**Private Sector Instruments and Blended Finance**

**What are Public Sector Instruments and Blended Finance?**

Providers are increasingly focusing on ways of engaging the private sector in development, and on using ODA as a way to ‘mobilise’/’leverage’ more private finance for development purposes. Most providers have created public sector institutions and other vehicles structured to mobilize private sector finance for development purposes. These private sector instruments (PSIs) work in close harmony with private sector investment initiatives through grants, loan and investment guarantees, public equity investments, loans and credit facilities. Under the DAC’s modernization of ODA agenda, DAC Members have agreed to better reflect PSIs in the DAC ODA accounting, while assuring the right incentives and removing ODA-related disincentives in the use of these instruments.

In the past decade, DAC providers have dramatically expanded the numbers of public sector Development Finance Institutions (DFIs), based on the largely untested rationale that the SDGs will only be achieve if ODA is deployed to catalyze major private sector finance at both national and international levels. Providers therefore deploy ODA as “blended finance”, combining public and private finance, with public finance acting as an incentive to allay investment risk for the private sector.[[1]](#endnote-1) The DAC calculate that there are now 167 provider mechanisms for blending public and private finance for development.

How successful have PSIs been in mobilizing and allocating blended finance? The OECD estimates that these mechanisms mobilised US$81.1 billion in private finance between 2012 and 2015 (approximately US$20 billion a year), but they were unable to estimate the amount of public finance used to catalyze this finance.[[2]](#endnote-2) Convergence, an independent aggregator of concessional blended finance contracts through DFIs, estimates that this form of blended finance currently averages US$15 billion annually. But relative to the scale of ODA (Real ODA at approximately US$130 billion in 2018) or South South Cooperation (estimated to be approximately US$28 billion), blended finance may be growing over the past few years, but still represents a very modest investment in development. There is a mismatch between documented spending and the rhetoric of engaging the private sector.

It also seems that the expectations for the mobilization of significant private capital for SDGs by blended finance are unrealistic – on average blending institutions have mobilized only US$0.75 in private sector finance for every dollar of public investment, which dropped to US$0.37 for low income countries.[[3]](#endnote-3)

**Why are PSIs and blended finance important for Africa?**

Overall for DAC providers, there has been a trend in ODA towards greater attention to sectors in which the private sector plays a major role and/or align with private sector interest in development.[[4]](#endnote-4) What is the implications for Africa?

1. **Overall allocations to private sector-oriented sectors.** Allocations to these sectors increased from 21% in 2010 to 26% in 2016 (Reality of Aid 2018 Global Report), with a similar trend for Sub-Saharan Africa (21% to 25% of bilateral ODA). Blended finance is likely to have played a role in this increase. Conversely, ODA allocated to poverty-oriented sectors since 2010 has remained constant at 35% (slightly below all regions at 37% in 2016).
2. **PSI goes largely to Middle Income Countries, with potential for less aid to LDCs:** The OECD study documented that 77% of the US$81.1 billion went to middle-income countries, especially in Africa, which was the largest beneficiary region (30% of total). But 73% of this finance directed to Sub-Saharan Africa was in the form of loan and investment guarantees in which the public finance never left the provider country. Nigeria and Ghana were among the top ten country recipients globally.

The Convergency study also points to Africa as the main beneficiary in 2016-2018, receiving 37% of concessional blended finance transactions (number of transactions, not total dollar amount), but down from 44% in 2010-2012 period. They also point to Ghana, Nigeria, Kenya and Uganda as countries in Africa with high numbers of blended finance transactions.

According to the OECD/UNDCF, in the six years between 2012 and 2017 only 6% of mobilized blended finance went to LDCs, with over 70% of middle income countries.

1. **PSI focuses on hard business sectors, with potential for less to social development and governance sectors.**  Almost three-quarters of the OECD US$81 billion was dedicated to banking, energy and industry sectors and 26% was for climate finance (of which 88% went to mitigation). In the Convergence study energy and financial services at 71% are the priority sectors (60% in Sub-Saharan Africa), again with an emphasis on climate change.

**What are the key issues in blended finance and PSIs?**

There are a number of issues about the relevance of PSI/blended finance as a resource strengthening ODA for the reduction of poverty and inequality:

1. Blended finance is directed to activities/sectors in which the business case is strong, which are often not high-risk poverty-oriented sectors. Public subsidies in blended finance cover the risk of the business investment itself but does not push investment into these latter sectors. With overall stagnant ODA levels, ODA may be diverted to blended finance away from more poverty-focused interventions. But with the emphasis on blended finance there is a risk that providers will promote the commercialization of social sectors, undermining access for the poorest and most vulnerable populations.
2. Concessionality in all transactions that are included as ODA is not currently assured. Some providers are getting ODA credit for activities that are at or close to market terms, which blurs the lines between development-motivated and commercially-motivated investments.
3. Monitoring and evaluation systems for blended finance are weak and are compounded by multiple layers of private finance involved in a project. More broadly there is little evidence that these investments have a positive impact on poverty or inequality reduction. With few evaluations it is impossible to determine whether blending results in development additionality on the ground.
4. Similarly, without explicit safeguards that are monitored, providers may be promoting private sector engagement that do not comply and/or undermine human rights, labour rights and social and environmental standards.
5. The high level of loan and investment guarantees involved in blended finance risk further “inflation” of levels of provider ODA, as these guarantees are only deployed when the loan or investment fails but are counted at their full value at the time of issuing. Currently, due to the lack of agreement at the DAC, guarantees are not reported as ODA.
6. The DAC is clear that only private finance that is additional to what would have been available without the pubic resource is considered mobilized finance. But the DAC has no definition of financial additionality – which makes it difficult to assess whether blending is resulting in an unnecessary subsidy to the private sector.
7. Promotion of blending arrangements may result in increasing unsustainable public and private debt in partner countries and increased informal tying of aid in provider countries. In the OECD study 62% of private finance originated in the provider countries and 38% in developing countries.

The diversity of more than 160 mechanisms for blended finance adds to an already highly fragmented development finance environment with different modalities, terms and conditions. With some exceptions, transparency in the projects supported through DFIs is weak, with accountability for public ODA finance a major challenge.

**DAC rules determining the ODA-eligibility of PSIs:** there are no clear ODA rules to govern the use of PSI. At its 2016 High Level Meeting (HLM), the DAC agreed on general principles for counting PSIs as ODA, and committed to develop detailed ODA rules. At the DAC HLM in 2017, the Members failed to agree on a common set of rules, but nevertheless agreed to allow members to report PSI finance as ODA. The [interim reporting arrangement](https://www.oecd.org/dac/stats/What-is-ODA.pdf) is highly problematic in that it allows for this ODA to be claimed on either an institutional basis (provider estimates the share of PSI finance eligible for ODA) or an instrumental basis (where each PSI activity is examined and reported based on its ODA eligibility).[[5]](#endnote-5) CSOs strongly favour the latter approach as institutional level reporting will likely lead to inflated levels of ODA and thereby undermine the credibility of ODA data. It also fails to establish strong safeguards to address many of the issues described above.

**DAC policy guidance for blended finance**: In 2017 DAC members agreed to [a set of principles](http://www.oecd.org/development/financing-sustainable-development/blended-finance-principles/) to guide blended finance, which are vague and fail to deal with many of the issues set out above.[[6]](#endnote-6) Since then the DAC has been working on guidance to operationalize these principles, but have failed to reach consensus. In 2019 the Global Partnership for Effective Development Cooperation (GPEDC), in which all DAC members participate, agree to the [Kampala Principles on Effective Private Sector Engagement](https://effectivecooperation.org/wp-content/uploads/2019/06/Kampala-Principles-final.pdf) in Development Cooperation.[[7]](#endnote-7) CSOs involved in the GPEDC participated in the articulation of these Principles. They go some distance in providing specific guidance relating to development effectiveness, transparency and accountability for blended finance and other forms of engagement with the private sector.

**What are the main priorities for the DAC CSO Reference Group on PSIs and blended finance?**

The DAC CSO Reference Group recognizes that the private sector can, in the right context and with the right regulatory framework, make important contributions to sustainable development, the reduction of poverty and inequality – by providing decent jobs and livelihoods and by paying taxes that enable states to deliver essential public services.

However, the right rules and safeguards are needed to ensure that if providers are using ODA to support PSIs or to engage in blended finance, the impact on poverty and inequality reduction is maximised, and that the risks laid out above are mitigated. The DAC CSO Reference Group is therefore calling for the DAC:

1. **To reach Member consensus on reporting rules** for PSI finance as ODA that mandates instrumental reporting only, preserves strong concessionality as a core principle for ODA, and that excludes equity, mezzanine finance and guarantees as well as export credits.
2. **To put in place the means for full public and timely scrutiny** through the DAC on how ODA for PSIs in being spent. Available data is aligned with other ODA reporting in the CRS and should augment the latter with information on the country locations and ownership of companies, financial terms, estimated amount mobilized, and expected additionality of the investment for development. The Reference Group will be examining 2018 data when it becomes available in December 2019.
3. **To review the consequences of DAC reporting rules for PSIs in 2020**, based on 2018 and 2019 data, analyzing not only consistency with the agreed rules, but also risks in relation to distortion of aid directed to the poorest countries and people, informal tying of ODA, erosion of development effectiveness principles (particularly local ownership, accountability and transparency), implications for human rights and environmental standards, and debt sustainability. The *Kampala Principles* provide an important framework for this assessment.

To enable the Reference Group to contribute to a 2020 review of PSI reporting, it will be important to document country level experience with DAC Member supported blended finance and provider DFI projects that have been included as ODA. The Reference Group intends to bring together a body of evidence in this regard.

1. Note that blended finance is only one way in which providers are working with the private sector in developing countries. The latter includes support for small and medium enterprise, micro-credit institutions, agricultural extension through domestic private actors, etc. [↑](#endnote-ref-1)
2. OECD, *Making Blending Finance work for the Sustainable Development Goals, Executive Summary*, January 2018, accessed May 2018 at <http://www.oecd.org/publications/making-blended-finance-work-for-the-sustainable-development-goals-9789264288768-en.htm>. [↑](#endnote-ref-2)
3. S. Attridge and L. Engen, “Blended Finance in the Poorest Countries: The need for a better approach,” ODI, April 2019, accessed August 2019 at <https://www.odi.org/sites/odi.org.uk/files/resource-documents/12666.pdf>. [↑](#endnote-ref-3)
4. These sectors are Large scale water and sanitation, transport, energy, formal financial intermediaries, business services, industrial, minerals, construction and trade policies. [↑](#endnote-ref-4)
5. See <https://www.oecd.org/dac/stats/What-is-ODA.pdf> [↑](#endnote-ref-5)
6. See <http://www.oecd.org/development/financing-sustainable-development/blended-finance-principles/>. [↑](#endnote-ref-6)
7. See <https://effectivecooperation.org/wp-content/uploads/2019/06/Kampala-Principles-final.pdf> [↑](#endnote-ref-7)