Navigating the Next Wave of Blended Finance for Financial Inclusion

Blended finance is at the heart of the discussion on how to attract private investors to close the estimated $2.5 trillion annual gap to finance the Sustainable Development Goals (SDGs) (UNCTAD 2014). In financial inclusion, the use of blended finance is not new and has attracted private investments from international and local sources (see Box 1). How will this most recent emphasis on using blended finance to mobilize private capital for development affect funding for financial inclusion? This Brief presents opportunities for the new wave of blended finance and points to areas that deserve further attention to optimize the use of different funding sources to advance responsible financial inclusion.

Increasing role of private capital in development finance

The signs are clear, even if progress is slow: More private capital will become available for the SDGs and development, including financial inclusion. More than 160 blended finance facilities have been launched since 2000, and US$81 billion has been mobilized from the private sector between 2012 and 2015 (OECD 2018). Budgetary constraints on public funds and changes in rules for measuring official development assistance that reward donors for mobilizing private capital have prompted public donors like the World Bank and the European Commission to use blending instruments to raise private capital.1,2 Foundations are also committed to help close the SDG funding gap and use blended finance mechanisms to mobilize private capital.

In financial inclusion, blended finance has a long track record. The State of Blended Finance Report (Convergence and BSDC 2017) notes that the financial sector accounted for the largest number of blended finance deals (26 percent), including a total of 187 deals from 1980 to 2016.3

The development community’s call for private investments is mirrored by an increasing interest from private investors who seek investments that generate social or environmental benefits beyond financial returns, as evidenced by the expanding impact investing industry. Impact investors project a 17 percent increase in their impact portfolios for 2018 (GIIN 2017). Mainstream asset managers and investors (including Blackrock, Bain Capital, and TPG)4 have recently entered the impact investment sphere, and Deutsche Asset Management (now DWS), UBS, and Morgan Stanley are constructing larger funds and platforms to accommodate large institutional and retail investors. Digital platforms for impact investing are also emerging, and asset managers report that the boards of public and some private pension funds are urging them to pursue market rate investments aligned with the SDGs.5

In financial inclusion, the maturity and track record of the microfinance sector as an impact investment asset class has attracted private investors focused on impact. Private investments accounted for 26 percent of total commitments for financial inclusion as of December 2016 (Tomilova and Dashi 2017). Private institutional investors (e.g., insurance companies and pension funds) rank as the largest funding source of microfinance investment vehicles (MIVs).

Advancing financial inclusion with blended finance

Financial inclusion is an important enabler of the SDGs, and it is a sector that is successfully leveraging private capital.6 Development finance institutions (DFIs) and donors that want to use blended finance in financial inclusion should focus on areas where private investors are not (yet) comfortable investing and where there is promise in terms of impact and

Box 1. What is blended finance?

The Organisation for Economic Co-operation and Development (OECD) defines blended finance as “the strategic use of development finance for the mobilization of additional finance towards the SDGs in developing countries.” The risk-return profiles of investments in developing countries often do not meet the expectations of commercial investors. Blended finance can improve the risk-return profile to attract commercial investments by managing, mitigating, or transferring risks to funders with a higher risk appetite (e.g., public or philanthropic funders). Several mechanisms can be used to this end, and this paper focuses on three principal ones: (i) junior or subordinated capital, which incurs losses before senior investors, thus minimizing risk to senior investors; (ii) guarantees and insurance mechanisms that fully or partially protect investors against risks; and (iii) grant-funded technical assistance, deployed either alongside an investment vehicle for building the capacity of investees, or to fund the preparation and design of funds or individual deals.

1 OECD’s Development Assistance Committee introduced a new development assistance statistical concept—Total Official Support for Sustainable Development—which complements bilateral aid data with information on all “officially-supported resource flows” (including private capital).
2 The World Bank recently introduced a $2.5 billion Private Sector Window that, along with IFC and MIGA, will facilitate private sector investments in low-income countries. The European Commission’s External Investment Plan is projected to mobilize Euro 44 billion or more for SDG-related financing.
3 While financial sector development is broader than financial inclusion, it is assumed that most blended finance deals in the financial sector seek to improve financial inclusion. In terms of amount of capital (as opposed to number of deals), the clean energy/climate and health sectors surpassed the financial sector, reflecting larger deal sizes in these sectors.
4 TPG is a global private investment firm that has raised an impact investment equity fund—the Rise Fund—with commitments of over $2 billion and support from several celebrities, U.S. West Coast technology entrepreneurs, and institutional investors.
5 ImpactUs and Align 17 (a World Economic Forum Young Global Leaders Program initiative with UBS support) are two digital platforms for impact and SDG investing.
6 Financial inclusion is explicitly targeted in seven SDGs, and there are four financial inclusion indicators to track progress, including one that tracks the proportion of adults with a transaction account (SDG 8, Economic Growth).
scales. The following are three areas where blended finance has an important role to play.

**Technology-enabled business models.** Blended finance mechanisms have helped crowd-in private international and local investors for over 20 years and were important in scaling microfinance. Today, private investors that are investing through MIVs are increasingly comfortable with microfinance investments and do not need subordinated capital. Since private international and local investors are increasingly less dependent on risk mitigation for core microfinance investments, DFIs and donors are expected to pivot to innovative, often technology-enabled business models, including FinTechs.7 Through blended finance instruments, DFIs and donors have the opportunity to de-risk the next generation of financial services providers (FSPs) and support companies that will bring efficiencies to incumbent FSPs. Risk-taking capital from donors, DFIs, and impact investors can fund promising companies and product pilots to give innovators the opportunity to flourish and scale financial inclusion (see Box 2).

A spectrum of investment opportunities is available to a broad range of investors. DFIs, impact investors, and traditional venture capital firms are already investing in FinTechs, albeit to a limited extent. Certain countries in Asia and Africa have received sizeable private investments for FinTechs, but concentration on a few lead markets is high (Intellecap 2018). For example, Kenya received 98 percent of FinTech investments in East Africa. Other challenges include the lack of debt funding in local currency, the difficulty FinTechs face in securing subsequent rounds of funding, and issues around equity (Intellecap 2018). There is significant room for DFIs, public donors, and foundations to address these market gaps, including through blended finance mechanisms. The potential for new technology-enabled companies to scale quickly and efficiently is compelling, yet start-ups and technology are risky, and private investors will need risk-mitigating capital and support. Donors and DFIs can provide that, but they need stronger frameworks to assess investment opportunities that make business sense, while at the same time contributing to development outcomes.

**Emerging business models to deliver essential services.** Many donors and DFIs are already adjusting their strategies and organizational structures to reinforce links between financial inclusion and other development objectives, a trend that is expected to continue.8 The SDG-related push for private investment in development presents opportunities to use blended finance to identify and stimulate connections between financial inclusion and essential services, such as energy, education, and water.

Businesses that link financial services and energy-efficient products are one example of new investment opportunities. Clean energy finance is growing through standard microfinance institution (MFI) distribution channels: MFI investees that offer green loans in MIV portfolios jumped from 16 percent to 24 percent in 2016 (Symbiotics 2017).9 In addition, companies are providing solar home systems (and potentially other assets) on a pay-as-you-go (PAYGo) basis by leveraging the mobile money infrastructure, and thus enabling customers to access clean and efficient energy. This partially makes the PAYGo solar business a finance company (Sotiriou et al. 2018). PAYGo companies have gained ground in recent years among both impact and commercial investors and DFIs. Investments in off-grid companies reached $317 million in 2016, with the lion’s share of capital going to PAYGo companies (World Bank Group 2018). Still, the sector is in its infancy. Critics suggest that investments are concentrated in too few companies with aggressive growth strategies despite unproven business models (Neichin, Isenberg, and Roach 2017). There is also room to expand the development of PAYGo models in markets outside of East Africa. The PAYGo sector, therefore, could benefit from blended finance to de-risk investments, improve investment readiness, and build capacity.

**Business models to advance farmer and agricultural finance.** The SDG-related push for private investment is also encouraging DFIs and impact investors to explore investment opportunities in the agricultural sector. In 2017, for example, many impact investors reported plans to increase allocations to food and agriculture (GIIN 2017), and nearly a quarter of MIVs’ nonmicrofinance assets are invested in agriculture (Symbiotics 2017).10 Financial services can play an important role in increasing agricultural production and promoting food security by helping farmers make profitable investments and cope with shocks.

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7 FinTech refers to the use of technology and technology-enabled innovative business models in financial services.
8 In 2016, one-third of international funder commitments were made as part of broader financial-sector development projects (20 percent) and other development projects (e.g., water and sanitation, environmental protection, energy efficiency, etc.) (Tomilova and Dashi 2017).
9 “Green loans” are designed to finance the purchase of energy-efficient or environmentally friendly products, such as solar panels, home insulation, biodigesters, clean cookstoves, etc.
10 As of 2016, nearly 10 percent of MIV total assets financed sectors other than microfinance, 23 percent of these assets are investments in agricultural value chains (Symbiotics 2017).
Smallholder families remain a priority because of their low level of financial inclusion.11

Many financial institutions still perceive agriculture and agribusiness as a risky sector. As a result, farmers and agribusinesses depend on informal financial services or finance provided by value chain actors (e.g., suppliers, buyers) (Dalberg 2016). Blended finance mechanisms could be used to address these challenges. For example, donors and DFIs can provide junior/risk capital in agriculture investment funds that seek to increase access to finance for smallholder farmers and agribusinesses. There is also an opportunity to test more efficient models of financial services provided by value chain actors. For many of these organizations, this is risky; blended finance can help share the risk at the farmer portfolio level and help these organizations expand their outreach and increase scale (IDH 2016).

To date, the experience with blended finance solutions to encourage financial institutions and other types of providers to serve the financing needs of farmers and agribusinesses has not found many solutions at scale (Convergence 2018). DFIs and donors will need to build on past experiences to innovate and optimize the use of blended finance instruments.

Optimizing the role of donors and DFIs for crowding in private capital

The SDGs have spurred new investors to pursue impact investments. Donors and DFIs can use their funding more effectively to crowd in private capital. At the same time, they must continue to address the underlying constraints that hold back the development of inclusive financial services markets or the inclusion of specific populations or communities. The following are a few ways donors and DFIs can optimize their impact.

Address issues that discourage private investors. Blended finance may improve the risk-return profile of businesses to attract private investors and help build a pipeline of investment opportunities, but it will not resolve the underlying deterrents to private investments in financial inclusion. Significant barriers include macro risks (e.g., political, economic, and currency), weak regulatory environments, market transparency, and illiquid investments. While donors and DFIs cannot mitigate all such risks, they can facilitate the development of inclusive financial sector policies and regulations and strengthen the capacity of supervisors, thus building investor confidence.

Leverage funds and facilities. Testing diverse funding approaches, structures, and business models can be catalytic and beneficial, but a haphazard proliferation of new funds and facilities can also be inefficient and slow to scale. In light of the intensifying quest to catalyze private capital, donors and DFIs may be tempted to create their own funds/ facilities for emerging markets that the private sector will capitalize. Often, donors and DFIs do not have the expertise to create or manage these funds efficiently, thereby creating unproductive competition that may crowd out seasoned impact fund managers. Donors and DFIs should create funds only where they can add value that private sector players cannot. Donors and DFIs need to collaborate closely as they attract and “steer” new private sector players into development finance and financial inclusion.

Empower DFIs to take more risks in building markets more broadly. Most DFIs support financial inclusion by funding FSPs (92 percent of total commitments), including already established MFI s that have ample capital access (Moretto and Scola 2017). However, once the path has been cleared for private investments, DFIs need to pare back and rationalize their own investments to ensure that they do not crowd out private investors. (A common MIV complaint is that there is too much money chasing too small a group of top-performing entities.) There is a call for DFIs to focus on building markets (e.g., market infrastructure, coordination, enabling environment, etc.) and supporting promising new business models to become investment-ready for private investors. This will require adjusting the DFI business model to allow them to take more risks; make smaller, early stage investments; prioritize development returns over financial returns; and be more patient. Ultimately, donor-governments represented on DFI boards are responsible for empowering DFIs to play a more catalytic role and ensure the complementarity between DFIs and donor agencies.

Focus on developing local capital markets. Donors and DFIs should focus on using their instruments to build reliable local capital markets that will crowd in local investments and support a variety of investment products (e.g., certificates of deposit, commercial paper, bonds, and securitizations). Donors can fund studies and facilitate reform processes for more enabling policies and regulations, for example, by stimulating public-private dialogue. DFIs can invest in pilots and facilities like KfW’s sponsored African Local Currency Bond Fund, which is an example of applying a blended finance approach to developing local bond issuances and attracting local private investors.

Mitigate foreign exchange risk. Private investors and DFIs are still largely lending in hard currency such as Euro or U.S. dollars (approximately 70 percent), which creates risk for all parties (lenders and borrowers) (Moretto and Scola 2017). Donors and DFIs need to ramp up support to expand existing hedging mechanisms to encourage lending in local currency.12

Support information and transparency to build investor confidence. Private investors have been attracted to microfinance not only because donors and DFIs de-risked the business model but also because transparency on financial and social performance significantly enabled private investors to identify well-performing MFI s and build investor confidence. Support organizations like MIX and rating agencies developed indicators and standards to assess the financial and operational performance of

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11 Data from six CGAP national surveys of smallholder households indicate that financial inclusion varies substantially across the sample, ranging from a low 7 percent in Mozambique to 45 percent in Bangladesh and 49 percent in Tanzania. See CGAP’s website (http://www.cgap.org) and its Smallholder Families Data Hub (www.cgap.org/smallholder-families-data-hub).

12 Namely, The Currency Exchange and MFX, Microfinance Solutions. In the past 8 years, MFX has hedged $1.5 billion in loans to small entrepreneurs in 45 currencies (http://mfxsolutions.com/aboutmfx/).
MFIs and made information publicly available. Other organizations like the Smart Campaign and the Social Performance Task Force created standards and transparency on social performance. To crowd in private capital, whether it is in FinTechs, PAYGo businesses, or other new business models, robust and comparable data on financial and social performance are needed. Donors and DFIs should support efforts to build this information infrastructure and capitalize on the lessons from microfinance.

Promote and implement responsible investing. To avoid harming customers, donors and DFIs should encourage responsible practices by new types of businesses (see Box 3). But, they also need to set practices and standards for themselves and private investors. As seen in microfinance, aggressive growth targets, high return expectations, and concentration of funding across the same players have posed significant risks that ultimately have harmed poor customers (e.g., client over-indebtedness). Recently launched guidelines for investing in responsible digital financial services reflect investor efforts to promote responsible investing (Responsible Finance Forum 2018). To operationalize the guidelines, investors can build on the practices, market infrastructure, and experiences of microfinance.

More funding does not necessarily lead to better results. As funding for financial inclusion evolves under the overarching umbrella of the SDGs, donors, foundations, and DFIs have an opportunity and obligation to shape innovation in financing mechanisms that leverage private capital for financial inclusion. However, mobilizing resources should not come at the cost of neglecting problems that cannot be solved with investments. There is a risk that projects that do not create financial returns receive insufficient attention. Addressing the barriers of financial inclusion is complex and requires more than investing in business models. Donors, foundations, and to some extent DFIs play a crucial role in addressing systemic constraints that are often linked to incentives, relationships between different market actors, and weak capacity. Donors, foundations, and DFIs must not lose sight of these issues to widen and deepen coverage of both populations served and products offered.

Box 3. Keeping client protection and responsible finance at the forefront

With the proliferation of new businesses (such as FinTechs or PAYGo companies) come new risks that funders need to consider. Hacking, identity theft, and aggressive credit offers are among the risks poor people face, and the effects of new business models on customers are not clear yet. Therefore, the focus on the responsible delivery of financial services by new types of providers is still essential. Funders can promote responsible practices by (i) supporting industry-led initiatives, such as client protection-focused codes of conduct and standards development, (ii) supporting consumer protection regulation and supervision, and (iii) encouraging FSPs to help empower customers by engaging with them in ways that reinforce choice, respect, voice, and control.

References


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