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OPINION

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Blended finance is in fashion in the development finance world. It refers to the merging of public and private funds to maximize development impact and is most often called upon in reference to meeting the sustainable development goals (SDGs) that countries valiantly agreed to in 2015.

Blended finance is talked about as a mechanism to reduce investment risks associated with things such as basic healthcare, energy access and livelihood for the poorest. The phrase is being floated at all manner of international gatherings—from meetings of the World Bank to those of the Organisation for Economic Co-operation and Development (OECD), as a way to make the limited pool of $140 billion international public funds go farther.

Enthusiasts advocate three main hopes: One, that blended finance can reduce investment risk; two, enhance returns; and three, increase financial flows. There are plenty of examples being floated around advertising the clever use of such capital. For example, a €360 million hospital in Turkey was made investible through the use of credit enhancements that allowed the issuance of investment-grade bonds, whose ratings were higher than sovereign ratings. A $58 million local currency, multi-country debt fund for off-grid energy in rural African homes was made possible through clever structuring of monies from the African Development Bank, Calvert Impact Capital, Global Environment Facility and the Nordic Development Fund. And in true spirit of blending, the government of Norway and Unilever have invested $125 million in a fund mandated to invest in agriculture companies to create inclusive, deforestation-free commodity production ecosystems.

No doubt these examples have removed otherwise insurmountable barriers, but they are only the tip of the iceberg for what can be achieved if blending were to truly catalyze private investment. For blended finance to change development finance, it has to scale. For this to happen, five fundamental issues that are inherent to the way public and private capital is managed, need to be addressed.

The first is to do with the way money is managed. Most aid agencies need to spend their commitments in a given calendar/fiscal year; internal accounting systems disallow payables over time. This means that any contract that entails future payments is prohibited. For example, making efficient cook stoves available to households suffering from indoor air pollution needs payments of at least $7 per stove per year. Assuming carbon credits accounted for 60% of that, at least $3 of top-up would be needed in order to generate a decent rate of return for private investors. Many agencies are unable to enter into such forward contracts.

Relatedly, many agencies still have an archaic “use it or lose it” approach—if you don’t spend the money in that calendar year, chances are you will forfeit it in the following year. In reality, projects get delayed and cost overruns happen—particularly in the typically challenging markets that SDGs are relevant to. This approach not only creates perverse incentives where organizations focus on spending; sometimes, it even translates into corporate performance indicators where staff are monitored against money spent. When this becomes the primary objective that defines the life of an organization or the tenure or the staff member, a focus on impact and outcomes is naturally a dismal secondary.

The second relates to how money is monitored. Public agencies, aid in particular, focus on monitoring every dollar spent, whereas private funds monitor outcomes over a pre-agreed period of time and rely on audited financial reports as the benchmark for healthy financial management. This perceived micromanagement distracts from focusing on the real outcomes of the investment and redirects often significant human resources into the production of micro level financial reporting. The underlying problem is how governments set the rules. Rather than control the process, public agencies should set their ‘public benefits’ criteria upfront, and private entities should make those integral to normal financial reporting.

The third is related to the pricing of risk. In commercial finance, the higher the risk, the higher the cost of capital. In an ideally blended structure designed to cater to risky markets or make investments economical, public capital should bear a higher share of the risk—but at lower costs of capital. However, in reality, public capital tends to be risk-averse, and so the line between costs of public and private capital end up getting blurred with the result that the sources sometimes compete with each other rather than be complementary.

The fourth relates to how failure is handled. While every private agency works to minimize failures, some degree of failure is inevitable when investing in new technologies, business models or untested markets. After all, the average failure rate of venture capital funds is 25-30%. Without venture money, new ideas would never be backed. Public monies, on the other hand, are intrinsically risk-averse, to the point of zero tolerance when it comes to ‘failure’. While this is understandable given that most public monies tend to be people’s tax dollars, unless some level of failure is permitted, innovative business models of types needed to meet the global goals are unlikely to emerge.

And finally, the biggest hurdle to public and private monies coming together lies in an ideological difference between governments and businesses. While the landscape is changing, many aid agencies I have dealt with, still cannot fathom the idea that public monies will be used to enable private entities to make profits. The longer this ideological difference remains, the harder it will be to develop large scale solutions where public monies will be needed to mitigate the risk that private entities will not otherwise take.

All this notwithstanding, the larger goal of blending is a noble one and it is time that a common understanding were achieved among the blenders of capital so that both sides know what to expect.

The author thanks Michael Schlup, of Sail Ventures, an investment firm based in Amsterdam.

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