risks during the development stage and construction stage are no longer an issue. With ordinary operation, projects have stable revenue and cash streams, and the risks are considerably lower during this stage. The Construction Equity Fund can thus reduce its holdings and refinance at a lower capital cost with local or international lenders and investors through the refinancing fund. The money from the sale can then be reinvested in new projects in the Construction Equity Fund.

Figure 13. Climate Investor One's three investment funds:



Source: Partners for Development, 'Rethinking Norwegian Official Development Assistance towards 2030 – more effective ODA to engage with and mobilise the private sector', May 2021.

<sup>32</sup> <https://www.climatefinancelab.org/project/fmo-climate-development-finance-facility/>

73. Capital for the refinancing fund can be raised when projects developed through the first two funds are approaching the operational stage. This structure was first introduced in the renewable energy sector,<sup>33</sup> but it can be replicated exactly in other sectors.

We have described blended finance structures 1 and 2 so far. These tend to result in what the financial sectors consider to be medium-sized funds (usually less than USD 200 million). They are therefore normally unable to mobilise institutional investors seeking portfolios/funds of USD 500 million or more.<sup>34 35</sup>

74. While donors can mobilise a substantial amount of private capital for projects in developing countries through structures 1 and 2 – a gradual increase in investment volumes in the years ahead – this increase in investment will not be fast enough to close the developing countries' SDG investment gap. Institutional investors must be mobilised to close this gap. This will require a larger scale, which can be achieved in **blended finance structure 3**.

### **Blended finance structure 3: Aggregation vehicle to achieve large-scale mobilisation of private capital in portfolios – either as loans or equity**

75. This structure aggregates several investment funds in a pooled fund, a 'fund of funds', with both private capital and concessional funds. A fund manager distributes the money from the pooled fund into a number of different investment funds with structures 1 or 2. See Figure 14.

76. This aggregation is necessary to accumulate an amount that mobilises institutional investors. For example, structure 1 and 2 funds have normally been worth USD 100–200 million. However, institutional investors seek investment instruments that can absorb a total of USD 500 million. An aggregation tool, like a fund of funds, may attract institutional investors by pooling enough underlying potential investments (i.e. companies in developing countries that can be invested in/granted loans) in the aggregation fund to achieve critical mass and sufficient diversification in projects and countries to spread the risk. Even though participation in such structures has so far been a challenge for donors, there are examples of operational aggregation funds.

Examples of funds of funds:

#### **The UNCDF SDG500 fund**

77. SDG500 (see Figure 15) is a fund of funds worth USD 500 million that was launched in January 2020 by a coalition of partners, including the United Nations Capital Development Fund (UNCDF), the International Trade Center (ITC), the International Fund for Agricultural Development (IFAD), the Stop TB Partnership, Smart Africa, CARE USA and impact investment fund manager Bamboo Capital Partners. The fund finances projects that target the SDGs by investing in over 300 small businesses in the agriculture, finance, energy, education and health sectors in developing countries in Africa, Asia, Latin America, the Caribbean, and the Pacific island states. The different funds either use debt instruments (loans) or equity (shares) to fill 'the missing middle'<sup>36</sup> in these countries, i.e. lack of access to financing for SMEs with growth potential.

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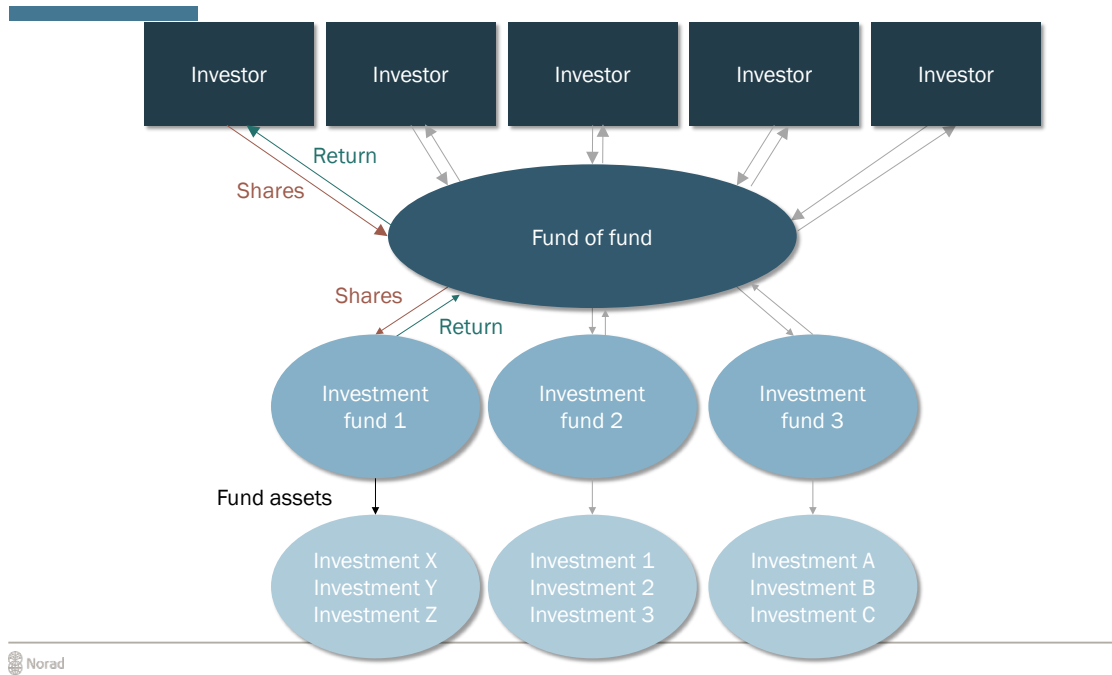
<sup>33</sup> The NGO Zero submitted a report in March 2021, proposing a Norwegian climate/renewable energy investment fund that is similar to the Climate Investor One design, and which can provide inspiration for the structure for the proposed climate fund that Norfund will manage.

<sup>34</sup> About 20 out of 630 blended finance transactions have been worth over USD 500 million.

<sup>35</sup> The reason why institutional investors want this minimum amount is as follows: to cover transaction costs, each investor needs to invest at least USD 100 million. In addition, each investor wants to spread the risk, so that their capital makes up no more than 20% of the total capital in the portfolio (the fund), i.e. to ensure that other investors provide at least 1/5, so that the total amount is (preferably) at least USD 500 million.

<sup>36</sup> Missing middle: This refers to companies' access to financing in the medium and long term, which is difficult to obtain for companies that are not established, large businesses. While the expansion of microfinance has begun to serve microcompanies,

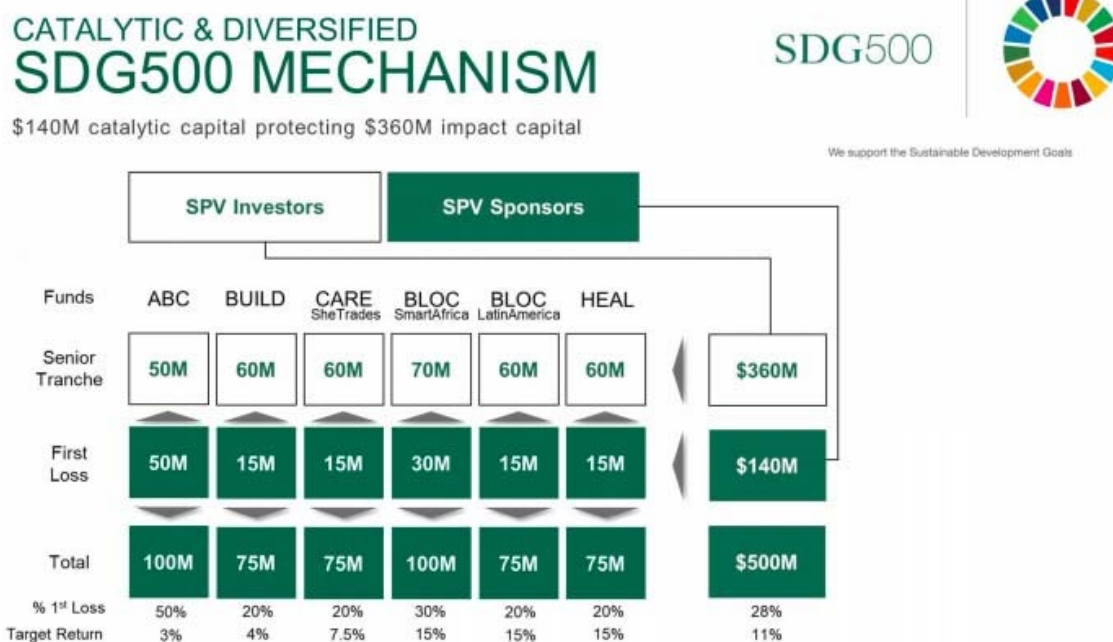
**Figure 14. Fund of funds structure**



Source: V. Vikjord (Norad) based on <https://www.slidegeeks.com/>

businesses in the middle category, i.e. SMEs, are generally too large to be served by microfinance institutions, but also too small and too high-risk to be attractive to the formal banking sector. This middle category of businesses which do not receive financing is called 'the missing middle'.

Figure 15. The UNCDF SDG500 fund



Source: UN Capital Development Fund (UNCDF) - The SDG500 Platform Investment Opportunity. UNCDF.org

78. The fund structure is as follows: The main fund and associated securities have two tiers of capital: senior capital (corresponding to tier 3 in previous examples) and tier 2/mezzanine tier capital. The main fund has injected capital into 6 underlying, diversified impact funds. The 6 underlying funds have the same three-tiered capital structure as blended finance structures 1 and 2. The USD 500 million is distributed as follows: USD 360 million for the senior and mezzanine tiers and USD 140 million for tier 1 capital with first loss facilities that are financed using development aid. In 2020, Norad provided a grant for a first loss facility in one of the 6 underlying funds – the BUILD fund. The combination of the first loss facilities and aggregation of securities in an overarching fund that spreads risk over many countries, sectors and categories of securities catalysed a total of USD 370 million in capital from institutional investors. This is an example of successful large-scale mobilisation of institutional capital by attracting investors with different risk-return preferences.<sup>37</sup>

### Blended finance structure 4 – guarantees

79. Blended finance structure 4 provides a financial guarantee that reduces risk for private investors (see Figure 16).<sup>38</sup> A financial guarantee is a contract to ensure that a creditor or lender is reimbursed for losses incurred due to a debtor not paying the outstanding debt as per the loan agreement. In development cooperation, guarantees are used as an instrument to remedy market failure and poor capital markets in developing countries. Market failure can occur when, for example, financial institutions (e.g. banks) do not lend money to specific groups of recipients (e.g. SMEs, solar cell companies, investment in energy efficiency, etc.) in developing countries. Banks have limited knowledge about and lack experience with these

<sup>37</sup> Another example of a 'fund of funds' with a similar structure is Sarona Frontier Markets Fund 2. Link: [Sarona Frontier Markets Fund 2 \(SFMF2\) Case Study – Convergence Resources | Convergence](#). The fund has USD 150 million with a first loss facility (development funds from Canada), commercial capital from the U.S. International Development Finance Corporation (DFC) and from institutional investors and others in the private sector. Technical assistance/capacity building facility associated with the fund. This fund invests in 12 active ownership funds which, in turn, have invested in over 100 businesses in developing countries (unlisted).

<sup>38</sup> The guarantee mitigates part of the risk in the investment that otherwise would have been borne by the investor.



groups and technologies. Their assessment of the risk on these loans is therefore exaggerated. This means that projects that are otherwise profitable are unable to find financing,<sup>39</sup> which results in underfinancing of the target groups. The guarantees help create a knowledge base for the guarantee recipients (e.g. local banks) so that they can grant loans to the markets without needing guarantees in the future.

80. Guarantees are a very effective risk mitigation instrument for private investors, and are clearly the most widely used instrument in blended finance to attract private investment to developing countries. Development guarantees have been used in a full 33 per cent of all of the blended finance transactions (680) that have been registered during the past decade, while the rest are spread among a large number of other instruments, and these transactions backed by guarantees have represented 45 per cent of the capital mobilised during the period.

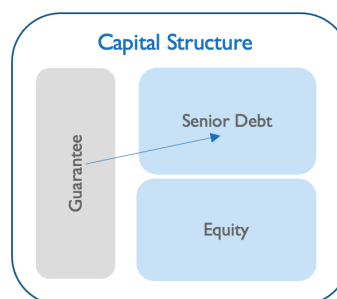
81. A number of donor countries offer government guarantees, like Sweden, the USA and Canada, as described below.<sup>40</sup> The following structure is used in other cases: a group of aid agencies provide concessional funds, sometimes with the addition of private investment capital, to form an organisation with the financial backbone to issue financial guarantees itself.<sup>41</sup> These are specialist organisations which issue guarantees based on their good credit rating and solidity.

82. Financial guarantees support:

- projects in developing countries that are considered commercially sustainable if they gain access to credit (guarantees from organisations like Sida, USAID, the African Guarantee Fund (AGF) and GuarantCo); and/or
- near-bankable sustainable projects by offering credit guarantees for all or part of the risk and the debt obligation (e.g. Sida, USAID, GuarantCo and the Multilateral Investment Guarantee Agency – MIGA);
- loan portfolios (e.g. guarantee issued to a bank in a developing country).

**Figure 16. Structure 4: Guarantee that mobilizes debt investment**

- Guarantee best deployed at project level to convert a “near-bankable” project to bankable
- Guarantor must be rated (Investment Grade, e.g., “A”)
- Guarantee can be for 100% of debt obligation or less
- Guarantee can be for all risks, or sub-set of risks (e.g., political risks)
- Big 3 Rating Agencies cap credit enhancement uplift for partial guarantees to 2 notches (e.g., “B” risk can become “BB-”)
- Proposition: Investors and project would benefit more from a 100% guarantee from an “A” listed entity (e.g., GuarantCo) more than from a “AAA” entity (e.g., development agency)



Source: Convergence, Blended finance research working paper, 2021.

### Government schemes for development guarantees

83. Sweden, through Sida, is a major issuer of development guarantees together with the USA. Sida's guarantee instrument allows mobilisation of private and public capital for development purposes by sharing

<sup>39</sup> In cases where financing may be offered, this becomes disproportionately expensive, which means that the project is no longer profitable.

<sup>40</sup> So far, donor countries have provided guarantees without the OECD-DAC registering or approving them officially as official development assistance. However, the guarantees have had a considerable development effect. The OECD-DAC has initiated a process to discuss whether guarantees or the grant equivalent of guarantees should qualify for recording as development cooperation.

<sup>41</sup> Like insurance and associated insurance premiums, the guarantor bears the risk of providing a guarantee because it has revenue streams from a guarantee premium. The premium may be subsidised using development funds, among other means.

risk between private and public players. More and more donor countries are using guarantees in their development cooperation. Canada launched its own development guarantee programme in 2019, and the Danish government recently (end October 2021) launched a pilot scheme (2022–2025) for government development guarantees.

84. **Sida's guarantee scheme:** Sida offers several types of guarantee. The two most common ones, which cover 90 per cent of the guaranteed capital volume, are:

1. a loan portfolio that covers several loans or investments in a financial institution's portfolio individually;
2. a balance guarantee (which targets the entire capital structure of an enterprise, e.g. a bank) where Sweden's excellent international credit rating is used to give the bank latitude (in terms of the financial regulations) to be able to lend more money.

85. Sida's guarantees work as follows. A guarantee from Sida is supported by the Swedish government. A Sida guarantee can cover different types of risk, such as credit risk or political risk. An important aspect of guarantees is that only part of the guarantee amount is expected to be disbursed. The risk is shared with others to trigger additional financing and investment for development purposes. The Swedish National Debt Office performs an external risk assessment of the political and commercial risks.<sup>42</sup> The risk is calculated as an amount that corresponds to the expected loss. Sida charges an annual premium from the bank or the organisation that receives the guarantee based on the expected loss. When necessary, part of the premium can be subsidised by Sida grants. This means that the subsidy can be approved as development funds under the OECD rules. The purpose of the guarantee scheme is to balance over time, and it has been structured accordingly.<sup>43</sup> Premiums and any subsidies for premiums are paid into a designated account for the government guarantee – a loss provision account. The account balance corresponds to the expected loss. The

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<sup>42</sup> In Norway, this is done by e.g. Export Finance Norway (Ekstfin).

<sup>43</sup> The guarantee scheme makes a profit when it does not incur a loss, but it can have a deficit in connection with market correction, crises, etc.

funds from this account – and no other grant funds from Sida – are used for payments if a guaranteed loan is defaulted.

### **Text box 3. Examples of Sida's use of development guarantees**

#### **1. Sida provides guarantees for social sustainability bonds sold to Swedish institutional investors**

Sida has issued a first loss guarantee of SEK 60 million to a GSS (green, social and sustainability) bond called Financing for Healthier Lives, in which two Swedish institutional investors – the occupational pension company Alecta and the insurance company Afa Insurance – placed a total of SEK 1.5 billion upon its issue in June 2021. Danske Bank, the capital manager responsAbility and Sida collaborated to make this possible.

The funds from the bond sale – SEK 1.5 billion – are invested in accordance with the UN SDGs, focusing on health and social development. They are lent to capital-constrained companies in low and middle-income countries in Africa, Latin America, and Central, South and Southeast Asia which operate in the sectors of health, WASH, climate-smart agriculture, clean and renewable energy, as well as financial inclusion for marginalised groups. The goal is to contribute to better health, living conditions and quality of life for people living in poverty. The selected companies' business models are characterised by their products and services having a measurable positive impact on society.

Sida's guarantee was essential to mobilise commercial capital. It reduces the investors' risk, covers the first credit losses and gives the GSS bond a credit risk that institutional investors can accept. Investors have the exact same required rate of return as for any other social investment. This is a strictly commercial proposition. The project will create benefits in developing countries and revenue streams for Swedish pension companies. The GSS bond is based on a framework for such bonds developed by Danske Bank. The framework has been verified by a third party and ensures that investors and Sida receive clear feedback regarding the benefit to society of the financed loans.

The close collaboration between the three partners – Sida, Danske Bank and impact investment fund manager responsAbility – represents a new approach to the design of a GSS bond which exploits their individual strengths. The Swedish government, through Sida, reduces the investors' risk by providing a partial guarantee for the portfolio and Danske Bank uses its position in the market to place the bonds. This means that it raises funds by selling the bonds to investors. responsAbility is responsible for choosing borrowers and negotiating loans, disbursing funds and managing the risk during the life of the bond. This structure thus catalyses the private sector's ability to invest and receive an attractive return, at the same time that the investment benefits society.

**2. Sida provided a guarantee (together with the USA) to the Middle East Investment Initiative (2013–2014) in Palestine:** guarantees catalysed bank loans to SMEs that had previously been precluded from receiving credit. During this project, Sida and the US DFI – OPIC – provided partial guarantees to local banks for their loans to microbusinesses and SMEs, most of which were run by women. The guarantees helped trigger loans to these types of business. In addition, the project trained bank staff how to perform credit assessments of this new customer group. The training was funded by the Norwegian Ministry of Foreign Affairs. As a result of the guarantees, the local banks' new experiences with this customer group and their training, the banks eventually established a practice of granting new loans to these customer groups as part of the banks' ordinary operations. Within a year, they no longer needed the guarantees to continue granting loans. The development cooperation project was assessed and found to be a major success. The combination of guarantees for the banks' loans and training was very effective.

86. Sida's guarantees are a strategic and cost-effective instrument that can be used in every sector within the framework of Sweden's development cooperation strategies. The current portfolio covers areas such as infrastructure, environment, development of markets, agriculture, health and democracy, and human rights. In bilateral development cooperation, guarantees are mainly used to mobilise increased lending to target groups with limited access to credit, including SMEs, female entrepreneurs and farmers. Sida provides TA in connection with the guarantees, e.g. for skills enhancement of bank employees, but has also indicated that it would like more TA with the guarantee schemes. Guarantees also target investment in renewable energy, energy efficiency, emissions reduction and projects that improve the environment. Guarantees are also used to address global challenges and to promote economic, social and climate-related/environmentally

sustainable development, as well as human rights and democratisation. Examples of Sida's use of guarantees to promote innovative financing and private capital mobilisation are provided in Text box 3.

**87. Effect of Sida's development guarantees.** Since Sida's guarantee scheme was launched in 2009, it has provided guarantees of a total of SEK 8.8 billion (outstanding guarantees) within a statutory guarantee limit of SEK 15 billion. These guarantees have mobilised almost SEK 24 billion in capital (i.e. which can be directly attributed to Sida's guarantee). In addition, the fact that Sida has provided a partial guarantee means that other donors (like the USA or Canada) in many cases have provided a supplementary partial guarantee. Overall, transactions based on Sida guarantees have mobilised a total of SEK 47 billion and are available for lending. During this period, the total loans in default (i.e. realised risk) where lenders have demanded repayment of the loan by Sida, have amounted to SEK 99 million. This means 1.2 per cent of the total volume guaranteed. On average, losses are covered by the accumulated premiums from guarantee recipients (e.g. local banks) and any development assistance subsidies for the premium, both of which have been deposited in a reserve account. With a total guarantee volume of close to SEK 9 billion, and at a cost of about SEK 330 million in development funds for subsidies for guarantee premiums and administration costs, Sida has helped make SEK 47 billion available for lending. This is 5 times more than the amount guaranteed and about 140 times more than Sida's total costs of SEK 330 million over 12 years. Furthermore, Sida has helped develop the market for new and large groups of borrowers that were previously precluded from receiving loans.

**88. Danish government development guarantees.** The Danish government recently launched a pilot scheme for 2022–2025 with government development guarantees as a separate instrument under the development cooperation. A guarantee limit of up to DKK 2 billion has been allocated which could mobilise up to DKK 3–4 billion in private capital for development purposes in poor countries during the pilot period – if fully exploited. The goal is to ensure that a large proportion of this is climate investments, e.g. though loans to SMEs, among others, and for investments in the transition to green energy. Examples of possible guarantee recipients during the pilot scheme: funds that lend money to suppliers of solar power to villages and households; local banks that facilitate loans to local SMEs for sustainable energy solutions, for example in energy efficiency; joint ventures with multilateral institutions with the objective of persuading institutional investors like pension funds and insurance companies to invest in developing countries, e.g. climate investments like solar and wind parks and water supply.

**89.** In principle, the Danish model for the development guarantees is similar to the Swedish scheme. The guarantee scheme will be implemented in collaboration with Sida. The main features of the pilot scheme are as follows: the scheme will be placed in a separate fund under IFU – a fund operated under principles different to those of IFU's own funds. This fund will not be included in IFU's balance and will be operated independently of IFU's other activities, and will not touch IFU's capital. In other words, decisions regarding guarantees issued by the fund will not affect IFU's return on capital. The guarantees must target development objectives and developing countries, and must not have a commercial purpose or be intended to promote exports. All of the costs incurred by IFU in connection with operation of the guarantee fund will be covered by premiums, but can be subsidised from the development cooperation budget when necessary, and IFU must not back the guarantees with equity in the event of loss. The Danish government will have sole responsibility for covering losses on guarantees issued. The government's financial risk associated with this scheme will be reviewed regularly when issuing new guarantees under the guarantee limit, and must be financed according to the government's principles for guarantees and re-loans.

**90.** In order to keep reserves available in the event of loss, the government will charge premiums set according to the risk and expected loss, and these will be placed in a loss provision account. The purpose is for the premiums and the losses on the guarantees to offset each other over time, so that the government does not incur a loss or make a profit. In cases where the guarantee recipient in a poor country cannot pay the full guarantee premium, it can be partly subsidised using development funds that are also deposited into the loss provision account. If the realised loss on guarantees exceeds the amount set aside in the loss provision account (corresponding to the expected loss), the government, as solely liable, will cover the excess in the

national budget.<sup>44</sup> Based on the issuing of guarantees of up to DKK 2 billion during the pilot period, the need for development assistance grants to cover subsidies for guarantee premiums is calculated at DKK 25–30 million per year.

91. Organisationally, the board of IFU will have overarching responsibility for issuing and supervising guarantees. Work is being done to structure implementation of the guarantees in IFU. There are plans to appoint a guarantee committee composed of staff from IFU and the Ministry of Foreign Affairs of Denmark which will assess and recommend project proposals to the board with a view to ensuring that the guarantees have a targeted and strategic focus in accordance with the development policy objective. There may be some form of guarantee secretariat in IFU that is financed through development funds and guarantee premiums. In principle, the guarantees will be designed in close collaboration with Sida, including developing guarantee projects, risk calculations and issuing joint guarantees.

92. The guarantee scheme will be evaluated before the end of the pilot scheme and preliminary findings will be presented, including mobilisation of private capital, expected development results, risk and management. The scheme may then be adapted and developed accordingly.

### **Guarantee schemes from specialist organisations**

93. There are also many examples of guarantees provided by specialist organisations supported by development funds, including organisations like GuarantCo, Frontclear and the AGF.

(i). One such guarantee was issued by GuarantCo to the Ghanaian company Quantum Terminal.

94. A group of governmental donors established GuarantCo in 2005 with capital from development funds. This capital gives the organisation the financial backbone to guarantee loans. It specialises in catalysing investment in infrastructure projects in developing countries through securities issued in local currency and in developing local capital markets with the guarantees.

95. In 2018, GuarantCo provided a guarantee to the company Quantum Terminals (QTL), a local fuel and energy infrastructure developer in Ghana which plays a key role in supporting Ghana's objective to give half of the population access to liquefied petroleum gas (LPG). GuarantCo provided a partial (75 per cent) guarantee for a loan taken out by Quantum Terminals to expand its operations. The loan took the form of a corporate bond in local currency worth USD 10 million. The guarantee considerably reduced the credit risk on the bond, which was subsequently fully subscribed by local institutional investors. The corporate bond was later listed on both the Ghana Stock Exchange and the London Stock Exchange. This is the first corporate bond from Ghana to be listed on the London Stock Exchange. This may make it easier for other African companies to raise capital on international stock exchanges.

96. This example provides useful knowledge. Guarantees can help reduce local currency risk for projects, mobilise private investors and develop local capital markets. The use of specialist organisations which offer blended finance instruments, like GuarantCo does with guarantees, means that the donors that have financed the organisation can have a greater impact and reach a broader range of private investors. It will nonetheless take time and require repeated similar transactions before investors in international capital markets feel more confident about investing in financial instruments issued in local currency from African countries.

(ii). The AGF<sup>45</sup> was established using government development funds from Denmark (Danida), Spain and France, in addition to the AfDB, the Nordic Development Fund, IFU and German KfW. The AGF's mandate

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<sup>44</sup> Theoretically, there may be a period where the expected loss is greater than paid, accumulated guarantee premiums and development cooperation subsidies, theoretically, a temporary negative 'net reserve'. The Swedish net reserve has never been negative, however, should the net reserve become negative, there is a line of credit from the government linked to the reserve that will offset the reserve against the expected loss. The line of credit will be repaid as the net reserve balances. The government will only incur a loss if the scheme is shut down while the net reserve is negative. The government will make a profit if the scheme results in a positive reserve.

<sup>45</sup> Source: Africa Guarantee Fund annual report 2019.

is to facilitate access to funding for SMEs in Africa. It has been awarded an AA rating, which means that its guarantees can mobilise additional credit. For example, a guarantee provided to a local bank which guarantees loans to local SMEs will allow the bank to expand its lending volume and grant loans to more borrowers. The AGF provides several types of guarantees and also supplements this in a number of cases with capacity building.

97. At the end of 2019, the AGF had issued a total of USD 1.1 billion in guarantees to 161 partner finance institutions in 40 African nations. A total of USD 1.7 billion in loans was accordingly disbursed to about 21 000 SMEs, which normally would have been denied credit. It is estimated that the enterprises' investments have generated about USD 4 billion in extra revenues.

98. Since its establishment, the unpaid volume of loans guaranteed by the AGF has been USD 12.9 billion. This is less than 2 per cent, compared with the volume guaranteed. This means that the actual risk of default has been low. Over 60 per cent of the loans granted by collaborating finance institutions were for less than USD 31 000, and went to SMEs in agriculture, education, health and commerce. Among the enterprises supported by AGF, 30 per cent are owned or led by women. At the end of 2019, it was estimated that about 130 000 workplaces had been established in SMEs as a result of loans triggered by AGF guarantees. There can also be ripple effects in the local economy which create many more workplaces.

### **Guarantees in general**

99. While guarantees are effective for mobilising investment in developing countries, the scope of guarantees is limited by several factors. First, a government that issues a guarantee is limited by the maximum guarantee limit that has been set aside, and a specialised guarantor is limited by the size of its capital base, which in turn depends on how much the guarantor can provide in guarantees. Second, since the guarantor in the longer term must raise more funds from premiums to offset expected disbursements (e.g. due to losses on loans that trigger guarantees), it is often too expensive for recipients in developing countries if the premium is not subsidised. While some guarantees become self-funding in that the recipient pays the full premium itself, there are also many cases where part of the premium for a recipient in a developing country is subsidised through development funds, e.g. from Sida. A third limitation is often a lack of 'guaranteeable' projects.

100. In Norwegian ODA, it is therefore possible to collaborate with aid agencies with government guarantees, as well as specialised guarantors. The first limitation can be addressed using grants to cover a first loss provision associated with the guarantee. This reduces the capital exposure for the guarantor. In addition, a grant in the form of a capital contribution to a specialised guarantor allows the guarantor to expand its guarantee volume. For example, a USD 1 million capital contribution to the AGF allows it to issue USD 4 billion in new guarantees. The second limitation can be addressed using grants to subsidise the user's guarantee premium. Measures must be taken to ensure that the benefit reaches the end-user, e.g. the business that receives a loan from the bank. The third limitation can be addressed through grants for early-stage project development and TA to improve the risk-return profile. Furthermore, since the guarantors often provide TA associated with their guarantee programmes, they need co-financing from other donors to increase the scope of such assistance.

### **Raising capital and selling securities on a stock exchange**

101. The backdrop to these four structures for mobilising capital on a large scale is that, today, developing countries cannot sell debt instruments and equity instruments on international stock exchanges. Since the markets are not yet equipped to handle this, the funds in these structures are taking action to allow private investors to place their investment capital directly in the fund. If markets can be developed so that securities from investments in developing countries can actually be sold on international stock exchanges and thus have a second-hand market, this would be a ground-breaking step in terms of giving developing countries

access to international capital.<sup>46</sup> The British FCDO has taken the initiative to such an approach - a fifth option - through its MOBILIST programme.

### **UK MOBILIST programme:**

#### **Build a market on the stock exchange for large-scale capital mobilisation for developing countries<sup>47</sup>**

102. The International Conference on Financing for Development in 2015 in Addis Ababa encouraged donor countries to increase their collaboration with the financial markets and the large international financial centres. In 2020, the British FCDO established the MOBILIST programme with over NOK 900 million in funding. The programme supports development of new investment products (e.g. infrastructure projects) in developing countries, and the objective is to list them on international and local stock exchanges<sup>48</sup>, and to bring in large investors, like pension funds and other institutional investors, to help close the financing gap for the SDGs.

103. The programme works with financial services companies in the City of London and in a number of developing countries. The objective is (1) to mobilise capital for developing countries by engaging financial institutions in investment in sustainable infrastructure which can be listed on public stock exchanges, either the London Stock Exchange and/or local stock exchanges; and (2) to show the markets that this is possible. Listing, and its associated pricing, starts a 'price discovery' process which is important to investors in general. This and the demonstration effect are important for building markets for such investment products.

104. The benefit of listed securities is that both institutional and private investors prefer this investment structure, partly because of the protection public markets offer investors. Listed securities (which consist of shares and interest products, like bonds) account for more than 90 per cent of most large institutional portfolios, which represent at least USD 80 trillion in assets under management. Listed securities dominate in products for institutional and private customers.

105. The 5-year MOBILIST programme aims to catalyse listing on the large stock exchanges in public markets with up to 5 investment products which focus on developing countries. MOBILIST will identify relevant products for investment by FCDO, leading to listing.

106. The programme has 3 components:

- (i) an investment platform which focuses on equity products (FCDO funds: GBP 76 million);
- (ii) a policy and TA platform (FCDO funds: GBP 6 million);
- (iii) research/analysis, including monitoring and evaluation (FCDO funds: GBP 3.5 million).

FCDO can expand these operations if further development funds are provided, e.g. for component (ii) or (iii)

107. The objective is to take a big step forward in both the method for and in the scope of mobilisation of private capital for developing countries. This will be achieved by demonstrating that new models for financial intermediation using the aforementioned 'price discovery' may begin to attract new investors and capital to developing countries.

108. The challenge that will be addressed: the programme will remedy the lack of clear price and risk signals, which is an obstacle to effective investment assessments. The portfolio of investment products will begin to build the necessary economic architecture to move institutional capital from international financial centres to developing countries where the financing gap and needs are greatest.

109. The MOBILIST approach may create opportunities for investors to choose what development effect they want from their capital and in which country they want to place it, and thus create new channels for financing the investment needed to achieve the SDGs.

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<sup>46</sup> The liquidity of such securities will increase considerably and the risk premiums will eventually drop.

<sup>47</sup> Source: FCDO, UK: MOBILIST Business case, December 2019.

<sup>48</sup> Listing is the first public sale of shares issued by a company.

110. MOBILIST announced its first competition in the spring of 2021, to a very good response from the market. Thirty-one proposals were received from project developers (on large commercial projects) in sub-Saharan Africa, internationally renowned fund managers, international banks and DFIs. No proposals were submitted by Nordic institutions.

111. FCDO stresses that greater reform of DFIs and their experience with mobilisation of private capital is increasingly important. A number of players feel that the 'buy and hold strategy' of DFIs displaces private capital, and that this is a competing model. MOBILIST provides an opportunity to reshape this as a distribution model by allowing (also) DFIs and MDBs to inject funds during the development stage of its investment products, bring the investment products to market (i.e. for listing and sale on the stock exchange) and to create a completely new market. In other words, MOBILIST allows exit mobilisation for DFIs and MDBs. This means that, in the long term, they can sell the shares and spend the funds released on new investments. This is important to these financial institutions and allows them to help mobilise and build a new market.

112. MOBILIST is a pioneering initiative lauded by the OECD<sup>49</sup> as a good example of an innovative approach to mobilising private capital for SDG investments in developing countries. At present, there are very few such products for investors on the stock exchanges. For example, if an investor were to approach the world's largest capital manager, Blackrock, which manages USD 8.67 trillion, Blackrock would struggle to offer an Africa-related product which is clearly linked to the SDGs.

113. Aid agencies can, for example, finance more TA in the MOBILIST programme. This will increase the probability of successful stock exchange listings, sales to institutional investors and market building.

## II.b Other relevant blended finance instruments

114. The previous section looked at blended finance structures and measures that are particularly well suited to mobilising capital on a very large scale, but which also require a major, and probably coordinated, effort from several donors. This section covers other effective blended finance options which are used often by aid agencies.

### II.b.1 Bonds

115. Bonds are an alternative source of funding and the term encompasses corporate bonds and government bonds. Developing countries have limited access to international capital compared with higher income countries, but they have to some extent been able to issue bonds: Convergence's blended finance database shows that companies and authorities in countries in sub-Saharan Africa and Southern Asia have lent a total of USD 4 billion during the past 5 years by issuing bonds.<sup>50</sup> The list only shows bonds with funding from blended finance, and does not include government bonds that are issued on market terms.

116. An important aspect of bonds is that they are well suited to mobilising capital when the funds are earmarked for a specific purpose, like the environment, nature-based solutions, women's economic empowerment, etc. These are called theme bonds. Established financial markets in higher income countries have shown much greater interest in recent years in investing in bonds that focus on climate, environmental, and social sustainability measures. There is reason to believe that, over time, this trend can spread to similar investments in developing countries, as there is a large overlap between development-oriented and sustainability-oriented investments in these countries.

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<sup>49</sup> <https://www.ipe.com/reports/oecd-plans-to-mobilise-institutional-capital/10052380.article>

<sup>50</sup> To reduce the risk for private investors,  $\frac{3}{4}$  of these were supported by guarantees and  $\frac{1}{4}$  by concessional capital.



117. During the past decade, there has been enormous international growth in the sustainable debt market,<sup>51</sup> which covers 'green and blue bonds', social bonds and sustainability bonds, also known as GSS bonds.

118. The sustainable debt market reached a total of over USD 1.7 trillion at the end of 2020 – a 70 per cent increase from the year before.<sup>52</sup> Almost 10 000 sustainability bonds have been issued since 2006. While green bonds have become increasingly popular for over 10 years, social bonds and sustainability bonds are newer instruments.

119. USD 700 billion in sustainability bonds were issued in 2020, almost twice the figure for 2019, despite the pandemic. In 2020, new green bonds were worth USD 290 billion, and new sustainability bonds were worth USD 160 billion. This was 2.3 times as much as in 2019. In the financial markets, social bonds exploded in 2020, with the issuing of USD 249 billion in new bonds, representing a more than 10-fold increase year-on-year. The Nordic countries have achieved great success in recent years, developing a Nordic market for sustainability bonds, and they have secured a leading place in sustainability financing. The Nordic countries represent 5 per cent of the global sustainability bond market. This is high in relation to the Nordic region's total GDP, which is less than 2 per cent of the global GDP. Three Nordic countries – Sweden, Denmark and Norway – are on the 'top 20' list of green bonds.<sup>53</sup>

120. Most theme bonds have focused on high-income countries so far, but some have been placed in developing countries. These investment instruments offer great potential for mobilising more financing in developing countries that targets the SDGs. See Text box 3 regarding the successful issue of a NOK 1.5 billion social bond in May 2021 which targeted developing countries with support from Sida, and which was acquired by Swedish institutional investors. The same is possible in a Norwegian context.

121. There is a need for standardisation to ensure that money is being spent on the specified sustainability purposes.<sup>54</sup> Some of these bond types already meet international standards,<sup>55</sup> while more work needs to be done on others, including harmonising standards for different geographical regions. The EU has established a 'green bond standard' to help define green bonds. In collaboration with international financial players, the UNDP has drafted proposals for such investment standards in some areas. The OECD adopted these 'SDG Impact Standards' for investments,<sup>56</sup> and launched them in the spring of 2021. The work of establishing international standards for certain types of bonds and other types of investments is ongoing. This is an area where development finance can contribute to the development of such standards and establish a consensus.

122. In order for the bond markets to grow, a greater range of investible projects and more private sector cooperation are needed. Development cooperation can provide early-stage support here for the planning and development of new projects.

123. Although the long-term goal is for a permanent market to be established for sustainability bonds in developing countries, this is still a long way off. In the process of achieving this, many planned bonds in developing countries will need support from development cooperation in order to make them available for sale in financial markets. This could include support to cover the costs of monitoring the objective and the effects of the activities that the borrowed capital is spent on. One example of such support is Singapore's

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<sup>51</sup> Green bonds: financing for climate and environmental projects. Blue bonds: financing and implementation of the SDGs related to the oceans and marine resources, and the transition to a sustainable ocean economy (blue economy). Social bonds: raising funds for projects with a positive social impact, often targeting a specific group. For example: (1) reasonable costs for access to clean drinking water, sewerage/sanitation, transport, energy, education and vocational training, health services, financing and financial services and housing; (2) increased job creation and economic development, e.g. as a result of SME financing and microfinancing; (3) food security and sustainable systems for food production.

<sup>52</sup> Climate Bonds Initiative Global State of the Market 2020 Report.

<sup>53</sup> Nordic State of the Market, Second report, 'The Nordic Sustainable Debt Report', April 2021.

<sup>54</sup> Donors are not the only players that want to ensure that funds are spent on sustainability. This has been a factor for a constantly growing proportion of private investors, partly with a view to enhancing their reputations.

<sup>55</sup> Such standards must cover a wide scope of criteria which are measured: reporting, transparency, access, etc.

<sup>56</sup> Norad entered into a grant agreement for this initiative in 2019. The agreement covers the period 2019–2022.

launch in January 2021 of the ‘Sustainable Bond Grant Scheme’, an international open grant scheme to support the development of bond markets, including the drafting of standards.

124. Over time, knowledge of and confidence in these instruments will also increase in the financial markets in developing countries. Helping to develop this type of market is an important aspect of the development cooperation.

The following are examples of how the development cooperation has contributed to successful entry into financial markets.

### **Seychelles Blue Bond**

125. The Seychelles authorities issued the world’s first ‘blue bond’ (Seychelles Blue Bond) in 2018 with assistance from the World Bank. The bond raised USD 15 million in capital from private institutional investors for projects in marine protection and fisheries. The projects are a collaboration with the World Bank, which manages them together with local authorities.

126. The 10-year bond was the first bond earmarked for marine protection. In arranging the bond, the Seychelles had to address a number of problems, including managing risks associated with the country’s BB credit rating. Two risk mitigation instruments were used to attract private investor capital: a partial World Bank guarantee of USD 5 million, and a concessional loan from the Global Environment Fund (GEF) of USD 5 million, which partly subsidises the bond’s interest payments. Development aid from a private foundation covered most of the transaction costs for the bond. The World Bank provided TA for the bond issue and integration with the marine projects.

127. Although the capital raised was not high for capital markets, the bond illustrates how decision-makers can work with aid agencies and private institutional investors to bring innovative environmental bonds to market. As the first bond of its kind, the Seychelles Blue Bond can serve as a model for other small island states facing similar challenges.

### **The AfDB Social Bond Program<sup>57</sup>**

128. In April 2020, AfDB issued two social bonds in connection with COVID-19. The social bonds were quickly bought up by institutional investors. One of them was launched on the London Stock Exchange, with a value of USD 3.1 billion. The other was aimed directly at Scandinavian institutional investors and had a nominal value of SEK 2.5 billion. The money is directed towards lending for social projects aimed at reducing poverty and creating jobs, and which help to manage and counteract the social and economic repercussions of COVID-19 for households and SMEs.

129. In April 2021, AfDB issued and sold a social bond with a value of NOK 1 billion, primarily aimed at Norwegian institutional investors. The sale of these three bonds to institutional investors was made possible by the AfDB’s high credit rating (AAA).

130. As a result of the COVID-19 pandemic, there has been an almost explosive growth in the issue of social bonds. Although progress has been made in selling social bonds for developing countries to institutional investors, either a high credit rating from bond issuers, such as in the AfDB examples, or contributions from donors in blended finance structures such as grants, a first loss facility, guarantees or TA will be needed in the foreseeable future.

### **Africa Local Currency Bonds**

131. These are described in the next section on bond issuance supported by the Africa Local Currency Bonds Fund.

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<sup>57</sup> Source: [Social Bond Program | African Development Bank - Building today, a better Africa tomorrow \(afdb.org\)](#)

### III. Instruments that protect borrowers in developing countries from currency risk

132. Over 90 per cent of foreign loans to low- and lower-middle-income countries, both to the private and public sector, are denominated in foreign currency.<sup>58</sup> Since the borrowers' income is in the local currency and the debt obligations are in a foreign currency, there is a currency mismatch, where the borrowers run a significant risk if the local currency depreciates. The consequences for borrowers vary from bad to catastrophic. There may be bankruptcy, job losses, an economic downturn, an increase in defaulted loans, reductions in investment flows and a financial crisis.<sup>59</sup> While borrowers ought to borrow in local currency, local currency loans may not be available or only available at sky-high interest rates. In the absence of alternatives, local borrowers are forced to bear the risk without any hedging against fluctuations in the exchange rate. For example, MDBs, other international financial institutions and DFIs are unwilling or unable to provide financing with an open currency risk, even with a risk premium. Consequently, such institutions almost always provide foreign currency loans, and vulnerable borrowers all too often bear the currency risk.

133. The European Commission, the OECD, EDFI, Convergence and TXC all stress<sup>60</sup> that currency risk is a significant obstacle to sustainable development in developing countries. This risk limits sustainable financing to agriculture, SMEs, infrastructure, energy and other sectors that are vital to achieving the SDGs. The UN's Agenda for Sustainable Development and the Addis Ababa Action Agenda on financing for development (2015) both highlight the importance of blended finance for reducing currency risk in developing countries in order to achieve long-term sustainability, including:

- (i) to reduce the proportion of loans from abroad where the borrower bears the unhedged currency risk; and
- (ii) to increase financial intermediation in local currency in domestic financial and capital markets.

134. In the long run, the authorities in developing countries can solve the problem by developing national financial markets for local currency loans by introducing appropriate reforms and regulations and strengthening institutions. However, achieving this is proving to be a long-term process in most developing countries. In the meantime, there is a need to ensure that the currency risk is managed correctly and not transferred to the most vulnerable borrowers. A set of donor-supported instruments and facilities are in place to help protect borrowers from such currency risks.

Examples and results:

#### 'The Currency Exchange Fund' (TCX) protects against exchange rate fluctuations<sup>61</sup>

135. TCX is a development finance initiative where the fund's shareholders consist of a group of donor countries and a wide range of DFIs and lenders. The fund offers solutions in the form of financial instruments<sup>62</sup> that protect the user from currency risks in developing countries. These solutions enable TCX's investors and clients (e.g. banks, MDBs and DFIs) to provide borrowers in developing countries with

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<sup>58</sup> 'The Need to Reduce FX Risk in Developing Countries by Scaling Blended Finance Solutions', by the European Commission, the OECD, EDFI (European Development Finance Institutions), Convergence and TXC, 2017.

<sup>59</sup> For example, the Asia crisis that erupted in Thailand in July 1997 and spread to large parts of Asia was due to the fact that the private sector in these countries, which had had a stable exchange rate against the USD for 15–20 years, had high debt denominated in USD due to the low dollar interest rate, and when the local currency fell against the dollar (e.g. in Thailand from 25 THB/USD to 35 in a few days) many companies went bankrupt and a financial crisis ensued.

<sup>60</sup> 'The Need to Reduce FX Risk in Developing Countries by Scaling Blended Finance Solutions', by the European Commission, the OECD, EDFI, Convergence and TXC, 2017

<sup>61</sup> Sources: TCX annual reports 2019, 2020; TCX Impact Report 2020.

<sup>62</sup> Financial instruments such as currency swaps and futures contracts. In a currency swap a player sells, for example, NOK against foreign currency at the current exchange rate and at the same time enters into an agreement known as a futures contract to buy the NOK amount back at a specific, future date at a rate determined at the time of entering into the agreement. Source: Store Norske Leksikon.

financing in their own currency, while transferring the currency risk to TCX. Borrowers are therefore protected against exchange rate fluctuations.

136. TCX brings added value to users through its capacity to absorb the currency risk arising from the hedging they provide for market players. TCX does not need a functioning local market to be financially sustainable. The risk model is based on the effect of portfolio diversification where the currency risk is spread and absorbed across all regions. On average, the high interest rates in developing countries compensate for the depreciating trend in these currencies, which means that TCX has been moderately profitable since it was established in 2007 with a capital of USD 700 million.

137. As of 2018, TCX has hedged currency exposure to a value of more than USD 6 billion in more than 60 developing countries, where the loans have been converted into local currency and protected against exchange rate fluctuations. Microfinance institutions and SMEs in particular have benefited from such loans. Several million in loans has been granted to local businesses and households. Three currency crises in developing countries have been absorbed through the fund's activities, and 2 300 currency hedging transactions have been completed. In addition, by offering hedging products where there were previously no markets, TCX has operated as a 'market builder' and encouraged other participants to enter markets in a number of developing countries.

138. The scope of TCX's activities to support developing countries is limited by how much capital the donor countries have invested in the organisation. With regard to development assistance in the form of regular grants, there are several areas and programmes where TCX can expand its activities, e.g. within TA/capacity building and subsidies of risk premiums on interest rates and currency.

### Africa Local Currency Bonds Fund provides long-term financing in local currency<sup>63</sup>

139. The Africa Local Currency Bonds Fund is a blended finance instrument that focuses on local currency bonds in African countries. It was developed in 2012 by the German bank KfW, which has since raised capital from various aid agencies and development and impact investors. The fund improves local investors' access to long-term financing by strengthening and improving underdeveloped bond markets in the local currency. The fund acts as an anchor investor and provides TA for arranging bond issues in the local currency. These bonds are issued by financial institutions and businesses in sectors such as finance, agriculture, housing, education and renewable energy. The fund uses hedging mechanisms to reduce the currency and interest rate risks. KfW has outsourced the management of the fund to a professional fund manager.

140. The fund has its own TA facility to ensure that well-structured bond agreements enter the market. The TA it provides is on a cost-sharing basis and covers a number of areas related to bond structuring and pre-issue approval. The TA reduces the bond issuer's costs of raising capital, which stimulates further growth in local capital markets.

141. At the start of 2020, the fund had made 66 investments in 18 countries by providing both capital and TA for the bonds being bought up in the market. For every dollar it invested, the fund had mobilised over nine times as much private capital from co-investors on average. This corresponds to USD 1.2 billion from over 3000 local co-investors since start-up. The capital that financial institutions raise through the bonds is loaned to projects in which:

- 21 per cent of borrowers are from rural areas, particularly in connection with agriculture
- 43 per cent are women
- 1.3 million tonnes of carbon emissions have been avoided

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<sup>63</sup> Source: Africa Local Currency Bonds Fund annual reports 2019, 2020; ALCB Fund impact report 2020.

By securing the bonds in local currency, the fund has stimulated and supported a number of innovative transactions. Below are some examples of areas the fund supported in 2019:

- the first green bond issued by an infrastructure company in Nigeria (NS Power);
- the first green bond for the financial sector in South Africa (Nedbank);
- the first bond issued by a regional bank in the CEMAC region (OraBank);
- the first diaspora bond in the WAEMU region (Banque de l'Habitat du Sénégal).

With support from the development cooperation, the fund can expand its activity by improving access to local currency loans in African countries.

#### IV. Support for preparing and making investments – capacity building and design support

142. Capacity building/TA is one of several development cooperation instruments that can accelerate commercial sustainability and strengthen the development effect for projects and businesses in developing countries. It is a versatile instrument that can be effective in managing risks and ensuring commercial sustainability in blended finance transactions. It can reduce high transaction costs associated with investments in developing countries, address technical uncertainty and strengthen the supply line of new, promising businesses in which funds can invest. Building capacity in government institutions and businesses can also help improve local framework conditions for business and strengthen markets in developing countries. Capacity building is particularly useful and often necessary in combined blended finance transactions in low-income countries and LDCs.

143. Capacity building is particularly relevant for businesses that are either fairly new, not yet sufficiently robust or are experiencing rapid growth, especially in countries and markets with challenging framework conditions. Increased capacity and greater expertise will help the transition to commercial sustainability and increase the likelihood of good development outcomes. In investment funds that invest in such promising businesses and where the fund manager can only provide limited capacity building financed by the fund's management fee, the need for capacity building will often be greater than what can be covered by the standard fund management fee. Aid-financed capacity building is therefore a very useful supplement to the blended finance structure.

144. Empirical data in the Convergence database shows that financing capacity building as a component of blended finance transactions, in addition to other risk mitigation measures, is a widespread practice in the development cooperation. Convergence has found that as at May 2021, there were 133 aid-financed TA facilities in the set of blended finance transactions (a total of 424) to developing countries that have also received aid-financed concessional capital contributions. These TA facilities are operated on the arm's length principle in respect of the investment fund. For example, an investment fund may apply to the TA fund for assistance for SMEs that need it, e.g. businesses in the early growth stage. Another example is an independent, aid-financed TA fund in which a number of investment funds can apply for funds to set up their own TA facilities, in line with the arm's length principle.

145. TA has been part of the blended finance in low-income countries in particular, forming part of more than half of all blended finance transactions targeting low-income countries. It is also worth noting that the database only includes blended finance transactions with capital investment, and that there are also many other aid-financed TA facilities aimed at the same business purpose in developing countries.

146. TA has been included in these blended finance transactions primarily to:

- (i) develop the supply line of bankable projects in the pre-investment stage;
- (ii) strengthen the development effect of the project after investment, i.e. in the execution of the project;
- (iii) subsidise project/investment costs;
- (iv) improve the framework conditions for local business.

147. About half of the TA facilities in blended finance transactions have included support after investment, often to integrate principles and reporting according to standards for ESG and sustainability, or for capacity building and training for more efficient operations. In the pre-investment stage, TA has accounted for around a third of the measures to date, but it is important to develop the supply line of projects that are ripe for investment, especially where the risk is higher, e.g. in LDCs and sectors such as health. The rest of the TA has been aimed at reducing project and investment costs to make the projects feasible and commercially viable. This includes feasibility studies, project preparation, project administration and legal costs.

148. It is worth noting that as more capital becomes available for blended finance transactions in low-income countries and in sectors with a large social development effect, such as health and education, more TA will probably be needed in the future in the pre-investment stage in order to strengthen and expand the supply line of bankable projects.

149. There is also often a need for support for the design and development of the blended finance transaction itself. Grants to finance the design are different from TA, as they are specifically aimed at providing support at an early stage to a team that designs and structures the transaction. Thirty per cent of blended finance transactions for sub-Saharan Africa and South Asia have design stage grants.

150. Financing at the design stage supports blended finance transactions that may otherwise be too risky or complex to carry out, by funding activities such as i) feasibility studies (for example, to assess the commercial viability of the project associated with the transaction), or ii) proof of the concept (for example, to complete the design and structuring of activities in order to initiate a transaction).

## V. What blended finance is currently used in Norway's development cooperation?

To date, blended finance has only been used to a limited extent in ODA. A preliminary survey shows that this has been in two main areas: 1. Renewable energy and energy efficiency, and 2. Business development.

**Within renewable energy and energy efficiency**, Norway has contributed concessional capital to the Global Energy Efficiency and Renewable Energy Fund (GEEREF). GEEREF is a fund of investment funds in which Norway injected concessional capital together with the EU and Germany (a total of EUR 112 million) when the fund was launched in 2008. The fund mobilises private capital for investments in underlying, private equity funds with projects in renewable energy and energy efficiency in developing countries. GEEREF is a fund of funds corresponding to blended finance structure 3 described above, where development finance has been used for concessional, long-term/patient capital to mitigate risk for private equity investors and for dedicated TA funds linked to project investments. The total public, concessional capital of EUR 112 million has mobilised EUR 110 million from private investors directly to the funds. In addition, the investment funds are mobilising additional private capital for the individual investment projects on the ground in developing countries. It is estimated that over EUR 10 billion of GEEREF's assets under management, which total EUR 222 million, can be mobilised through the funds in which it invests and through the final projects in developing countries in which these funds invest (*source: <https://geeref.com/>*). GEEREF is set to achieve excellent results, and the public funding will be repaid to Norway in the near future without a loss.

Norad has recently established a guarantee scheme for renewable energy investments in developing countries corresponding to blended finance structure 4. Norad has entered into agreements with two international guarantee institutions – MIGA and African Trade Insurance (ATI) – where Norad provides an annual grant. The increased capital in these guarantee institutions will help to (i) trigger further commercial, sustainable renewable energy investments through support for relatively small projects and in doing so close the gaps in the international guarantee arena, and (ii) increase the institutions' guarantee capacity and help enable Norwegian and international renewable players to gain better access to guarantees. Norad has been able to provide support for guarantee instruments for renewable energy based on proposed resolution X.10 (Proposition to the Storting 1S, 2021–2022). In addition, Norad provides a subsidy for guarantee premiums

for renewable energy investments through its business support scheme, especially in demanding markets where premiums can be very pricey due to the perceived high risk.

**In business development**, Norad has been providing blended finance support to UNCDF's SDG500 fund and to the Equity Foundation/Equity Bank in Kenya since 2020. SDG500 is a fund of investment funds corresponding to blended finance structure 3. Norad has provided grants to one of the six underlying investment funds – the BUILD fund. This fund is aimed at investments in SMEs in developing countries. Norad's support has gone to a first loss facility and to dedicated TA in the fund. The concessional capital in SDG500 has mobilised three times as much private capital, bringing the total capital managed by the fund to USD 500 million.

Norad has also provided blended finance support to the Equity Foundation/Equity Bank in Kenya through the scheme for strategic partnerships with the business community. Some of this support has been in the form of grant funding for a first loss facility associated with the portfolio of loans that Equity Bank provides to farmers and SMEs, i.e. blended finance structure 1. In addition, Norad has provided grants for TA that the Equity Foundation has given to the recipients of the loans.

Both measures aim to mobilise significantly more financing for SMEs in developing countries. Norad has been able to provide support for these measures in business development based on proposed resolution X.11 (Proposition to the Storting 1S, 2021–2022).

In addition to these blended finance measures within business development, Norad has also provided early-stage support through the business support scheme in which grants are given to individual projects based on announced competitions. The grants have enabled some cost savings for individual companies' project development in the initial stages, but these have been relatively moderate, at an average of just under NOK 1 million in 2018–2019. The mobilisation effect of the grants has been mixed, but the scheme has been an effective tool for triggering commercial investment in renewable energy projects in particular.

## Chapter 4

### Blended finance in Norwegian ODA – proposal

151. This chapter proposes new and improved instruments that can be used in Norwegian ODA for blended finance. It also sets out how such instruments can be applied to new flagship programmes in which Norwegian development funds mobilise significant amounts of private capital, preferably from institutional investors. The chapter shows how both Norad and Norfund play key roles in their respective areas and highlights the possibilities for an effective collaboration where they can provide complementary measures and play to each other's strengths. In a coordinated collaboration in blended finance transactions, Norfund and Norad can create win-win situations that make it attractive for Norwegian institutional investors to contribute commercial capital in the proposed transactions, typically larger funds. It is therefore also important to have a dialogue with Norwegian (and other Nordic) institutional investors about investment opportunities. Norway can play a big part in mobilising private investment in developing countries. In order to realise this, it is essential to establish a cohesive and coordinated partnership in Norway, both in the private and public sector, and especially a close and good collaboration between Norad and Norfund.

#### I. Existing and proposed instruments for blended finance

152. **Grants for first loss facilities:** As mentioned in Chapter 3, Norad is already able to provide partial risk reduction through grants for loss provisions on loans and guarantees on the basis of proposed resolution X.11 in Proposition to the Storting 1S, 2021–2022. The decision reads as follows: *‘Grants under Chapter 162 Business development, agriculture and renewable energy, item 70 Business development and trade, can be paid as a provision for losses on lending or guarantee instruments for the grant recipient.’* As things currently stand, the usefulness of this decision is limited by the set of capital instruments it covers and by the funds allocated for this one item in the national budget. The suggested solution is to: (i) also include equity instruments in the decision, (ii) extend the decision to cover all chapters under Programme Area 03 International Development Cooperation, and (iii) revise all relevant scheme regulations related to these budget chapters to enable co-financing with the private sector. These measures will pave the way for potential blended finance in the mobilisation of private investments in all areas and the SDGs listed in Table 1 and Figure 3.

153. **Guarantees - proposal for support measures:** Although the use of grants for first loss facilities associated with funds can mitigate risk and mobilise private capital, **development guarantees** are an even more effective instrument as these do not require funds to be paid out before losses are realised and, as other countries have experienced with development guarantee schemes, they can be largely self-financing. If the risk event covered by the guarantee never occurs, no payout will be made on the guarantee and the guarantee limit can be applied to new projects, loan portfolios, etc. Guarantees are a good mobilisation tool in the short and long term: in the short term the guarantee mobilises an investor (e.g. a local bank and its lending) to undertake SDG-oriented investments it would not otherwise make, and in the long term the guarantee demonstrates to the investor that the risk was less than what they originally envisaged: the investor will then often make new investments without the need for a guarantee.

154. Several donor countries have very positive experiences from development guarantees. As mentioned, over the last twelve years, Sida has mobilised NOK 47 billion for lending to businesses in developing countries at a cost to the national budget of NOK 330 million, i.e. mobilisation of new loans that is 140 times greater than Sida's total cost. Sida has also helped develop the market in developing countries for new and large borrower groups that were previously precluded from obtaining loans. The risk for the Swedish government has been moderate: out of guarantees totalling NOK 8.8 billion over twelve years, losses charged to the guarantees have been 1.2 per cent (NOK 99 million). These losses are typically fully covered through guarantee premiums paid to the loss provision fund. Even if, in a hypothetical worst-case scenario, there were insufficient funds in the loss provision account to fully cover the losses, the uncovered portion



would only be small (due to accumulated payments of guarantee premiums), and the cost risk for the Swedish state would therefore remain moderate.

155. For a donor country, e.g. Norway, the cost and risk of burden on the national budget can be controlled within set moderate parameters. Denmark recently decided to initiate a pilot scheme for development guarantees in 2022, and Canada introduced a scheme for development guarantees a couple of years ago. It is proposed that Norway also launches a pilot scheme for development guarantees similar to that of the Danish (and Swedish) models.<sup>64</sup> It is further proposed that discussions take place with Sida about the practical design of the guarantee scheme and a ‘Norad TA fund’ linked to this scheme in line with Sida’s positive experiences. The guarantees can then be used as an effective tool in blended finance programmes where, for example, Norwegian institutional investors can participate, e.g. in funds or bonds aimed at achieving the SDGs in developing countries. More details of this are given in the next section.

#### **156. Other subsidiary measures related to development guarantees**

- a. Norad can enter into cooperation agreements with, for example, Sida and the AGF<sup>65</sup> to (i) provide grant funding for first loss provisions linked to their guarantees, e.g. to a specific programme or loan portfolio, (ii) provide grant funding to subsidise the guarantee premium where the benefit filters through to the end user (borrower), and (iii) provide grant funding to co-finance TA associated with their guarantee programmes.
- b. Making a capital contribution to a guarantor that specialises in developing countries will also make for effective use of development funds at ministry level. Such capital contributions to, for example, the AGF, can be assessed by the Norwegian Ministry of Foreign Affairs.

## **II: Proposal for flagship programme that uses suggested blended finance instruments**

157. The rest of this chapter mainly elaborates on proposed blended finance programmes in Norwegian partner countries. However, we will start by providing some background to the discussions on blended finance programmes in such countries.

158. As mentioned in Chapter 1, developing countries face an enormous challenge in creating millions of new jobs for a rapidly growing working-age population. Population growth is particularly high in sub-Saharan Africa. With strained public finances in most developing countries, the public sector has little opportunity to absorb the young population entering the labour market. Virtually all jobs therefore need to be created in the private sector. At least two-thirds of all formal sector employees in these countries work in SMEs. A large number are also employed in the informal sector. SMEs account for at least half of the GDP in the countries, and most jobs created are in these businesses. As much as 90–95 per cent of all employees in the private sector in developing countries are in SMEs. These are the employers who need to create the vast majority of jobs by growing and expanding their businesses, and in order to do so they need access to financing.

159. One of the most critical factors for companies in developing countries being able to invest and grow is gaining access to capital, particularly credit from the country’s financial sector. The credit provision for the private sector in developing countries is very limited, especially in low-income countries. This also applies to countries that receive development funds from Norway. Table 3 shows the extent of domestic credit to the private sector as a percentage of GDP. These are the most widely used statistics from the World Bank for

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<sup>64</sup> There are at least two options here: (a) A division of roles can be considered where Eksfin manages the guarantee scheme, but Norad is the ‘owner’ of the product, and makes decisions related to the guarantee scheme. Eksfin can assess potential guarantees (premium calculation and/or risk assessment) and has the necessary expertise to manage such a scheme. It is also worth noting that Norad’s Section for Energy is considering a possible collaboration with Eksfin on co-financing/guarantees for development projects. (b) A similar set-up for Norfund and Norad that corresponds to that in Denmark with IFU and Danida (the Danish Ministry of Foreign Affairs’s name for its development cooperation), as described in Chapter 3, sections 85–86 and 89–91.

<sup>65</sup> DFC and Global Affairs Canada are also candidates.

calculating financing to business and industry.<sup>66</sup> Twenty of the 22 partner countries in Norwegian development cooperation listed in the table are below the average for middle-income countries. In fact, access to domestic credit for the private sector in all of Norway's partner countries in sub-Saharan Africa is below the average for this region. While lack of access to credit in general impedes business growth in developing countries, it is SMEs in particular that are affected.

160. In developing countries and especially in sub-Saharan Africa, SMEs typically do not receive credit or other financing from the domestic financial sector. Large established companies are able to access financing. Microenterprises also largely receive credit, from microfinance institutions. Over the last 30 years, with considerable help from international aid, microfinance has developed into a stable segment in the credit market in developing countries. SMEs are smaller than the established companies, but larger than microenterprises, and cannot be defined within one particular category in the current financing system in developing countries – they are ‘the missing middle’ in terms of access to credit.

161. There are several reasons for the limited access to credit. Domestic financial institutions themselves have limited access to capital from domestic and international sources. In addition, their capacity to take lending risks is limited, and lending to SMEs often entails a higher risk than lending to other customers. There is also often a lack of expertise on SMEs in financial institutions.

162. Transfer of capital to, for example, SMEs at grassroots level in developing countries is necessary to realise concrete investments. For developing countries, job creation and the growth rate in the national economy depend on creating conditions for growth among SMEs, including improving access to finance. Blended finance can help improve access to credit and equity financing, which is discussed below.

Capital inflows via the domestic financial sector in developing countries will therefore be vital.

Source: Convergence

Country name	2016	2017	2018	2019
Afghanistan	3.9	3.8	3.5	3.2
Malawi	10.5	...	...	...
Haiti	10.7	10.4	11.5	10.9
Niger	11.5	11.4	10.2	11.2
Liberia	13.5	17.3	17.8	...
Tanzania	13.7	13.1	12.5	12.1
Nigeria	14.6	12.9	10.2	10.5
Mali	26.4	25.9	25.6	24.5
Mozambique	31.6	24.5	22.4	21.7
West Bank and Gaza	36.5	41.7	44.8	45.0
Indonesia	39.4	38.7	38.8	37.8
Colombia	47.1	49.8	49.7	51.5
Brazil	62.2	59.5	61.2	63.7
Jordan	71.0	74.9	76.4	76.9
Nepal	80.8	78.9	86.6	88.1
Tunisia	81.7	86.6	...	...
Ethiopia	...	...	...	...
Somalia	...	...	...	...
South Sudan	...	...	...	...
Syrian Arab Republic	...	...	...	...
Lebanon	103.9	106.3	...	...
South Africa	143.8	147.5	138.8	139.5
Norway	145.8	146.5	144.3	151.4
World	125.6	126.5	126.1	132.3
High income	142.0	144.4	140.4	147.6
Middle income	96.3	96.1	101.8	106.5
Low income	13.3	12.9	13.1	...
LDCs (UN classif.)	27.8	28.6	29.8	31.3
Sub-Saharan Africa	44.3	47.3	44.4	45.0

## Indicative proposals for blended finance programmes

163. Based on the knowledge base and the analysis in Chapter 3, this chapter presents indicative proposals that illustrate the potential for blended finance programmes that have a major effect on development. These

<sup>66</sup> This indicator is particularly relevant for SMEs that typically do not have alternative financing.

are measures that Norad can implement under the current mandate and rules for some budget items and for some sections in Norad.<sup>67</sup> Since the blended finance measures impact on multiple sectors in which the development funds are covered by other budget items and sections in Norad, it will also be necessary to secure a corresponding mandate for these items and update the respective rules for the management of grants for these schemes. This will remove any bottleneck and release a large proportion of Norad's grant funding for blended finance measures.

164. The proposals in this chapter are based on the discussion of other donor countries' experience with blended finance. They are also based on a review and analysis of Convergence's database of over 600 blended finance transactions.<sup>68</sup> We have assessed the underlying risks in the partner countries<sup>69</sup> in Norwegian development cooperation, the types of financial institutions that are active in these countries, as well as the countries' underlying financing needs in the private sector. On the basis of this analysis, a set of blended finance programmes is proposed that is well-adapted to the goals of the Norwegian development cooperation. The programmes all have the same overarching objectives, i.e. to create jobs and reduce poverty by increasing household income. Since the different programmes aim to attract different categories of investors, use different financial instruments and are aimed at different investment purposes in developing countries, some of the operational goals will vary between the programmes.

165. The blended finance programmes can be designed so that Norwegian official development assistance can steer the direction of supported investments to greener and more sustainable initiatives by being clear about Norwegian requirements and expectations. Investors can choose to support existing investment funds or create new ones whose investment strategy selection criteria and priorities match Norway's preferences, and where Norwegian ODA can serve as an incubator for green projects that have a strong development effect and expand investors' investment universe. For example, development assistance can manage investments with criteria for priority sectors, SDGs, recipient groups, themes and groups of developing countries. The same set of criteria can be used in, for example, an expanded mandate for the business support scheme, project development support and TA linked to the businesses in which investment funds invest, and other specific support for the development/piloting of concepts and technologies.

166. In addition to the structures for blended finance, it will also be necessary in most cases to supplement the 'finance-oriented' measures in these structures with support measures for relevant projects/SMEs in a start-up and growth stage (e.g. TA) in order to make them investable and strengthen the supply line into the investment funds. Each set of measures must therefore be viewed in conjunction with the other.

167. The structure for the rest of the chapter is as follows: section III presents a selection of proposals for blended finance programmes that are assumed to have the greatest potential for mobilising private capital on a relatively large scale, i.e. from institutional investors. These are based on the main categories of blended finance structures described in the preceding chapter. Section IV presents a selection of other approaches for blended finance transactions in which contributions from Norwegian ODA can also yield significant results. An underlying premise for all the proposals is that the investments are made in accordance with the OECD DAC principles, as well as MDBs' and DFIs' guidelines<sup>70</sup> for blended finance in order to stimulate good development results and impact in developing countries. Section V provides a preliminary overview of potential partners in any blended finance efforts.

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<sup>67</sup> Ref. proposed resolution X.11 for item 162.70 (Business development and trade) in Proposition to the Storting 1S (2021–2022).

<sup>68</sup> Convergence's Historic Deals Database.

<sup>69</sup> The focus could be extended to include other countries in the Norwegian development cooperation, low- and lower-middle-income countries respectively.

<sup>70</sup> Links to the two sets of principles for blended finance: [OECD-Blended-Finance-Principles.pdf](#); [DFI-Blended-Concessional-Finance-for-Private-Sector-Operations\\_Summary-R....pdf \(eutviklingsfinansieringsinstitusjon.eu\)](#). The OECD-DAC has also issued guidance on how to carry out blended finance transactions in line with the principles adopted by the DAC: [https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC\(2020\)42/FINAL&docLanguage=En](https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC(2020)42/FINAL&docLanguage=En)

### III. Programmes that can have a major development effect and mobilise institutional investors

1. Reducing risk by providing grant funding for a first loss facility or partial guarantee (ref. Items 51–55) to boost financing for SMEs in developing countries

Pursuant to the authority granted in proposed resolution X.11, p. 236 in Proposition to the Storting 1 S (2020-2021), it is already possible to use grant funding for loss provisions, e.g. in the form of a first loss facility (although so far only for one budget item – business development and trade). The programme involves providing grants for a guarantee issue programme carried out by guarantee providers (e.g. the AGF). The grants reduce the risk and costs associated with expanding their guarantees to include financial institutions in developing countries, local SMEs and other businesses. This is the core of Norad's contribution to the proposed structures 1.a–2.b, as described below. If a pilot scheme with development guarantees is introduced, as seen recently in Denmark, the programmes can use a guarantee instead of providing grant funding for a first loss facility. This will be an even more effective mobilisation instrument.

#### Example: Norwegian flagship programme for job creation in SMEs, based on blended finance

168. Lack of access to financing for SMEs from their countries' financial sector is a widespread problem in developing countries in general and Norwegian partner countries in particular. A flagship programme for job creation in SMEs in sub-Saharan Africa (possibly even more countries) is proposed, based on blended finance. The programme can in principle be broad and cover SMEs in most sectors.<sup>71</sup> This will significantly increase funding from local banks and microfinance institutions for microenterprises and SMEs. In order to achieve this, the programme will address two key challenges: (i) how local banks can access more capital that they can lend to SMEs domestically, and (ii) how banks can lend more to local SMEs. Each component of the programme addresses one of these challenges. The Norwegian flagship programme will focus on broad-based and inclusive job creation in SMEs and have positive knock-on effects on the national economies. By increasing the supply of capital (from foreign investors) to domestic financial institutions, these can provide more loans to SMEs and invest equity in such companies. This will help develop and strengthen the financial sector, which is crucial for long-term economic development, job creation and poverty reduction in these countries.

169. The programme will focus on finance in local currency for SMEs, which will protect them from currency risk. Primarily promoting financial intermediation through debt instruments is considered to be most suitable and effective, both for the supply of foreign capital to the financial sector in a developing country and for domestic lending from the financial sector to local companies (proposals 1.a and 1.b below). This assessment is based on analyses of country risk, risk attitudes and the preferences of different investor categories (both from international capital markets and domestic sources of financing in developing countries).<sup>72</sup> However, there is also potential for effective measures that can boost equity investments from foreign investors to the financial sector in developing countries and onwards to local businesses (proposals

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<sup>71</sup> As an alternative to a broad focus, the programme could have a special focus on the Norwegian government's high-priority areas, such as renewable energy, climate measures and food security.

<sup>72</sup> Analyses carried out by Convergence: (i) risk analysis of countries that are prioritised in Norwegian official development assistance, (ii) interviews conducted over the past six months with a total of 78 private players in international capital markets (investors and asset managers) about their assessments of various aspects of investing in low-income and lower-middle-income countries, including investor preferences, (iii) The GIIN's annual survey (responses from 294 investors managing over USD 400 billion), (iv) GISD, an alliance that the Secretary-General of the United Nations has initiated and holds regular consultations for. Encompasses 30 global, institutional investors that manage over USD 16 billion.

2.a and 2.b). The programme can be carried out within Norad’s and Norfund’s existing mandates and implemented quickly with external partners. Components of the proposed programme are as follows.

### 1.a Risk sharing on loans to financial institutions that provide financing for SMEs

170. It is difficult for many banks and microfinance institutions in some sub-Saharan African countries to obtain debt financing, i.e. loans from foreign and domestic sources, without support measures. In addition to the overarching objective of job creation, this component has an operational goal of better access to capital for local banks/financial institutions, which in turn can be used to finance local SMEs. This can be done through an intervention based on the design in blended finance structure 1 (described in Items 51–55 in Chapter 3). An investment fund will then be established where Norad enters into a risk-sharing agreement with the AGF. The risk-sharing can take the form of grants for first loss provisions, or a partial guarantee if a pilot scheme with development guarantees is adopted.<sup>73,74</sup> The AGF will then enter into risk-sharing agreements with foreign, private financial institutions that can provide loans to the banks and microfinance institutions.<sup>75</sup> This solution will increase the supply of capital to the financing of ‘near-bankable’ projects (see Figure 17). The actual operation of the investment fund is outsourced to a fund manager. The costs of the fund manager are covered by the commercial payment flows in the fund. There is therefore no additional cost for Norad beyond the grant funding for the first loss provision.

Figure 17

## BLENDED FINANCE - LOANS TO FINANCIAL INSTITUTIONS IN DEVELOPING COUNTRIES FOR ONWARD LENDING TO SME CLIENTS

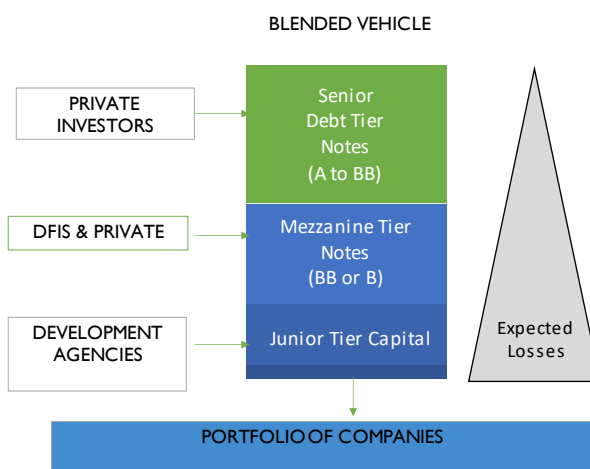
Blended finance fund with three tiers of capital:

Tier 1: (junior capital, bottom tier in the illustration):

ODA/Norad grants for first-loss facilities, which mitigate some of the risk for tiers 2 and 3.

Tier 2: (mezzanine capital): capital from MDBs and/or DFIs (such as Norfund, Swedfund etc.) as well as from (private) impact investors- this capital is near market terms but mitigates some of the risk for tier 3.

Tier 3: (senior capital): commercial capital whose risk is mitigated by the other sources of capital. In addition to private investors: IFC, the AfDB, Islamic Development Bank, Trade and Development Bank East Africa.



CONVERGENCE

Source: Convergence Blended finance research working paper, 2021.

171. It is important to understand the difference between the roles of an aid agency such as Norad and a national DFI such as Norfund. The distinction is clearly reflected in this structuring. Because of risk exposure restrictions set out in its mandate, a DFI can only invest in tier 2 capital (mezzanine level) or fully

<sup>73</sup> Authority for such use of grant funding is given in proposed resolution X.11, p.236 in Proposition to the Storting 1 S (2020-2021).

<sup>74</sup> There is a precedent for Norway having participated in investment funds with development purposes, e.g. since around 2010 in the Global Energy Efficiency and Renewable Energy Fund (GEEREF) which is a fund of funds. This investment fund is set to achieve excellent results where public funding is repaid without loss.

<sup>75</sup> Convergence considers it highly likely that the facility proposed here will attract foreign private capital.

commercial capital (tier 3). Only aid agencies have a mandate to provide capital or grant funding in the most subordinated type of capital (junior capital, tier 1), which must bear the largest losses if they were to arise. There is therefore no overlap between, for example, Norad's and Norfund's contributions in such a structure. Another possibility for Norfund to participate would be as a fund manager, similar to the role of IFU in three Danish funds.

### **1.b Risk sharing on loans from local financial institutions to SMEs**

172. The proposal is for Norad and the AGF to enter into a grant funding agreement to share risk in portfolios of loans from local banks and microfinance institutions to SMEs. Norad will provide grant funding<sup>76</sup> that is used as a first loss facility – i.e. provision for losses on lending. In other words, the component has an operational goal of increasing banks' willingness to lend to local SMEs, and this will be done by making the bank's risk-return assessment more favourable for the loan applicant. Experience from similar programmes has shown that in many cases where banks would have rejected a loan application (in the absence of such a support measure), a loan is granted to the SME.

173. In turn, the AGF enters into risk-sharing agreements with many local banks and microfinance institutions. Risk-sharing of SME loans in two tiers will (i) enable the AGF to provide extended guarantees to banks and microfinance institutions, and (ii) provide incentives to banks and microfinance institutions to lend to SMEs that do not receive conventional loans.

174. The risk sharing structuring will be as follows:

- The local bank creates a new portfolio of loans to SMEs – e.g. 200 loans of NOK 500 000 each, totalling NOK 100 million.
- Norad agrees to cover the first loss on the portfolio (i.e. charge the loss provision) with up to 5 per cent of the portfolio (NOK 5 million).<sup>77</sup>
- The AGF and the local bank share the remaining losses exceeding NOK 5 million equally.
- The local banks and microfinance institutions pay the AGF a guarantee premium corresponding to an insurance premium. Norad can also consider subsidising the guarantee premium.
- Part of the guarantee premium (e.g. 20 per cent) will be paid to the reserve account, which will increase the capital set aside to cover losses on loans (in addition to Norad's contribution).
- Potential partner organisations: the AGF, local banks and microfinance institutions in Norway's partner countries.

175. There should be a clause in the grant funding agreement to recycle unused grants (unused part of the first loss facility) into new funding, i.e. use refundable grants that are best suited in terms of work with the private sector in blended finance in the development cooperation.<sup>78</sup>

176. While the grant funding for the first loss facility is at the core of Norad's support,<sup>79</sup> it can also be supplemented with grants to subsidise the borrower's guarantee premium, finance the capacity building of borrowers and local banks, and provide funding to cover legal costs.

177. If this programme is limited to only Norwegian partner countries in Africa, it can be implemented in 13 partner countries using Convergence's assessments of country risk. If the rest of the countries receiving Norwegian ODA are also considered to be candidates, it will be possible, based on the country risk, to implement the programme in far more countries, preferably with contributions from other donor countries. To get an understanding of the sizes involved, a hypothetical example is given in the text box below. Components 1.a and 1.b constitute a complete set. Component 1.b in particular is absolutely essential for job

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<sup>76</sup> Or give a partial guarantee if a Norwegian pilot scheme with development guarantees was initiated.

<sup>77</sup> The European Commission has implemented similar first loss guarantee programmes and, based on their experience, a first loss amount (Norad grant) of 5–10% of the loan portfolio will be a good level for catalysing local loans to SMEs.

<sup>78</sup> Refundable grants are used by some donor countries to provide funding to commercial enterprises. This means that if the project subsequently proves to be profitable, the grant funding provided to share the commercial risk of the project will be repaid (in full or in part) by the business.

<sup>79</sup> Possibly a partial guarantee if a Norwegian pilot scheme with development guarantees was approved.

creation in SMEs, although component 1.a is also important. It is considered highly likely that the latter will mobilise capital from foreign investors, while component 1.b deals with the intermediation of capital by local financial institutions (from domestic or foreign sources) to SMEs that invest locally.

**Text box 4. Example for case 1.b:**

Norad provides grant funding for a first loss provision of NOK 90 million. The remaining losses of over NOK 90 million are shared equally between the AGF and the local banks. The banks' average loan amount to SMEs: NOK 200 000. Expected loan loss ratio: 7.5%. The banks' increased lending volume to SMEs (in the first round of loans as a result of Norad's first loss provision):  $\text{NOK 90 million} / 0.075 = \text{NOK 1.2 billion}$ .

Number of extra SMEs that receive loans in the first loan round:  $\text{NOK 1.2 billion} / 200\ 000 = 6000$ .

For SMEs that are prospering and repaying the loan ( $100\% - 7.5\% = 92.5\%$  of the businesses), we can assume a certain growth in the years ahead – for example, an increase of five employees per SME within a few years. The direct job creation (first round of loans round) is then:  $6\ 000\ \text{SMEs} \times 92.5\% \times 5\ \text{jobs} / \text{SME} = 27\ 750\ \text{jobs}$ .

Assume that an average of 4 people are supported by each new job. Number of dependents as a result of increased lending.  $27\ 750\ \text{jobs} \times 4\ \text{people} / \text{job} = 111\ 000\ \text{people}$ .

Grants per dependent:  $\text{NOK 90 million} / 111\ 000\ \text{people} = \text{NOK 810/person}$ .

Norad's grant is a one-off payment of NOK 810/person that can contribute to a long-term source of income that provides for a large number of people (over 100 000) after the first round of loans alone. In addition, banks will be able to lend paid-in funds from the first round of loans in new rounds of loans, so that the total effect is greater.

## 2. Programme for job creation in SMEs via equity injection

178. Some investor categories prefer to place their capital as **equity** in businesses, investment projects or funds instead of in debt instruments such as loans and bonds. Although it has traditionally been more difficult in developing countries to mobilise capital for investments in equity in local businesses compared with investments in debt instruments (business lending), there is nevertheless good potential in this area. A programme that stimulates increased equity investment will also have other benefits: new equity provides greater financial additionality than new loans, and it will mobilise new categories of investors for SME financing – private equity firms/funds and venture capital funds that normally invest in businesses with higher capital (in contrast to local banks and microfinance institutions, ref. programme proposals 1.a and 1.b). In addition to the main components of the Norwegian flagship programme for job creation in SMEs, the programme could also include the following components to address SMEs' need for new equity:

### 2.a Risk-sharing for equity invested in SMEs

179. The AGF also has a guarantee product aimed at equity investments. This can provide equity guarantees covering parts of the first portion of investment losses for investors that inject equity into SMEs. This is an alternative source of financing for SMEs that have difficulty accessing bank financing due to their poor finances. The equity guarantee enables local partner financial institutions to increase equity financing for SMEs with promising prospects, but relatively poor finances, as well as those in the start-up stage.

180. Similar to the SME loans described above, grant funding for a first loss facility<sup>80</sup> could enable Norad to share the risk with the AGF and local private financial institutions and private equity funds in its portfolio investments. The mechanism is similar to that for loans described above. It will primarily mobilise domestic capital and stimulate the development of local capital markets.

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<sup>80</sup> Possibly a partial guarantee if a pilot scheme with development guarantees was initiated.

## 2.b Risk-sharing for equity for financial institutions that provide financing for SMEs

181. Like the case of debt financing, as set out above, obtaining equity financing from foreign investors without support measures is likely to be difficult for a number of banks and microfinance institutions in some of the aforementioned 13 African recipient countries. This component therefore has the operational goal of increasing equity investments from foreign investors to local banks/financial institutions. The banks' increased equity can then be invested as equity in local SMEs. The design of the measure is based on the structure described in Items 62–66: Norad will enter into a first loss agreement<sup>45</sup> with the AGF linked to risk-sharing agreements with MDBs, DFIs, private sector financial institutions and private equity investors who could inject equity into the banks and microfinance institutions. Convergence considers it highly likely that such an arrangement could attract capital from foreign investors and that this component would probably only be needed in some of the 13 countries. This could be an opportunity for Norfund, either as a fund manager or with the investment of tier 3 equity (senior capital) in the fund.

182. In addition to risk mitigation, development aid can be used for TA facilities for SMEs in the aforementioned investment funds. These TA facilities can thus provide early-stage support for the development of bankable projects and implementation support for SMEs in the investment funds' portfolios.

183. **Assessments:** programme proposal 1 (with components 1.a and 1.b) is thus proposed as the primary programme as it is considered most appropriate and effective for primarily promoting financial intermediation through debt instruments. In addition to factors described at the start of section III, the following can also be noted:

- Expected losses that are written off in the first loss facility are likely to be lower for debt instruments (programme 1) than for equity (programme 2).
- Use of Norad funds associated with the debt instruments in programme 1 is expected to mobilise more private investment than is the case for equity in programme 2.
- Programme 1 will most likely appeal to a wide range of debt investors, while in programme 2 there may be more uncertainty about how much demand there will be from investors (private equity firms/funds and venture capital funds) to invest equity in the local financial institutions.
- In contrast, programme 2 supports the most underserved form of financing in African countries, which is equity for SMEs. It creates a new form of financing that is not normally accessible to SMEs – equity from private equity firms/funds and venture capitalists.

An overall assessment indicates that, in the short term, prioritising the implementation of programme 1 would be most appropriate and effective.

## 3. Aggregation funds

184. **Aggregation funds (funds of funds) with several underlying investment funds** - for example SME funds aimed at several countries or funds aimed at one or more impact themes/sustainability themes<sup>81</sup> with a view to broad diversification of the portfolios. This is a parent fund corresponding to blended finance structure 3 (ref. Items 75–78 and Figures 14 and 15), which invests in several funds where each of the underlying funds can have the same structure as in 1.a. (see Items 52–55 and Figure 11). The aggregation of investment funds into several funds helps to create the magnitude required to mobilise institutional investors. It also makes it possible to increase the number of underlying funds that can raise enough private capital aimed at the SDGs. In addition, due to the broad diversification of the portfolio, it may be possible to include

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<sup>81</sup> Investors are increasingly allocating capital to socially responsible investment strategies, such as 'Responsible Investment, Sustainable Finance, ESG (Environment, Social and Governance oriented) Investment, Impact Investment, SDG Investing, Green Finance and Transition Finance'. All blended finance transactions include financing from aid agencies that only contribute capital if this is aimed at the SDGs. As a result, all blended finance transactions meet the criteria for one, some or all of the aforementioned socially responsible investment strategies.



investment projects at grassroots level in the vast majority of developing countries. A fund of funds will typically require contributions from several donors in order to achieve the amount of concessional capital or risk mitigation needed to mobilise private capital on a large scale.

185. **Fund structuring:** investors invest capital in the main fund/aggregation fund in the form of securities in two capital tiers (tier 3/senior and tier 2/mezzanine). The collective funds are invested in underlying, diversified funds that all have the same three-tier capital structure as blended finance structure 1.<sup>82</sup> In addition to senior and mezzanine tier capital, each underlying fund will have a first loss facility (tier 1 capital, at the foot of Figure 16).<sup>83,84</sup> In the structure with three capital tiers, each tier has different preferential rights to payment flows and different risk distribution in the event of loss. Capital in tier 1 is financed with development aid for a first loss facility (or a partial guarantee) that mitigates some of the risk for tiers 2 and 3. Tier 2 has capital from MDBs and/or DFIs (e.g. Norfund) as well as from (private) impact investors. This capital is near market terms, but reduces some of the risk for tier 3. Capital in tier 3 is private capital on market terms whose risk is reduced by the other sources of capital.

186. The bulk of the capital in the aggregation fund is private, but a limited share is from development aid and capital from MDBs/DFIs. In addition to risk-sharing through a first loss facility, Norad grants<sup>41</sup> can fund TA and early-stage support in order to develop a supply line of good investment projects/promising SMEs.

187. **Assessments:** The fund of funds solution/aggregation fund addresses the needs of private investors for scale and diversification, and has a number of benefits. The solution provides opportunities to aggregate a very large number of individual investments and thus achieve a larger scale of collective investment volume (at grassroots level in developing countries), better risk diversification and greater mobilisation of private capital. An aggregation fund will typically target at least USD 500 million in private investment, probably a minimum of USD 450 million. It has lower transaction costs and entails very efficient use of development finance – which is preferably directed at one or more of the underlying funds and only at the parent fund in special cases. An aggregation fund creates high financial additionality for MDBs and DFIs that want to invest both senior capital and mezzanine capital in the fund. It also makes it possible to create additional sub-funds of USD 100 million or less where donors can support specific SDGs with catalytic finance. This can be, for example, a sub-fund which, due to the need for large amounts of capital, would be much more difficult to launch as a stand-alone fund, or it could be a sub-fund that can invest in high-risk market segments that investors do not usually invest in alone. The fund of funds structure is very well known in private investor circles and the financial sector, and there is a good precedent for such funds. For example, Bamboo Capital/UNCDF SDG 500 was the prototype fund of funds, and is now well understood by both private investors and donors.<sup>85</sup>

188. However, due to the challenge of achieving large-scale mobilisation of capital from institutional investors to developing countries, relatively few large aggregation funds (around a dozen) have so far been launched with blended finance compared to smaller investment funds (several hundred). It will take longer to launch an aggregation fund, and a professional fund manager will also be required to attract private investors. Also, because it is a two-tier fund, fees will be paid to the fund manager at both tiers.<sup>86</sup> MDBs and DFIs are often inclined to invest in senior capital that displaces private investors, as opposed to mezzanine capital.

189. Internationally, groups of institutional investors<sup>87</sup> and donors are currently in a dialogue with a view to presenting proposals for large-scale blended finance transactions, e.g. funds of funds. As specific proposals for such funds are presented internationally, this will be a good opportunity to coordinate Norwegian

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<sup>82</sup> A fund manager allocates the investment funds from the aggregation fund to the underlying investment funds.

<sup>83</sup> In addition to financing from public development funds, it may be relevant to try to obtain contributions from private, philanthropic foundations, as has been seen in various blended finance transactions.

<sup>84</sup> An alternative could be to have a structure with only 2 capital tiers instead of 3. In this scenario, there would be no mezzanine tier – only senior capital from private investors and junior/concessional capital from aid agencies.

<sup>85</sup> Norad supports one of the sub-funds in the SDG 500 aggregation fund, see sections 77–78.

<sup>86</sup> The fees are covered by the payment flows in the fund structure.

<sup>87</sup> Scale Blended Finance Working Group, headed by USAID. Has a dialogue with Net Zero Asset Owners Alliance, GISD and a number of state aid agencies.

participation from both the public and private sectors – a coordinated initiative in which Norad and Norfund have different but complementary roles and Norwegian institutional investors place commercial capital.

#### 4. Funds with financing that changes the risk profile and investor base during the life cycle of the project

190. This is a variant of blended finance structure 2, with an interesting, extra dimension – varying needs for support and different types of capital over time (ref. the example with the linked fund Climate Investor One, Items 70–73 and Figure 12 above): an investment in, for example, a new small business or a sustainable infrastructure project will be high-risk in the early stages. As the business puts key factors in place, manages risks and grows, the risk for investors will decrease. This makes it possible to adjust the blend of concessional public and commercial private financing by having different affiliate funds geared towards different stages of the project's life cycle.

191. In the first stage, there is a role for (public and private) development assistance to provide grants to a project development fund/SME further development fund as a supplement to the commercial project developer's outlay.<sup>88</sup> This fund – the Project Development Fund – provides loans to the project company for project development, TA and other early-stage support. The commercial project developer typically covers 50 per cent of these costs. The collective funding from the project developer and development aid via the Project Development Fund ensures the development of the SME/project company up to a level where physical investments in stage 2 are needed.<sup>89</sup> An example of the first stage is project development of a renewable energy investment. The loan from the Project Development Fund to the project company will be repaid when the project moves to the construction stage. The development aid will then be recycled for use in new projects.

192. In the second stage, there is a blended finance fund (the 'Construction Fund'), which finances construction/physical investments in and further strengthening of the SME/project company. The blended finance fund has three tiers of capital. Tier 1 is Norad grant funding<sup>90</sup> for first loss facilities (junior tier), which reduces some of the risk for tiers 2 and 3. Tier 2 (mezzanine level) is capital from MDBs, DFIs and private impact investors, which reduces some of the risk for tier 3. Norfund, for example, can inject capital here (near market terms). Tier 3 (senior capital) is commercial capital. In the example of a renewable energy investment, this stage will correspond to the financing of the physical construction (installations) etc.

193. In the third stage, when the business/project company has been developed over time into an attractive investment prospect that is already operating with a stable cash flow, it is sold from the Construction Fund to commercial investors. This is done through a refinancing fund on market terms in which long-term investors in debt instruments have invested capital. The refinancing fund provides loans to external investors to finance part of the capital for the acquisition of the business/project company.<sup>91</sup> Investors who have invested capital in the refinancing fund have a long-term income stream from the lending to an external investor. The latter owns and operates the business (e.g. a power plant) and is left with a return on equity after paying borrowing costs to the refinancing fund. The net income from the sale of the business (the power plant) is ploughed back into the blended finance fund to develop new businesses (i.e. the Construction Fund in the second stage). This ensures that the Construction Fund is replenished with capital and has the financial means to fund new project companies.

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<sup>88</sup> This stage is too high risk for institutional investors given their investment mandate.

<sup>89</sup> Concessional capital from development assistance in some sectors and countries can be in the form of repayable grants. In such cases, the costs of developing the project company will be reimbursed to the Development Fund (from the Construction Fund) when construction in stage 2 begins. After repayment, the capital is then reinvested in the development of new project companies. This way, the Development Fund can preserve its capital. Its purpose is not to strive for profit.

<sup>90</sup> Or a partial guarantee if a pilot scheme with development guarantees was initiated.

<sup>91</sup> The remainder is equity from the external investors.

194. An external fund manager is contracted to manage the funds in the structure. The costs are covered by the payment flows in the fund structure. As mentioned, this structure has been successful in funds for renewable energy investments (e.g. the Climate Investor One and Climate Investor Two funds) and is a model for Zero's proposal in the spring of 2021 for a renewable energy fund.<sup>92</sup> The structure can also be used in other sectors and industries.

195. **Assessments.** One of the benefits of a multi-component fund model such as this is that it addresses different financing needs in various growth stages for a business/project company from start-up until it is operational, and it strengthens the supply line of investable project companies (up to the stage 2 fund and then for sale to external investors in stage 3). The business only needs to deal with one fund manager through the various stages of incubation and growth, which significantly reduces the transaction costs and time spent on dealing with new, potential sources of financing in each stage. The model has proven to be successful in several climate funds. The fund model is a good way to recycle development funds for new projects and raise risk capital in different stages: in the first stage, when attracting commercial investors is very difficult due to the high risk, and in the second stage, when risk-sharing makes it possible to bring in commercial investors for parts of the capital, and in the third stage, sell the project company directly to commercial investors. However, raising capital for all three components is a challenge, and ensuring successful completion of the various stages is complicated. A professional fund manager will therefore be needed.

This model is considered promising for building a better supply line of investable project companies (e.g. supply of investment prospects to Norfund in stage 2), and it is proposed that this is followed up in a dialogue with relevant players.

## 5. Programme for mobilising foreign investment to lower-middle-income countries

196. Norway and other donor countries provide development assistance to many lower-middle-income countries. A large proportion of the world's poor live in such countries, and there is a desperate need to create jobs and implement other measures aimed at these groups. Analyses (by Convergence and others) indicate that contributions from one or more donors towards the creation of a broadly diversified portfolio fund covering many lower-middle-income countries would facilitate the mobilisation of large-scale private investment in these countries. Norway provides development assistance to 86 countries, 32 of which are lower-middle-income countries, which receive half as much as low-income countries (see Table 4).

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<sup>92</sup> At the time of writing, there is no information on any planned structure for the climate fund to be managed by Norfund.

<b>Table 4. Total Norwegian official development assistance (ODA), 2015–2019. NOK mill.</b>					
	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
<b>I. Total ODA</b>	<b>34,482</b>	<b>36,786</b>	<b>34,113</b>	<b>34,635</b>	<b>37,820</b>
<b>I.a Country-specific ODA - by country category</b>	<b>11,575</b>	<b>11,811</b>	<b>12,157</b>	<b>12,075</b>	<b>12,897</b>
Total ODA to low-income countries	4,851	5,375	5,901	6,030	6,436
Total ODA to lower-middle-income countries	3,593	2,857	3,146	2,987	3,027
Total ODA to higher-middle-income countries	3,131	3,578	3,110	3,057	3,434
Total ODA to other countries		0	0		
<b>1.b Not specified by country</b>	<b>22,907</b>	<b>24,975</b>	<b>21,956</b>	<b>22,560</b>	<b>24,923</b>
<b>Percentage of total ODA</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
<b>I. Total ODA</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
<b>I.a Country-specific ODA - by country category</b>	<b>34</b>	<b>32</b>	<b>36</b>	<b>35</b>	<b>34</b>
Total ODA to low-income countries	14	15	17	17	17
Total ODA to lower-middle-income countries	10	8	9	9	8
Total ODA to higher-middle-income countries	9	10	9	9	9
Total ODA to other countries	0	0	0	0	0
<b>1.b Not specified by country</b>	<b>66</b>	<b>68</b>	<b>64</b>	<b>65</b>	<b>66</b>

\* In the World Bank's classification (for financial year 2021, i.e. 1 July 2020 to 30 June 2021), low-income countries are defined as those with GNI per capita of USD 1035 or lower in 2019, calculated using the World Bank's Atlas

Source: Section for Statistics and Analysis, Norad.

197. The number of people living below the poverty line is higher in lower-middle-income countries than in low-income countries. The (pre-pandemic) SDG investment gap for lower-middle-income countries is also 2.5 times greater than for low-income countries (USD 1 trillion versus USD 400 billion). Both groups need mobilisation of capital from blended finance.

198. Table 5 shows lower-middle-income countries that receive development assistance from Norway. The median risk assessment for these countries is B. Eighty-four per cent of the countries have been formally assessed for risk. Only 11 per cent of them are assessed to have a risk lower than B-. **In terms of blended finance structure 1 (I.1.a above, Items 52–55), Convergence reports that this means that a broadly diversified fund with 3 capital tiers for such countries will be viable.** By making the following two tweaks to the design of such a fund, adjusted risk and expected return for institutional investors can be sufficient for them to invest in the fund:

- (i) broad diversification of investment portfolios that spread the risk in the portfolio enough to push the rating up two notches from B to BB-;
- (ii) the two underlying capital tiers can de-risk the most senior capital (institutional investors), thereby improving the rating to BBB, i.e. investment grade. This makes it investable for institutional investors.

Convergence has also concluded that it will be possible to include a number of low-income countries with a rating of B (or better) that receive development assistance from Norway in such a fund.

**Table 5: Lower-middle-income countries ranked by risk assessment, Moody's, S&P and Fitch**

1	Indonesia	Rated	BBB		19	Kosovo	Unrated	B
2	Philippines	Rated	BBB		20	Kyrgyzstan	Rated	B
3	India	Rated	BBB-		21	Mongolia	Rated	B
4	Morocco	Rated	BBB-		22	Nigeria	Rated	B
5	Georgia	Rated	BB		23	Sri Lanka	Rated	B
6	Vietnam	Rated	BB		24	Tunisia	Rated	B
7	Guatemala	Rated	BB-		25	Ukraine	Rated	B
8	Uzbekistan	Rated	BB-		26	Cape Verde	Rated	B-
9	Armenia	Rated	BB-		27	El Salvador	Rated	B-
10	Bolivia	Rated	B+		28	Moldova	Rated	B-
11	Honduras	Rated	B+		29	Nicaragua	Rated	B-
12	Jordan	Rated	B+		30	Pakistan	Rated	B-
13	Kenya	Rated	B+		31	Papua New Guinea	Rated	B-
14	Cameroon	Rated	B		32	Tajikistan	Rated	B-
15	Egypt	Rated	B		33	Syria	Unrated	CCC or lower
16	Eswatini	Unrated	B		34	West Bank & Gaza	Unrated	CCC or lower
17	Ghana	Rated	B		35	Micronesia	Unrated	
18	Ivory Coast	Rated	B		36	Tokelau	Unrated	

Source: Convergence Blended finance research working paper, 2021.

199. Convergence, which works closely with financial market players as well as donor countries, reports that many donor countries are interested in supporting lower-middle-income countries. These countries are generally underfunded by MDBs and DFIs, which are very active in higher-middle-income countries. Lower-middle-income countries are relatively well known by private investors.

200. If there is a willingness to allocate a limited share of the development assistance that already goes to lower-middle-income countries (e.g. 5–10 per cent) to blended finance measures, while maintaining the volume of development assistance to low-income countries, the following proposals are outlined which can mobilise a significant amount of private capital.

201. In Convergence's view, blended finance structure 1 (portfolio of debt instruments) is likely to be the most effective approach for these countries, as this structure will make it possible to attract enough institutional capital through sufficient risk reduction for such investor groups in the form of (1) diversification of the portfolio across a number of countries and sectors, and (2) risk mitigation through the capital structure of the fund at various tiers. An appropriate structure would be as follows:

- Establish a fund that is capitalised in three capital tiers, where Norad and other aid agencies contribute capital at tier 1 (junior capital) and one or more MDBs/DFIs contributes at the mezzanine tier.<sup>93</sup>
- Mobilise capital from private debt investors to tier 3 (most senior). Such commercial capital can make up around 80-85 per cent of the entire fund.
- Norad grants absorb the first losses up to the ceiling set for the grant funding. The remaining losses are borne by the other investors. This arrangement reduces the overall risk of loss for the other investors.
- The fund will participate in loans originally issued by large banks in the respective developing countries, foreign banks (e.g. Standard Chartered and Société General), MDBs and DFIs.

<sup>93</sup> An alternative fund structure would be to have two capital tiers – senior capital for commercial investors and concessional (junior) capital from development assistance. A fund with three capital tiers (which also includes partial risk-mitigating mezzanine-tier capital) is more complex, but offers greater flexibility and can include a wider group of developing countries.

- Managing the fund is labour-intensive and will be carried out by an external fund manager. While Norfund could act as a fund manager – and this can be explored further – its limited staff capacity means that it may prefer a third party to undertake the fund management. Norfund can still play a prominent role by injecting mezzanine capital and helping to mobilise senior capital from Norwegian/Nordic institutional investors.

202. The fund structure will create securities at the senior capital tier that are investment grade debt instruments and are in demand by investors. In the long term, as the programme progresses, it may be possible to have this security listed and thus traded on stock exchanges. Such turnover in the capital market would be a major step forward and help to lower the threshold for other potential new investments in developing countries (see also the description of MOBILIST, Items 102–108). This also means that if Norwegian/Nordic institutional investors do not inject capital in the first stage, they can still invest at a later stage.

203. In order to sufficiently spread the risk to attract institutional debt investors, it is likely that the portfolio of investments will cover a mixture of lower-risk middle-income countries as well as relatively high-risk countries. As mentioned, the median rating (the ‘middle’ rating) for the country portfolio is B.

204. Assessments. Such a programme could prove to be very useful. It can mobilise large-scale foreign investment to lower-middle-income countries, and development funds will have considerable financial additionality. The programme is tailored to the needs of institutional investors, and safeguards the investment grade securities that are in demand among large-scale investors, including Norwegian institutional investors.

205. The programme provides good opportunities for a coordinated approach for Norwegian actors that will provide added value. Norfund and Norad can complement each other by covering different functions and playing to each other’s strengths, and the programme will be attractive to Norwegian institutional investors. There are several important and prominent roles that Norfund can consider: (i) mobilising capital from third parties (e.g. institutional investors) and potentially mobilising mezzanine capital from other DFIs or MDBs, (ii) investing mezzanine capital, and (iii) managing and investing the fund’s capital in investments in developing countries.

206. Over time, as the programme progresses, the securities (senior capital) could be traded on the stock exchange or sold as bonds. Such sales in a secondary market will be a major advantage. The fund can probably market senior loans under sustainability themes, i.e. invest in companies that make a positive contribution to sustainability in relation to the climate, natural environment and social conditions. Demand is high among capital owners and asset managers for sustainable investments of this type. The programme is therefore designed to cover a number of sustainability areas where development assistance is specified in the budgets of, for example, renewable energy and other climate change mitigation measures, food systems, oceans, etc. The programme may also provide access to support projects in lower-middle-income countries that are supported by export credit agencies (such as Norwegian Eksfin).<sup>94</sup>

207. However, the fund will require an external fund manager. If Norfund does not act as fund manager, the work may be more challenging, but Convergence is convinced that the programme can attract a high-quality fund manager who is interested in the ‘development component’ of the loans and has the confidence of the investment community and thereby the ability to attract investors with senior and mezzanine capital. It will also require some investors to invest capital at the mezzanine tier.<sup>95</sup> In light of its development mandate, Norfund and other DFIs/MDBs may be potential investors. However, at least in the case of foreign DFIs and MDBs, it has traditionally been difficult to convince them to take capital positions that are subordinate to senior capital from private investors, although this could mobilise large amounts of private capital for development purposes.<sup>96</sup>

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<sup>94</sup> For example, export credit agencies only cover up to 85% of a project’s need for finance. The programme can cover the last 15% and thereby increase the developing countries’ ability to carry out infrastructure projects.

<sup>95</sup> The mezzanine securities are likely to be rated at the Fitch equivalent of ‘B’.

<sup>96</sup> Source: Convergence Blended finance research working paper, 2021.

It is considered realistic (ref. Items 198–201) that such a programme can be implemented with sufficient investor interest for many lower-middle-income countries and other developing countries. The programme can have a major impact, with significant job creation and poverty reduction in these countries, and can facilitate progress in achieving various SDGs. It is advisable to have a close and good dialogue with Norfund primarily, but also with other relevant Norwegian and international players in order to initiate a process<sup>97</sup> that can further develop the concept and operationalise it with a view to potential introduction of the programme. Launching the programme within one or two years would be a reasonable time frame to aim for.

## 6. Climate finance measures

<b>Systemic challenge</b>	<b>Examples of potential blended finance solutions using Norad grants</b>
1. Limited access to bankable projects for renewable energy	1. Grant for facilities that support the development and preparation of projects that can be fed into the Climate Fund – PFAN <sup>99</sup> and IRENA <sup>100</sup>
2. Limited access to development funds for developing the projects into bankable projects	2. Grant for the development fund in stage 1 (equivalent to the Climate Investor One development fund)
3. Limited access to debt and equity financing for renewable energy projects at the construction stage	3. Grant for the first loss facility in the Construction Fund (for losses in the construction stage – stage 2). The Construction Fund is equivalent to the Climate Investor One construction fund. The grant can mobilise private capital for the fund.
4. Limited access to long-term lending (debt financing) for renewable projects after the construction stage, particularly in local currency	4. Contribute catalytic capital to the refinancing fund (equivalent to the Climate Investor One refinancing fund) in stage 3, i.e. when the physical investment is in the operational stage after development and construction. This in turn will mobilise private debt investors into senior capital positions in the fund. The refinancing fund will provide long-term debt financing for ‘mature’ projects, i.e. those which are already in operation (producing electricity).

208. The use of blended finance for climate investments in developing countries represents considerable potential. Since 2020, Norway has initiated a couple of new measures in this area. One is related to guarantees linked to renewable energy investments in developing countries. The aim here is for Norad to provide an annual grant to two international guarantee institutions (MIGA and ATI). Relevant agreements will be entered into soon. The increased capital of these guarantee institutions will contribute to two things: (i) trigger further commercial sustainable renewable investments through support for relatively small projects and in doing so close the gaps in the international guarantee arena, and (ii) increase the institutions’

<sup>97</sup> For example, an international call for a fund manager with a proposal for fund management and operationalisation.

<sup>98</sup> Source: Private Financing Advisory Network – <http://pfan.net>; International Renewable Energy Agency - <https://www.irena.org/ourwork/Project-Facilitation/About-project-facilitation-platforms>; Partners for Development, ‘Rethinking Norwegian Official Development Assistance towards 2030 – more effective ODA to engage with and mobilise the private sector’, May 2021.

<sup>99</sup> Private Financing Advisory Network (PFAN) is a global network of experts in climate and clean energy financing, offering free (funded by donors) guidance and investment facilitation to entrepreneurs who develop climate and clean energy projects in emerging markets and in low- and middle-income countries. PFAN bridges the gap that often exists between entrepreneurs and investors in these markets: it helps entrepreneurs build their businesses and present them in a language that investors will understand and be interested in, and it helps investors find these businesses and recognise their potential.

<sup>100</sup> The International Renewable Energy Agency (IRENA) is an international organisation that supports countries in their transition to sustainable energy. With a mandate from more than 150 member countries, IRENA encourages governments to adopt guidelines that facilitate investment in renewable energy, provide practical tools and policy advice to promote renewable energy production, and facilitate knowledge-sharing and technology transfer with a view to increasing the production of clean, sustainable energy. IRENA offers a wide range of products and services, including project development instruments for renewable energy investments.

guarantee capacity and help improve Norwegian and international renewable energy players' access to guarantees. Norad's business support scheme has therefore also been extended to cover the subsidising of guarantee premiums, especially in demanding markets. The second measure is the recently proposed Climate Fund, which will be administered by Norfund.

209. There are no concrete plans for the design of Norfund's new Climate Fund as yet. However, in light of the positive experiences internationally with the climate/renewable energy fund Climate Investor One (see Items 70–73), where a conceptual and practical distinction is made between three stages of a renewable energy investment project: development, construction and operation, and which has individual structures for each stage (a development fund, a construction stage fund and a refinancing fund for the operational stage), it is reasonable to assume that a similar structure will be a relevant alternative for the new Climate Fund. Even with this design, Norfund is likely to face a number of systemic challenges when trying to invest NOK 10 billion in the field. It is difficult for Norfund to address all these challenges on its own solely with the tools at its disposal. As an example of coordinating the development cooperation for increased effect, Norad could consider using development aid to help find solutions. Table 6 provides an overview of four systemic challenges and possible complementary measures from Norad's side that will support Norfund in the operation of the fund. Suggestions 2–4 in the table will be relevant if the Climate Fund has a three-stage structure in the same vein as the Climate Investor One fund.

210. There is a great need for climate investments with contributions from private capital, and this requires further development of blended finance. The grants to MIGA and ATI are around NOK 100 million each for a five-year period, and subsidies for guarantee premiums in the business support scheme are around NOK 50 million annually. In light of the desperate need for investment, there is considerable potential for Norwegian support beyond what is covered in this measure and the new Climate Fund. Given that Norfund's new Climate Fund will be channelled to the replacement of coal power plants, mainly in Asia, there will still be a large unmet need for the financing of all types of climate investments in many countries where Norway provides development assistance, particularly in sub-Saharan Africa.

211. **What types of blended finance structures are suitable for climate investments?** Empirical data from Convergence's historical deals database shows that **all of the four main structures for blended finance presented in Chapter 2 are used in existing, climate-oriented blended finance transactions internationally**. Consequently, all these main structures can be used for climate finance measures in a potential Norwegian portfolio with capital investment from Norwegian institutional investors and with support from development assistance, e.g. grants for first loss facilities, or partial guarantees. There is therefore no need to elaborate further on the details and alternatives here.

212. There is already significant activity in blended finance aimed at climate investments. Climate finance accounts for the largest segment in blended finance aimed at developing countries. Out of the 680 completed blended finance transactions that are registered to date, 252 (37 per cent) are aimed at the climate (measured by SDG 7: Ensure access to affordable, reliable, sustainable and modern energy for all, and SDG 13: Take urgent action to combat climate change and its impacts). Investment funds have mostly been channelled through funds and directly to projects (over 70 per cent). The rest have been distributed as (i) direct financing to companies, and to a lesser extent as (ii) financing facilities (as opposed to funds)<sup>101</sup> and (iii) bonds (the latter just 3 per cent).

213. Risk mitigation in the form of guarantees has been effective in mobilising private capital for climate investments: one-third of these had a guarantee, and these transactions accounted for more than half of the mobilised capital. In line with this, Denmark has recently chosen to implement a state guarantee scheme, initially for the period 2022-2025, where one of the goals is to increase climate finance from private sources to developing countries.

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<sup>101</sup> A finance facility is an earmarked allocation of public resources (sometimes including support from philanthropy), which can invest in development projects through a range of instruments aimed at mobilising additional financing (e.g. commercial) through operations.



## Role for Norwegian institutional investors

214. As mentioned, Convergence finds that some of the blended finance solutions suggested above may be attractive to Norwegian institutional investors in light of the portfolio diversification and risk mitigation built into the structures. For example, the proposed blended finance fund aimed at lower-middle-income countries (proposal 5 above) is designed to mobilise capital on a large scale from institutional investors. Through its capital structure, risk distribution and income distribution, this fund structure will create investment grade securities that fit the institutional investors' mandate and risk profile. The target group among institutional investors in Norway could include insurance companies, pension funds and banks.

215. Internationally, the scope of investments in such countries may increase in the years ahead, partly as a result of the aforementioned megatrend for climate investment and other sustainable investment, and in some cases with the support of blended finance. Thus, over time, a more comprehensive database will be built up that may be able to reduce the gap between perceived risk (before the investment decision) and realised risk (after the investment decision) in such countries. A particularly relevant area is investments in renewable energy infrastructure in such countries.

### **Future role for Norway's Government Pension Fund Global?**

216. Investment in renewable energy infrastructure is an area in which Norway's Government Pension Fund Global (GPF) – the 'Oil Fund' – has somewhat greater room to manoeuvre with regard to country choices than other sectors. This is regulated by the Ministry of Finance's 'Mandate to Norges Bank Investment Management for the Management of the Government Pension Fund Global' and rules for infrastructure management regarding the investment universe and risk limits for the Oil Fund (see references and links in Text box 5). According to these, the GPF may invest a limited proportion 'in interest-bearing instruments [e.g. bonds] issued by unlisted [not listed on the stock exchange] companies or fund structures whose main activity is the development of infrastructure for renewable energy, and which are based in countries that have a tax agreement with Norway.'

217. Discussion can then take place on whether the GPF within this allocation can, over the long term, invest a small share in interest-bearing instruments that finance investments in renewable energy projects in developing countries in accordance with the aforementioned criterion in the Ministry of Finance's mandate to NBIM for the GPF. Some of these potential investment vehicles could be in blended finance structures that focus on renewable energy investments in developing countries. As mentioned, all four main structures for blended finance are suitable for renewable energy projects and other climate measures.

218. Text box 5 describes the restrictions set by the aforementioned mandate and regulations, and on this basis calculates how much can be invested in interest-bearing instruments for investment in renewable energy infrastructure in developing countries, i.e. the maximum amount. **The Oil Fund can conservatively invest NOK 1 billion in renewable energy projects in such countries with a good margin to the maximum amount, some of which could be in blended finance structures.** This amounts to less than 0.01 per cent of the market value of the Oil Fund at the end of 2021 and is well below the maximum amount, which in practice is around 0.04 per cent of the Oil Fund.

219. If the Oil Fund makes such investments, this will send strong signals to other investors in blended finance structures, and the GPF's investment of capital can help to mobilise much more capital from other institutional investors. Overall, these will represent important capital contributions that can finance significant climate measures and also improve the energy supply, job creation and poverty reduction in these countries. At the same time, the risk to the GPF's total portfolio will be limited – probably less than the

daily exchange rate fluctuations in the currencies of the GPFG's investment vehicles.

**Text box 5. How much can the Oil Fund invest in developing countries in line with the mandate and regulations?**

Under the Ministry of Finance's 'Mandate to NBIM for the management of the Government Pension Fund Global' and rules for infrastructure management regarding the investment universe and risk limits for the Oil Fund, the GPFG may invest a limited proportion 'in interest-bearing instruments issued by unlisted companies or fund structures whose main activity is the development of infrastructure for renewable energy and which are in countries that have a tax agreement with Norway.' This may include 'emerging markets'. Developing countries make up a large part of this category.

The mandate and the aforementioned rules place the following restrictions on what and how much can be invested in developing countries.

A. Unlisted securities for investments in renewable energy infrastructure can be a maximum of two per cent of the entire Oil Fund. (However, in practice, Norges Bank must aim for somewhat less than two per cent in order to avoid exceeding the limit in the event of a major sudden fall in the value of the listed investments (i.e. in total market value of the Oil Fund's listed securities)).

B. A maximum of ten per cent of A. can be in funds (indirect investments).

C. A maximum of 30 per cent of B. can be in emerging markets, as classified by the securities index providers used by the Oil Fund (e.g. Bloomberg). The category 'emerging markets' mainly consists of developing countries (low-income and middle-income countries), but the securities index providers may in some cases include some OECD countries in this category.

The theoretical maximum limit for investments in renewable energy infrastructure in emerging markets as a percentage of the Oil Fund can be calculated as:

$$A \times B \times C = 2\% \times 10\% \times 30\% = 0.06\%.$$

In practice, when Norges Bank factors in the precautionary measure in A., this should be adjusted slightly downwards; as an example, let us assume by 20 per cent. Thus, the **maximum limit in practice** for investments in renewable energy infrastructure in **emerging markets** as a percentage of the Oil Fund will be:

$$0.06\% \times (1-0.2) = 0.048\% \text{ of the Oil Fund.}$$

Although under the mandate all of this can be invested in developing countries that satisfy the requirement for a tax agreement with Norway,<sup>2</sup> let us again for the sake of illustration assume that some of the 'emerging markets' for this investment portfolio are OECD countries, e.g. 20 per cent, and the rest, 80 per cent, are investments in the main category of emerging markets that are developing countries. As an illustration, the **maximum limit in practice** for investments in renewable energy infrastructure **in developing countries** as a percentage of the Oil Fund will thus be:  $0.048\% \times 0.8 = 0.0384\%$  of the Oil Fund.

With a conservative estimate of the expected value of the Oil Fund in relation to the value at the end of 2021, this will amount to around NOK 4 billion.<sup>3</sup> **If the Oil Fund allocates only a quarter of the limit in practice within its mandate, it can invest NOK 1 billion in renewable energy infrastructure in developing countries.**

<sup>1</sup> Documents: a. Mandate for the management of the Government Pension Fund Global, Lovdata, last amended 13 September 2021; b. 'Investment mandate – Government pension fund global', issued by Norges Bank Executive Board to the Chief Executive Officer of Norges Bank Investment Management, last amended 26 May 2021.

<sup>2</sup> As of December 2021, Norway has a tax agreement with 25 countries in Africa, South Asia and Southeast Asia, i.e. countries that are relevant recipients of development assistance and blended finance. Norway has a tax agreement with more than 40 countries outside the OECD and Western Europe that could possibly be considered as candidates for blended finance, mostly transition economies in Central Asia (former Soviet republics) and East Europe.

<sup>3</sup> The GPFG's total assets (at the end of December 2021) are over NOK 1.2 trillion.

## Considerations when choosing a blended finance solution

220. Important elements to consider when choosing a blended finance solution include how much effect the measure will have and how to implement it. As explained above, risk mitigation for private investors is essential, and the mobilisation of domestic private capital in developing countries has a particularly important role. In the structures proposed above, guarantees are an even more effective instrument than grants for first loss facilities. In a 4–5-year pilot scheme for guarantees as suggested, Norway can work with Sweden in the same way as Denmark does already, and develop its own expertise over time. Norad has considerable experience in managing grants, and when it comes to using grants for first loss facilities, coverage for this area is not problematic.

221. As mentioned above, the proposals are based on the main structures within blended finance that are presented in Chapter 3. These are the structures for blended finance transactions that aid agencies and commercial investors use most often. Many concrete proposals for SDG investments are therefore presented every year based on these structures, where other players invite aid agencies to contribute in the form of grant funding or capital.

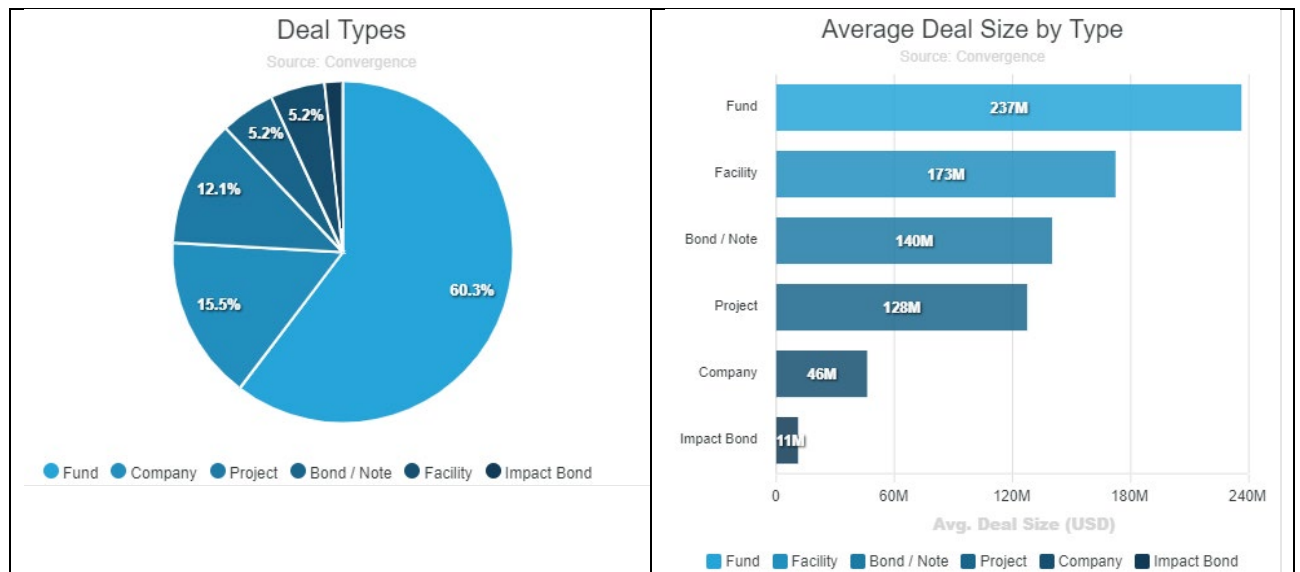
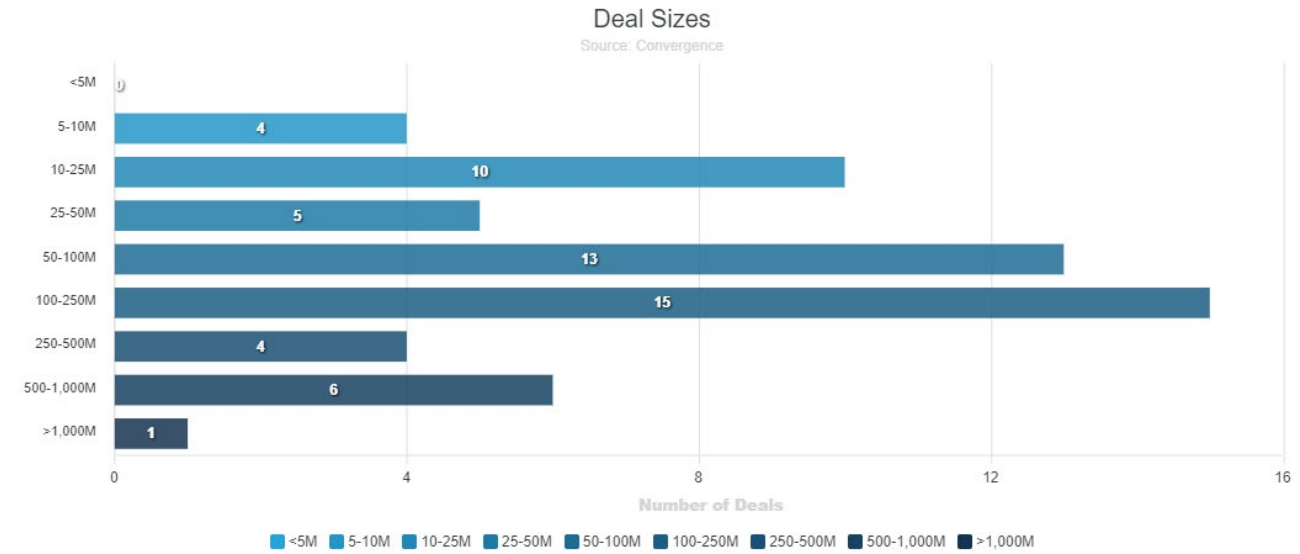
222. Norad (and preferably Norfund if they wish to be involved) has several solutions to choose from:

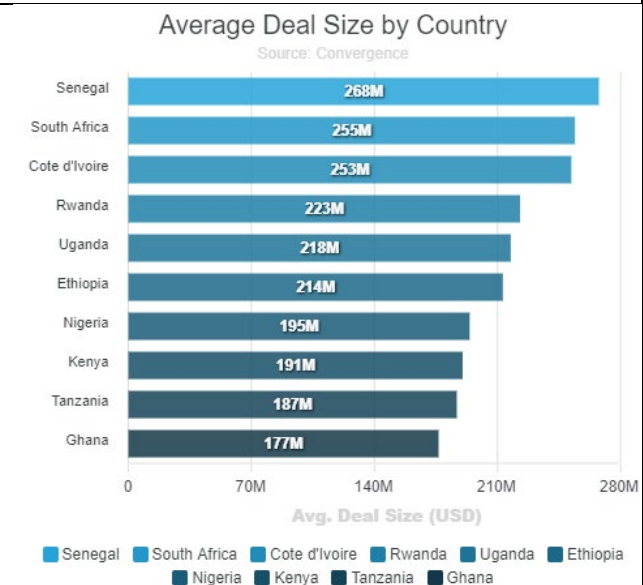
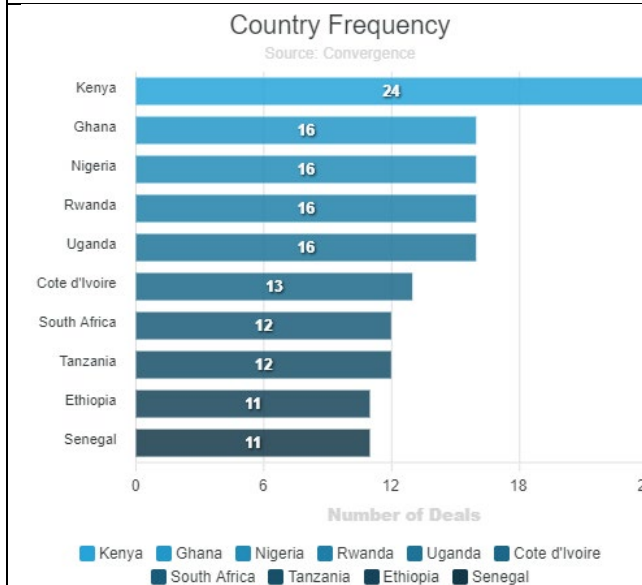
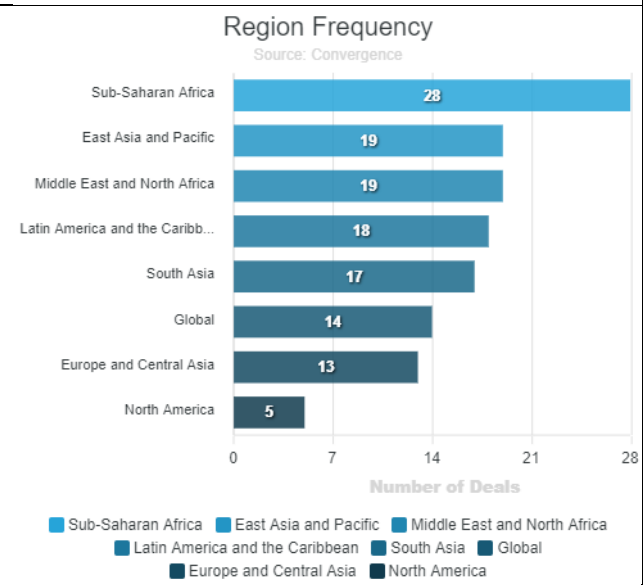
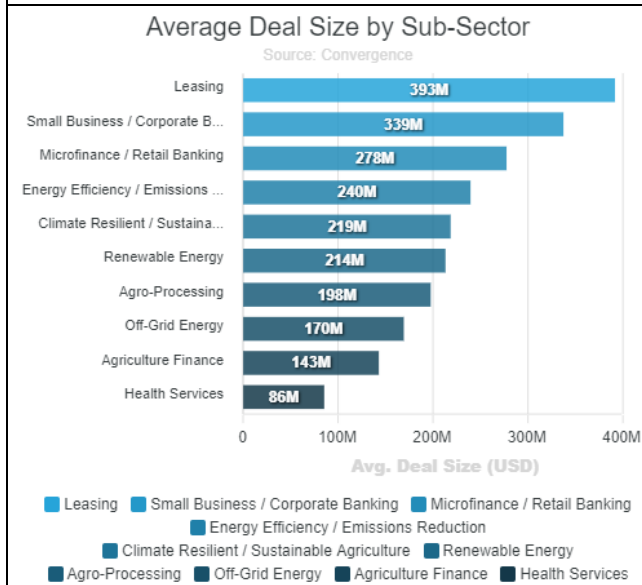
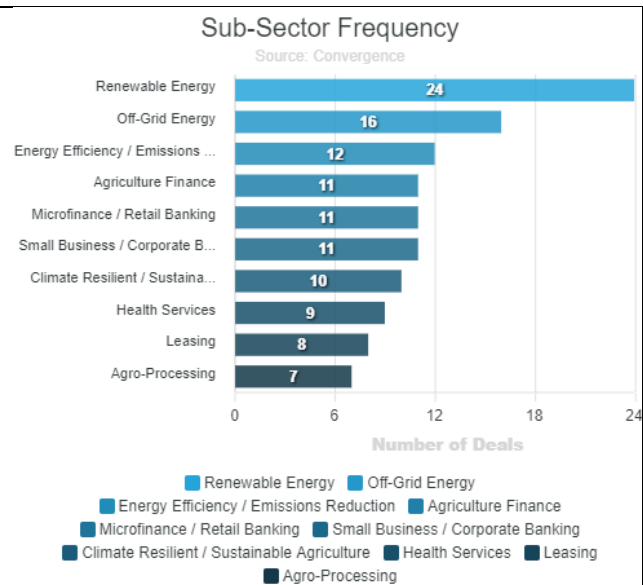
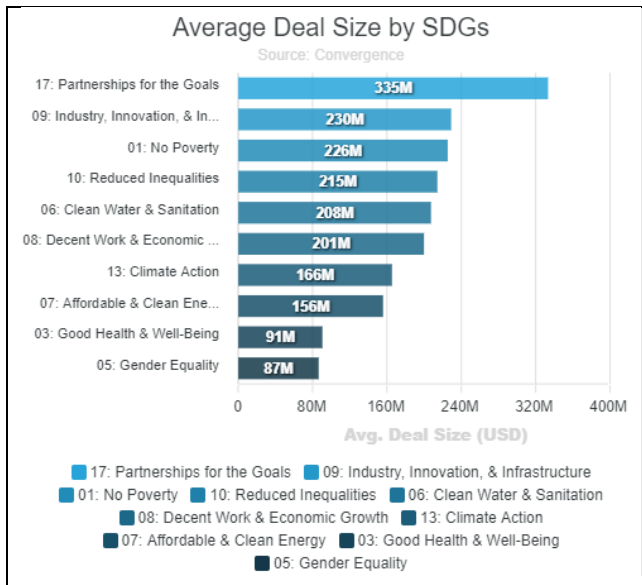
- (i) There are a number of such blended finance instruments that have already been in operation for some years and will now raise more capital in a new round. For example, an investment fund that has been financing projects in developing countries for a number of years and will now raise more capital to finance more projects.
- (ii) A constant flow of new, fully developed financing proposals for raising capital are also being presented. A key arena for this is Convergence's matchmaking platform, which currently has 76 transactions being prepared and seeking capital, of which 58 (with a total capital of NOK 90 billion) correspond to main structure 1 or 2. Figure 18 provides an overview of relevant prospects with a role for the development cooperation, including which SDGs they cover, distribution of prospects by sector, subsector, region and country, with associated average capital sought per transaction for each of these dimensions.
- (iii) In addition, a number of new blended finance transactions are at the design/incubation stage. For example, Convergence is working with Global Affairs Canada and Australia's Department of Foreign Affairs and Trade on quarterly international calls for proposals in which investors, fund managers, project sponsors, MDBs and DFIs submit proposals for new blended finance transactions. Convergence then provides grants (design-stage grants) to design and further develop the best proposals with a view to raising capital from the market and other players (such as DFIs, MDBs and aid agencies). Norad is a member of Convergence and can avail itself of their financial intermediation services.

**Figure 18. Blended finance transactions with structure 1 or 2 that are listed in Convergence’s matchmaking platform (fundraising), 2 November 2021.**

Number of deals: 58

Total deal volume: USD 11 billion





Source: Convergence's deals in matchmaking platform, November 2021.

## IV. Other key instruments

### 7. Bonds – proposal for support measures

223. An alternative to funds for large-scale mobilisation of capital for developing countries is bonds. Bonds are well suited to mobilising capital where the money is earmarked for a specific purpose, such as climate targets, nature-based solutions, job creation, women’s economic empowerment, social purposes (e.g. health), etc. As described in Chapter 3 (Items 116–123), the use of bonds aimed at climate, environmental and social sustainability measures in recent years has increased dramatically in countries with higher income levels. With some support from blended finance, sustainability and development bonds can also be introduced for similar investments in developing countries. A good example of this is the successful sale of a NOK 1.5 billion social bond to Swedish institutional investors in May 2021, aimed at developing countries, with support from Sida.

224. The following is therefore proposed.

- a. Catalytic use of a partial guarantee (primary proposal) or grant for a first loss facility (secondary) to mobilise capital from Norwegian (possibly Nordic) institutional investors in sustainability bonds (GSS bonds) aimed at developing countries. Success here can help build a permanent market for such bonds in developing countries. In light of Nordic countries’ recent success in developing a Nordic market for GSS bonds, we should start a dialogue with key investors about the opportunities (ref. Text box 3 and Items 119–120). Norad can, for example, support the launch of a social bond in collaboration with DFIs such as Norfund and other donors. The social bond will then be aimed at one or more SDGs and sold to institutional investors in Norway and other Nordic countries.
- b. Grants to support the development and issue of developing countries’ bonds in local currency.
  - (i) It is recommended that support is provided for programmes by key players which facilitate the issue of bonds in local currency, e.g. sustainability bonds (known as GSS bonds) (ref. Items 117–120), potentially linked to currency hedging through, for example, TCX.
  - (ii) Form a collaboration with other bond developers (such as DFIs) to duplicate KfW’s successful model ‘African Local Currency Bond Fund’ (ref. Items 139–141).

### 8. Currency hedging for local businesses – proposal for support measures

225. Currency risk in investments in developing countries is a major barrier to foreign as well as domestic investors (the latter because most loans for such investments are in foreign currency). Chapter 3 examined this and identified measures to address the problem for the respective investments. Chapter 3 also identified relevant players in the field (see Items 133–139), the most prominent of which is TCX. This has programmes and schemes that, for a fee, ensure that local borrowers and investors in developing countries as well as foreign investors are protected from exchange rate fluctuations on loans, which is equivalent to having loans in local currency. The organisation has been built from capital provided by several European donor countries. It can expand some activities in programmes using development funds. The main measure for triggering a large increase in TCX’s volume of currency hedging agreements in developing countries is injecting capital into the organisation. This will lead to a permanent increase in TCX’s capacity to protect businesses and other borrowers from exchange rate fluctuations, and enable it to extend the currency hedging to more developing countries.

- a. It is proposed that Norad provides grants for TCX’s programmes in order to increase TCX’s capacity to offer cost-effective currency hedging for foreign and domestic investors.
- b. Providing TCX with capital will also be an efficient use of development aid at ministry level. It is proposed that the Ministry of Foreign Affairs considers providing such capital.

## 9. Project development: Norad fund for project development and TA to support TA facilities linked to investment funds

226. As described in previous chapters, support for project development and TA is needed to expand and strengthen the supply to investment funds of investment prospects (promising SMEs) where the aim is to develop the projects to the stage where they become an attractive investment prospect for investment funds. TA is also often required in later stages of a company's development. If blended finance successfully manages to mobilise significant amounts of commercial capital for investment in developing countries, the lack of bankable projects will cause a bottleneck, particularly with the increased access to capital from institutional investors. Such project development support may be provided in separate project development and TA funds by supporting incubators and accelerators, or through a project development finance facility that is integrated with an investment fund.

227. There are several options to consider. Norad grants can finance a project development and TA fund in which various investment funds can apply for support to establish their own TA facilities. This could be in the form of the investment funds described in section III above. One example would be an SME fund in a fund of investment funds (structure 3 above). These TA facilities would thus provide early-stage support to develop bankable projects and implementation support for SMEs in the fund's portfolio – especially those that invest in SMEs in the earliest stages of the investment life cycle, where the risk is higher. The operation of the grant-financed TA fund can be outsourced via a tender competition, as has been done by various aid agencies. Another good alternative is an integrated finance facility for project development linked to an investment fund. International experience in recent years has shown that this type of facility for project development saves time and transaction costs when building a portfolio of investable projects. Such a portfolio is necessary to achieve large-scale and adequate diversification of risk with a view to mobilising institutional investors.

## 10. Support for a programme to build a market – on the stock exchange – for large-scale mobilisation of capital to developing countries

Norad can finance TA in FCDO's MOBILIST programme (ref. Chapter 3, Items 103–109 and 113), which seeks to identify investment projects and launch them in international stock exchanges. Norway's contribution to TA in terms of the development and strengthening of project companies and associated reporting with a view to meeting the standards to qualify for listing will increase the probability of successful commercial launches, sales to institutional investors and market building.

## 11. Norad can provide grants to the authorities in a developing country on the proviso that they allocate the funds to an identified blended finance instrument

228. A highly effective approach is for OECD/DAC aid agencies such as Norad to provide grants to the authorities in a developing country – preferably their Ministry of Finance – with the contractual condition that the authorities allocate the funds to an identified blended finance programme. This is effective for national blended finance programmes and increases government ownership in the partner country. We can use Tanzania as an example of such an approach.

229. Reference is made to section I, proposal 1.b. (Norwegian flagship programme for job creation in SMEs, based on blended finance). Norad can, for example, form a collaboration with the AGF and the Ministry of Finance in Tanzania, in which Norad allocates the money to the authorities and these then enter into a first

loss risk-sharing agreement with Norad and Tanzanian banks with a view to expanding the banks' lending to SMEs.

230. This can also be expanded to a collaboration with Tanzania's Development Bank and ensure compliance with the country's investment plan for the SDGs in line with the national development strategy. An example of the latter is the UN proposal for ODA Plus to identify, build and invest in a supply line of SDG investments in developing countries.



## V. Collaboration and partnership – a preliminary overview of relevant partners

231. Which actors would it be relevant to collaborate with on blended finance, and in which areas or instruments? The natural first step would be for Norad to cooperate on a number of blended finance structures with Norfund, and then extend this to Norwegian institutional investors. Norfund can invest mezzanine capital while Norad can provide grant funding for a first loss facility that mitigates risk or a partial guarantee. Norfund can also be invited to act as a fund manager in some Norad-supported blended finance transactions. Consideration can also be given to developing a closer collaboration between the two Norwegian institutions, where Norad, within the principles of good practice in blended finance, provides early-stage support to relevant businesses that Norfund has identified for potential future investment. In other words, coordinate the efforts to build a supply line of bankable projects. This can be explored in a further dialogue.

232. It would also be natural to apply to other Nordic DFIs such as IFU in Denmark, Swedfund and Finnfund. They may be relevant in terms of mezzanine capital (or senior capital) investment and possibly as fund managers. Another area for cooperation may be guarantees – in which case the most likely candidate is Sida. If there is a political appetite for this, a collaboration similar to that in Denmark can be initiated for a guarantee scheme with Sida and a pilot scheme introduced for guarantees over a few years. If Norway does not pursue its own guarantee scheme, it can subsidise the premiums on Sida guarantees, provide finance for TA in Sida's guarantee scheme and provide grant funding for a first loss facility on loan programmes that Sida supports with guarantees. Canada and the United States are also relevant guarantee partners.

233. Cooperation with NGOs specialising in the provision of guarantees in developing countries may also be relevant, e.g. with the AGF, which is made up of capital from several European donor countries. If the Ministry of Foreign Affairs contributes capital to the AGF, such a measure could have a major, positive effect as it will immediately increase the AGF's capacity to provide more guarantees. In turn, this will support new loans to African businesses which, in the first loan round alone, are several times greater than the capital contribution. A number of DFIs have already invested in the AGF (the Danish IFU has recently increased its capital contribution there), and an alternative may be for Norfund to invest in the fund as opposed to the Ministry of Foreign Affairs providing capital.

234. A collaboration with the British FCDO may be relevant in relation to, for example, the ground-breaking MOBILIST programme, which seeks to launch portfolio investments in developing countries on international stock exchanges. Norad can finance TA here, and this will increase the likelihood of businesses qualifying for listing. In addition, Norad could explore the potential for linking the proposed flagship programme for equity injection to financial institutions and businesses in developing countries (Items 178–181) to the MOBILIST programme (Items 103–110). This can stimulate the mobilisation of equity as it creates opportunities for the sale of shares on a secondary market (exit opportunities). Absence of the latter is a barrier to investors.

235. Norad can also collaborate with the German bank KfW on its programme to help African businesses issue and sell bonds in local currency. A Norad collaboration with TCX in the form of grants for some of their programmes will also be important and can increase TCX's ability to offer cheaper currency hedging for international investors, as well as domestic investors and local borrowers in developing countries with their own financing in foreign currency. If the Ministry of Foreign Affairs also establishes a collaboration with TCX through a capital injection, this can have a direct, positive effect as TCX can extend its local currency financing to more developing countries.

236. Direct cooperation with the authorities or the national development bank in a partner country in relation to a blended finance programme with guarantees or grant funding from Norad can be an effective tool in the development cooperation (ref. Items 228–230). This could be a major opportunity that should be explored further.

237. It will also be useful to have a close dialogue with Convergence, in its role as international resource centre for blended finance, on possible participation in and preparation for blended finance transactions. Use of its matchmaking platform would also be the obvious choice for any blended finance transactions.

238. With regard to private investors, the time is right for a dialogue with Norwegian institutional investors such as KLP, Storebrand, DNB, Danske Bank etc. Talks with other Nordic institutional investors could also be considered. A good place to start could be, for example, SISD, whose network consists of the largest institutional investors in Sweden.

## Chapter 5

### Recommendations

239. The recommendations below are set in a three-year time frame. Some measures can be initiated and implemented within one year, while others will need more preparation time before final implementation.

240. **In the short term, year 1, it is important to expand existing instruments in Norwegian ODA for blended finance.** This will lay the foundation for use of the development assistance aimed at many of the SDGs. First of all, a mandate should be put in place that allows grants to be used for first loss facilities, with broad application in the development assistance budget. It is therefore recommended that a proposal to proposed resolution X.11 in Proposition to the Storting 1S, 2021–2022 as described in section 153 be presented in the revised national budget for 2022 for all items in budget area 03. The proposal should build on the existing resolution for item 162.70 Business development and trade. The revision of the national budget will start in January 2022. It is also recommended that all relevant rules for the scheme are revised in order to pave the way for this type of cooperation with the private sector.

241. It is further recommended that the foundation is laid for an informed debate on development guarantees as an effective development cooperation instrument. It is proposed that in year 1, documentation is presented along with a rationale for a pilot scheme with development guarantees in the same vein as Denmark's scheme for 2022–2025, with a view to further debate and political clarification in years 1 and 2. It is also recommended that other subsidiary measures related to development guarantees in year 1 be implemented: prepare and enter into partnerships with guarantee providers (Sida and the AGF could be candidates), and submit documentation and the rationale behind the idea to the Ministry of Foreign Affairs in order to make a capital contribution to a guarantee provider specialising in developing countries (e.g. the AGF).

242. **It is recommended that preparations start in year 1 for some high-priority blended finance programmes.** Some of these can be established and implemented quickly while others will require more extensive preparation and later implementation, in year 2 or 3. In year 1, it is recommended that the proposed flagship programme for job creation in SMEs (programme 1,<sup>102</sup> which uses debt instruments) be launched in sub-Saharan Africa in collaboration with a guarantee provider. This programme can be implemented in accordance with Norad's and Norfund's existing mandates and implemented quickly with the help of external partners. Another high-priority measure that can be implemented in the short term is the preparation and provision of support to TCX, which can protect local businesses in developing countries from currency risk and stimulate investment.

243. **It is also important to start exploring and preparing for the possible introduction of more comprehensive blended finance programmes** that will eventually mobilise private capital on a large scale, preferably from institutional investors. A shared characteristic of these investors is that they will require more extensive preparation and dialogue with relevant actors prior to implementation. A realistic time frame is as follows: initiation of preparations in year 1 and possible launch in year 2 or 3, depending on the type of measure. Investigations and preparations for programmes should start in year 1.

Programme 5 – Mobilisation of foreign investment to lower-middle-income countries

Programme 6 – Climate finance measures

Programme 3 – Aggregation fund for multiple underlying investment funds

Programme 4 – Fund with financing that changes the risk profile and investor base during the project's life cycle (particularly strengthening the supply line of new project companies to investors). Programme 4 could be one of the fund models in Programme 6, and climate financing could be a core element of Programme 5. These possibilities should be investigated further.

244. In addition, TA and project development support are needed to strengthen the supply line of new projects and SMEs to potential investors. It is therefore recommended that preparations start in year 1 for a

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<sup>102</sup> The number of the programme corresponds to the numbering of the programme proposals in Chapter 4.

grant-financed TA fund that can provide financing for TA facilities linked to investment funds. This will include a tender competition to outsource the operation of the TA fund.

245. Part of the preparation for the various initiatives involves exploring opportunities for partnerships with relevant players. In some cases, those suggested in Chapter 4 serve as a good starting point.

Over time, as the development of the above measures progresses, Norad can gradually consider looking more closely at the remaining measures described in Chapter 4.

**246. It is important to build a coordinated partnership with Norwegian players to ensure optimum results from blended finance in development assistance.** It is particularly important that Norad and Norfund have a close and transparent relationship based on trust, where they can complement each other while respecting and safeguarding their different roles. They can provide complementary measures that play to each other's strengths. A good example of this is that Norad can alleviate some of the risk for Norfund by providing grants for first loss facilities. Such a collaboration would enable Norfund to make a range of investments that foster extensive development, where the risk would not otherwise have been considered feasible. By coordinating their efforts, Norfund and Norad can create a win-win situation that also makes it attractive for Norwegian institutional investors to provide commercial capital in the proposed blended finance transactions.

247. Norway can make a major contribution to investment in developing countries in order to reduce their investment gap. It is therefore essential to ensure a unified and coordinated partnership between Norwegian players, and particularly a close and effective collaboration between Norad and Norfund.

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## Appendix

### International credit rating scale

Commercial investors must ensure that a professional, independent capital risk assessment is performed for potential investments or loans, typically bonds. The borrowers and portfolios of individual investments under consideration are therefore given a credit rating. This is an assessment of the borrower's credit risk (an individual, a business or a government), of their ability to repay the debt and an implicit prognosis of the likelihood of them defaulting. Credit ratings are given by large, international rating agencies. Standard & Poor's, Moody's and Fitch Ratings are the three leading providers and account for 95 per cent of all credit ratings. The credit rating scales used by Standard & Poor's and Moody's are presented on the following page. The credit rating codes range from A to D:

A: safe investment; B: speculative investment; C: high-risk investment; D: likely to default

A bond that is rated AAA (Triple A) is considered very safe, with an extremely low credit risk. Bonds with a D rating entail the greatest risk.

Higher scores indicate a lower probability of default. It is important to note that institutional investors will only have a mandate to invest their capital in portfolios or borrowers with a credit rating in the category 'investment grade', i.e. that are 'investable'. 'Investment grade' includes all scores from AAA down to BBB- (on Standard & Poor's scale). In blended finance measures aimed at mobilising institutional investors, the capital risk exposure should therefore have a credit rating of BBB- or higher.

	<b>Moody's</b>	<b>Standard &amp; Poor's</b>	<b>Credit rating</b>
<b>Investments grade</b>	Aaa	AAA	Triple A = credit risk is almost zero
	Aa1	AA+	Safe investment, low risk of default
	Aa2	AA	"
	Aa3	AA-	"
	A1	A+	Safe investment, unless unforeseen events take place in the economy or industry
	A2	A	"
	A3	A-	"
	Baa1	BBB+	Moderate investment risk. Adverse economic conditions more likely to lead to problems.
	Baa2	BBB	"
	Baa3	BBB-	"
	<b>Non-investment grade</b>	Ba1	BB+
Ba2		BB	"
Ba3		BB-	"
B1		B+	Speculative investment. Adverse situation is expected.
B2		B	"
B3		B-	"
Caa		CCC	High likelihood of bankruptcy or other disruption to operations.
Ca		CC	"
C		C	"
		D	Bankruptcy or permanent insolvency most likely.

Sources: Moody's Investors Service; Standard and Poor Global Ratings.

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