Blending loans and grants: to blend or not to blend?[♣]

San Bilal and Florian Kratke

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Blending loans and grants has become common practice in international development finance. It is one of the mechanisms regularly used with development finance institutions (DFIs) such as the Agence Française de Développement (AFD), the European Investment Bank (EIB), the KfW and the Nordic Investment Bank. It involves the combination of grant aid and other private or public sources of finance, such as loans, risk capital and/or equity. Grant aid (or grant equivalent) provided can take a number of forms, most commonly direct investment grants, interest rate subsidies, and technical assistance. Such grant aid is intended to leverage additional non-grant financing, generally for infrastructure, energy or private sector development projects, to meet unmet investment needs.

The European Union has recently put greater emphasis on the opportunities offered by blending, combining EU grant aid (channelled through a development finance institution) with non-grant resources. Since 2007, the EU has established eight loan and grant blending facilities (highlighted in Table 1) with a view to leveraging development finance. According to the European Commission, the €1.5 billion grants from the EU budget, the European Development Fund (EDF) and Member States have leveraged more than €20 billion of loans by development finance institutions, "unlocking project financing of at least €45 billion, in line with EU policy objectives".[1] Such facilities are also expected to increase efficiency, coordination, ownership and impact of the EU development finance.

The EU *Agenda for Change*, adopted by the Council in May 2012, includes a commitment to increase the share of EU aid through innovative financial instruments, including under facilities for blending grants and loans, and other risk-sharing mechanisms. The following European Commission Communication on *Improving EU support to developing countries in mobilising Financing for Development* of July 2012 further stressed that:

> "The EU, Member States and public financing institutions should step up efforts for increased use of innovative financing mechanisms on a coherent, coordinated and

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[1] http://ec.europa.eu/europeaid/news/2012-12-12-platform-blending-funds_en.htm

strategic basis. The EU should leverage more private resources and capacities through blending mechanisms that can crowd-in additional private and public financing: i) create a private sector window within the regional blending mechanisms, ii) make greater use of risk-sharing mechanisms such as guarantees that can unlock investments and iii) promote investments through instruments that entail improved risk management and equity participation in structured funds."

Figure 1: Key EU Loan and Grant Blending Facilities

LGBF	Date	Grant funding	Participatory financiers (end 2010)
ITF: EU-Africa Infrastructure Trust Fund 47 African countries	2007	Grant funds allocated: €308.7 million from 10th EDF + €64 million from MS budgets	AFD, AfDB, BIO, COFIDES, EIB, FINNFUND, KfW, Lux-Development, MoF Greece, OEeB, SIMEST, SOFID, PIDG
NIF: Neighbourhood Investment Facility Countries eligible for the European Neighbourhood and Partnership Instrument (ENPI)	2008	€745 million 2007-13 from EU budget (ENPI) + €70 million from MS budgets	AECID, AFD, CEB, EBRD, EIB, KfW, NIB, OeEB, SIMEST, SOFID
WBIF: Western Balkan Investment Framework Western Balkans	2009	€110 million from EU budget + €10 million EIB, €10 million EBRD, €10 million CEDB + grants from MS budgets	CEB, EBRD, EIB, KfW
LAIF: Latin America Investment Facility Latin American countries	2010	€125 million 2009-13 from EU budget	AFD, BCIE, BID, CAF, EIB, KfW, NIB, OeEB
IFCA: Investment facility for Central Asia Central Asian countries	2010	€65 million 2011-13 from the EU budget	NIF accredited institutions can participate.
AIF: Asia Investment Facility	2012		
CIF: Caribbean Investment Facility	2012	€40 million	AFD
IFP: Investment Facility for the Pacific	2012	€10 million	

Source: Adapted from Ferrer J.N. and A. Behrens (2011), Innovative approaches to EU blending mechanisms for development finance, CEPS Special Report.

Some arguments in favour of blending

The increased interest in blending, notably by the EU, is partly motivated by:

- the need to mobilise additional resources for development and global public goods (such as climate change);
- the prospect of closing the financial gap, for projects that could not be wholly financed through loans only;
- the prospect of improving the development impact of the investment, through the grant element as complementary funding;
- the objective of reducing the potential debt burden resulting from the investment, enhancing long term public sector borrowing capacity/sustainability;

- the economic downturn in Europe and resulting increased budget constraints on donors, which has put pressure on European spending on development; leveraging developing financing through blending is often perceived as a means to partly address the requirement “to do more with less”;
- the potential for greater aid/development effectiveness and potential economies of scale generated as a result of better pooling of resources and coordination among development financiers;
- the potential for enhancing the partner country governments’ ownership of the development assistance due to the loan component;
- potentially increased value added for developing countries, in terms of private sector development (notably banking and financial sectors), and demonstration effect (e.g. building on the experience of its European Investment Facilities).

Blending mechanisms are thus perceived as having the potential to not only leverage quantitative financing for development, but also to leverage qualitative development as well as enhancing the development impact and effectiveness of development cooperation. This is the basic rationale for the current approach adopted by the EU.[2]

Discussions are still on-going whether blended loans count towards official development assistance (ODA).

Some concerns about blending

Blending mechanisms, however, have also raised some questions and concerns, as to their effectiveness, development impact, and potential distortive effects. In particular, common concerns have been expressed regarding:

- **The risk of financial incentives outweighing development principles**. It remains unclear to what extent projects funded through blending have a development impact. Investors, including development finance institutions, may prioritise considerations on return-on-investment, overriding development priorities underlying development funds through grant aid. Coordinated efforts must be made to ensure and monitor development objectives and impact of development finance through blending mechanisms; the ratio of grant to loan for individual projects should also be assessed in terms of financial viability and development effectiveness. Current methods of project selection and monitoring, however, may leave doubts as to who is leveraging whom. Critics have argued that only one fourth of companies supported by blending facilities (EIB, World Bank and IFC) between 2006 and 2010 were domiciled in developing countries[3].

- **The risk to differentiate in favour of middle-income countries against poorer countries**. Most private investment currently flows to middle-income countries with better-developed financial sectors and to sectors towards which private investment is already flowing. Whereas blending instruments can therefore prove useful to those upper middle income countries (UMICs) affected by differentiation, it raises concerns whether the EU will be able to increase investment flows to low-income countries (LICs), lower middle income countries (LMICs) and fragile states.

[2] See Rudischauser, K. (2012), Engaging the Private Sector for Development: What Role for the EU Regional Blending Facilities?, GREAT Insights, Vol.1, Issue 8, October. www.ecdpm.org/great_1_8

[3] Kwakkenbos, (2012), Private Profit for Public Good?, Eurodad. http://eurodad.org/wp-content/uploads/2012/05/Private-Profit-for-Public-Good.pdf

- **The risk of crowding out private financing and distorting markets**. ODA grant aid could crowd out private capital under some circumstances where commercial loans would have been viable. It may also lead to a race to the bottom among development finance institutions and donors, in an attempt to capture new market for loans through implicit subsidies. This counterproductive competition among financiers to finance perceived "good" projects may ultimately lead to inefficient loans and over-subsidisation or concessionality of loans (i.e. with too high grant-to-loan ratio). This would not only lead to ineffective ODA, but would also distort the financial market, leading to inefficient financial allocation mechanisms.

- **The risk of providing insufficient attention to transparency and accountability.** Blending mechanisms may further cloud the transparency and accountability issues in the selection of projects, mechanisms of funding and flows of funds (sometimes through intermediaries in tax havens). Financial objectives may prevail over development concerns.

- **The risk of unclear or ill-defined monitoring and evaluation methods**. In addition to traditional monitoring and evaluation challenges inherent to all development projects, the assessment of blending mechanisms must include an evaluation of the leveraging effect. In addition to the quantitative leverage, sufficient attention must be given to the qualitative leverage; i.e. to assess whether blending facilities are successful not only in terms of the ratio of investment raised against ODA invested, and the size of projects, but also to assess the development impact of actual projects financed, including whether there is national or local ownership of such projects, and to which extent the grant element has further enhanced that impact. So far, evaluating the impact of this additional dimension of blending has proved extremely difficult. Critics have also argued that there has been no assessment as to whether projects funded through blending facilities are in line with the national development strategy of developing countries.

- **The debt risks for developing countries of increasing lending**. Blending facilities primarily fund projects undertaken by developing country governments. Some developing countries, notably in Sub-Saharan Africa and the Caribbean, have high debt ratios; introducing blending facilities could further increase their debt exposure, as most projects funded through such facilities have a grant-to-loans ratio of 1:4. This may affect not only the national fiscal space but also countries' ability to attract other funding, such as IMF loans, and will force them to link more with volatile international financial markets.

Towards a balanced approach

In considering the opportunity for blending mechanisms, the opportunities and challenges must be carefully assessed (see Table A1 in the Annex for an overview), and the added value of the additionality component of blending mechanism for each project clearly identified and assessed. This means addressing questions for each project such as:

- What added value do they have beyond projects already funded by private investment, in particular in terms of development objectives and sustainability?
- What is the opportunity cost of investing in blending facilities instead of the more straightforward public or private investment?

It is interesting to note that many of the concerns raised about blending mechanisms somewhat overlap with recurrent criticisms raised notably by civil society organisations about the operations of development finance institutions, in terms of commercial interests, transparency and accountability, monitoring and evaluation of development impact, debt burden, etc. In assessing the merits and shortcomings of blending instruments, it is therefore necessary to focus on characteristics that are specific to blending, distinct from those that concern development finance in general (by DFIs and traditional ODA).

Practical issues and considerations on the implementation of blending instruments must also be addressed. In particular, opportunity costs must be carefully assessed. Leverage loans with grants may provide vital assistance to project preparation and implementation (a third of EU grant support to blending takes the form of technical assistance); but it may also entail longer and more cumbersome procedures than simply disbursing the grant aid or a loan. Transaction costs related to blending mechanisms (management, coordination, implementation) may prove higher due to the multi-stakeholder nature of such instruments. EU instruments including the DCI and EDF have already been criticised for having low disbursement rates. Furthermore, blending facilities do not guarantee that grant funding introduced into them will be matched by loans. While funds can of course be reprogrammed, this would further harm the disbursement rate.

EU Platform for Blending in External Cooperation

Finally, it is worth pointing out the advisory *EU Platform for Blending in External Cooperation*[4] launched in December 2012 by the EU. It will first review existing blending mechanisms and develop a common framework to measure their impact. Furthermore, the platform will produce recommendations and guidance on how to blend public and private resources to increase the impact of EU development cooperation using existing blending and financial instruments in time for the implementation of the EU's new budget in 2014. The platform will afterwards develop key principles for blending, ensuring that blending activities are coherent, coordinated and flexible. Lastly, the platform will be tasked to develop new methods of funding. It was recommended that the platform should focus on sectors where funding can be most useful and where value added and impact of blending can be the highest given EU policy priorities (e.g. market failures, climate change and economic crises). The platform is composed of administrative and diplomatic staff from the EU institutions (EC and EEAS), policy and technical staff from the European Investment Bank (EIB), representatives of the Member States and representatives from various development finance institutions. The European Parliament will act as an observer, and civil society organisations, beneficiary countries, representatives from the private sector, and financial institutions could be consulted ad hoc (though they do not have a seat on the platform).

Contact: Dr San Bilal, Head of Economic Governance, Trade and Regional Integration Programmes, European Centre for Development Policy Management (ECDPM), Maastricht and Brussels (sb@ecdpm.org).

[4] The EU Platform for Blending in External Cooperation: http://ec.europa.eu/europeaid/news/2012-12-12-platform-blending-funds_en.htm

Annex

Table A1: Assessing Blending vs. Pure Loans and Pure Grants

	BLENDING vs. PURE LOANS		**BLENDING vs. PURE GRANTS**	
	PROS	*CONS*	*PROS*	*CONS*
Economic criteria	Contribute to solve the issue of debt sustainability in heavily indebted countries.	Market distortions.	Can mitigate the fiscal side effects of pure grants.	Reduced debt sustainability Risk of financial principles outweighing development policy principles
Strategic/Political criteria	Can finance projects with significant positive externalities but not financially sustainable, as well as solve the issue of negative externalities associated to a given project. Policy leverage especially in middle--income countries and emerging markets. Can enhance EU visibilities.	Loss of visibility of individual donors, because blending occurs at EU level.	Policy leverage, especially in low--income countries at the country sector and project levels. Can enhance EU visibility.	Loss of visibility of individual donors, because blending occurs at EU level.
Financial criteria	Financial leverage through risk mitigation. Can offer more flexibility with regards to disbursement conditions, initial costs or project speed.	Potential transparency issues. Risk of imprudence in recipient countries. Cannot eliminate risks but just transfer them to the EU.	Financial leverage, especially in low--income countries. Can offer more flexibility in adapting the volumes of funds to specific projects needs than pure grants.	Potential transparency issues.
Operational Criteria	Can allow speeding up projects. Can enhance project quality. Can enhance coordination between donors and lenders. Can allow for knowledge transfer and demonstration effect.	Loss of control of individual donor. Potential slowdown of decision--making.	Can provide greater incentives than pure grants for donors to monitor funded project. Give donors access to project management expertise of lenders. Can enhance coordination between donors and lenders. Demonstration effect. Can allow risk sharing and mitigation	Loss of control of individual donor. Potential slowdown of decision--making.

Source: ETTG (2011), EU Blending Facilities: Implications for Future Governance Options, European Think Tank Group (DIE, ECDPM, FRIDE, ODI). www.odi.org.uk/sites/odi.org.uk/files/odi-assets/publications-opinion-files/6658.pdf