Donor Engagement in Innovative Finance: Opportunities and Obstacles

This summary is based on a 35-page DCED report explaining different concepts of innovative finance and reviewing opportunities and obstacles for donor engagement. For more resources, see the DCED knowledge page on private sector engagement.

Donor agencies agree that they need to mobilise private capital to achieve the Sustainable Development Goals (SDGs) through ‘Innovative Finance’. This may include practices as diverse as 'Blended Finance' (an approach for raising funds), which has mobilised more than USD 126 bn for development to date; 'Impact Investment' (a way of deploying funds), with an estimated market size of USD 228 bn in 2018; and 'Results-Based Finance' (a specific set of instruments to encourage the effective use of private finance or implementation capacity for SDG-relevant projects).

Four sets of key obstacles however prevent donors from effectively grasping the opportunity of innovative finance:

1. The growing importance of innovative finance in donor strategies and budgets has not yet been matched by a corresponding clarity and consistency of definitions. For example, there are different views on whose or what finance is being blended in Blended Finance and what qualifies as Impact Investment (see the Summary Graphic on p. 2).

2. While positive data on leverage and investor perceptions is emerging, evidence on results is generally fragmented and generally scarce. The increase of aid funds for private investors may even lead to negative market distortion, if provided on the wrong terms and not matched by investable projects.

3. Innovative finance has led to shift in responsibilities of both donors and development finance institutions (DFIs), and there is a need to understand what roles would be best played by donors.

4. Despite their increased engagement in innovative finance, donor agencies tend to have limited expertise and experience in sharing and managing risk. To address this, many donors have started to explore implications for staff recruitment, training and participation in knowledge exchange.

The paper concludes with options of future work by the DCED and others to address these obstacles; examples are introductory learning formats for donor staff or exchange with DFI networks on the most strategic division of responsibilities.

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SUMMARY GRAPHIC: LEVERAGING PRIVATE FINANCE: ILLUSTRATION OF KEY CONCEPTS AND CONTESTED ISSUES

Note: This graphic illustrates various definitions and contested issues around innovative finance concepts in a simplified way. It is not inclusive of all existing definitions.

Innovative Finance for Development

New or more efficient approaches and instruments for raising additional funds

More effective or efficient use of existing funds for development

Involvement of new actors as providers of innovative finance (e.g. institutional investors)

Blended Finance
Agreed elements:
- catalytic nature
- contribution to development results
- generation of financial returns

Often described as innovative finance, some implementation formats and applications are newer than others

Blending finance from different sources (public or private)

Blending of different types of finance, using a variety of blending instruments (grant/non-grant)

3 categories of definitions, focusing on either:

- Blending of finance with different purposes (development/profits)

Payment by Results / Results-Based Finance
Instruments that pay for-profit service providers or investors for development results achieved, based on robust verification

Varying terms, definitions and formats, e.g. regarding implementing partners, entity receiving payment and form of payment

Including...

Development Impact Bonds (DIBs) and related formats, involving a service provider, investor, outcome payer and evaluator

A tool to encourage impact investors to provide upfront risk capital to impactful projects

Impact investment
- is made into companies, organisations and funds with the intention to generate social and environmental impact

Contested issues include:
- Nature/existence of financial return expectations
- Definition of impact
- How to measure impact

Blending can be a tool by development partners to channel finance into impact investments (traditional use: infrastructure)

Impact investors use Blended Finance if they leverage additional finance from financial service providers for development while expecting a financial return

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