AFFORD POLICY BRIEF

BLENDED FINANCE & THE ROLE OF DIASPORA FINANCE: OPTIONS FOR FUTURE DEVELOPMENT FINANCING SUMMARY

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"...based on conservative estimates, the volume of annual African migrant savings is USD $33.7 Billion (i.e. USD $1,980 average savings x 17 million African migrants living outside the continent)… If 1% of annual African migrant savings of USD $33.7 Billion is invested in Africa, this will mean an inflow of USD337m." (G.Faal)[1]

Executive Summary

Attracting private capital to emerging or frontier markets in Africa poses significant challenges for governments, development Finance Institutions (DFIs), philanthropists, and private impact investors. It also opens up opportunities, given the increasing shift by investors towards funds that help meet Environmental, Social Responsibility, and Governance (ESG) concerns. Drawing in such private capital flows to unlock the estimated USD $331 billion needed for small and medium-sized enterprise (SME) growth in Africa, will be critical in meeting targets set in the Sustainable Development Goals (SDGs).

This Policy Brief argues that judicious and effective use of diverse elements of so-called 'blended finance' (including grant funding and DDI - Diaspora Direct Investment) offers real potential for facilitating greater private investment in African Least Development Countries (LDCs) in order to help meet the continent's growing infrastructure and energy needs.

The Policy Brief makes the following recommendations:

- Governments, Multilaterals, DFIs, philanthropists, civil society, and the private sector should adopt a broader view of how financing for development in LDCs is conceived and implemented in blending finance.
- Governments and philanthropic foundations should consider increasing the deployment of grant financing components as part of blended finance packages, at least in initial phases, in order to pull in additional investment – especially patient capital - from other sources, including diaspora investors.
- Governments, Multilaterals, DFIs, and philanthropists should be more innovative and flexible in how they deploy Official Development Assistance (ODA) and grant funding in order to fulfil its potential as investment capital, especially in emerging and frontier markets.
- DDI is a potentially valuable but untapped component in blended finance packages. Financial institutions, Multilaterals, DFIs, and the private sector should develop a broader range of investment products targeting diaspora investors, including diaspora bonds, mutual funds, and social enterprise funds.

1. Introduction: Assessing the Development Financing Gap

Contrary to stereotypes the needs in much of the developing world are not so much a question of food, aid and emergency relief, but rather building infrastructure and utilities, and finding ways to develop and add value to local and regional markets and supply chains, and to strengthen the regulatory environments that enable these to grow and the private sector to invest more.

In many developing countries, and in LDCs in particular, the strategic and operational barriers to attracting investment capital to expand businesses, for example limitations on the lending capability of local banks, remain too high, and limit the private sector playing the pivotal and catalytic role in driving economic growth. Markets are also small and less well developed, and the enabling environment for business growth is frequently demanding. This is particularly the case in Africa, ensuring typically smaller deal sizes and higher transaction costs. The private investor is thus faced with a perfect storm of disincentives to invest in LDCs and drive economic growth in them.

One of the greatest challenges for governments, philanthropists, and private investors in maintaining and extending sustainable gains in socio-economic development in Africa is how to unlock the estimated USD $331 billion needed for continental SME growth. Micro, small and medium enterprises (MSMEs) form the backbone of most African economies and investment in this sector will significantly enhance sustainable job creation and wealth development. The informal sector contributes 38% of sub-Saharan Africa GDP and over 80% of jobs, yet 51% of the continent's 44 million formal MSMEs lack the finance necessary to grow.

Globally, the financing gap is also apparent. The Sustainable Development Goals (SDGs), set ambitious targets for global poverty reduction and development until 2030. Though it provides investment opportunities for new structures for capital generation such as blended finance, venture philanthropy, impact investment, it recognises there is a challenge financing the delivery of these ambitious targets, especially in a way that helps catalyse developing countries' growth out of poverty.

The consensus among experts and governments, is that the funding gap is likely to be in the region of USD $1.4 trillion. Also, there is a shortfall between resources required for, and those actually committed to, development of approximately USD $13 billion per year. The Addis Ababa Action Agenda on the

[1] Faal.G: Strategic, Business and Operational Framework for an African Diaspora Finance Corporation, 2019, p.7

Financing of International Development, agreed by UN member states in 2015, commits governments, civil society, and in particular the private sector to work together – especially through developing Public-Private Partnerships (PPP) - in order to achieve the SDGs by 2030.

Blended financing offers the potential for 'de-risking' projects or sectors to make them sufficiently attractive to private investors, as well as providing important demonstration effects which in turn can crowd in more

private sector investment. It also supports the development of a more enabling policy environments at the national and regional levels. While the term is used slightly differently in different contexts, in this case, 'blended finance' refers to blending different sources of finance – private sector, concessionary financial instruments, and traditional grant funding – to increase the impact of investments, mobilise greater private investment into a given sector or region, and to modify risk-reward profiles to enable greater investment from the private sector. Diaspora Direct Investment (DDI) is potentially a valuable but untapped component in blended finance packages.

Against the background of the scale of diaspora resource flows to the continent, this Policy Brief examines the role – potential and actual – that diaspora financial capital can play in supporting development outcomes. It argues that DDI should be used as a second or third round of investment, after concessional grant funding, to help scale-up investment in achieving development outcomes, especially in financing MSME growth. Indeed, diaspora financial flows (remittances and DDI) to Africa grew almost 10 percent to USD $87 billion in 2018, which was more than the monies committed to other blended instruments in the same period (USD $81 billion).

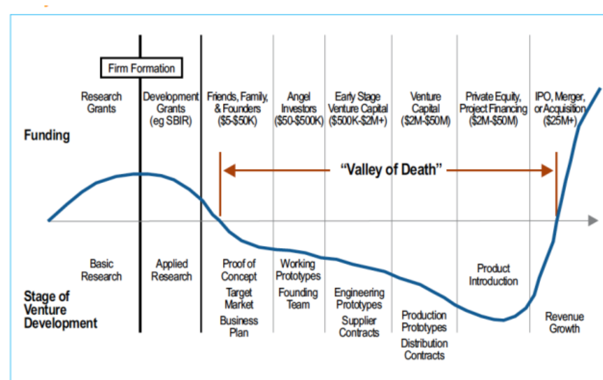
Before a more detailed consideration of the integration of DDI into the blended finance eco-system, the following section analyses the existing players in the space and looks at some of challenges facing them

2. Aid, Philanthropy, Investment & the 'Missing Middle'

A number of issues confront the potentially integrated blended finance eco-system as it responds to the development financing gap. The first challenge is the rigid existence of divisions between ODA, philanthropy, and investment capital that policy-makers, development practitioners and entrepreneurs maintain in developing countries. From a historical point of view this is understandable; governments have sought to differentiate ODA and other aid flows from private sector and philanthropic sources of finance due to the need to justify and monitor expenditure of taxpayers' money, while philanthropic foundations are often bound by their specific objectives and the need to demonstrate progress against these in their investments.

However, there are increasing calls for the development of more sophisticated models that would enable philanthropic capital – as well as ODA – to be more productive and be used to enhance private investment capital, over and above the 7% which is currently invested in blended finance instruments. This will entail a significant shift in institutional attitudes and priorities from philanthropic foundations. It is encouraging that traditional investment culture is already undergoing a change in mindset, with a renewed focus on environmental impacts, social responsibility, and governance (ESG) that is already informing investment trends, with investors increasingly shifting their portfolios to reflect these trends, in particular in response to pressure from foundation and pension funds.[2]

There is a second added complexity in private investors responding to the financing gap. In crude terms, it is easier to finance a large infrastructure project at the national level, or a microfinance scheme targeting small-scale women entrepreneurs at the micro-level, than it is to finance construction of affordable housing in cities, or support for SMEs to grow from micro- to medium-size. This 'missing middle' gap or more dramatically referred to in some investment circles as the 'Valley of Death', can be a major barrier to socio-economic growth and development, as governments and businesses find it hard to attract investments at this level. [3]



[2] EPWC, 'ESG considerations for private equity firms', available at: https://www.pwc.com/sg/en/publications/assets/esg-considerations-for-private-equity-firms.pdf

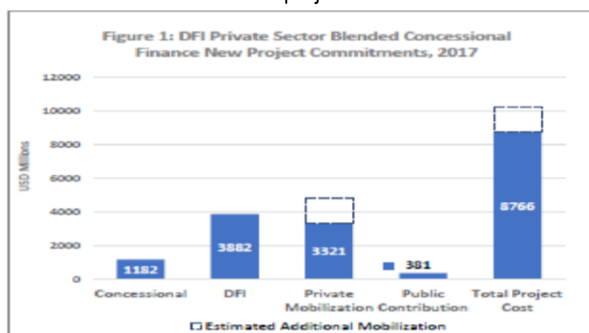
[3] A related issue here is also that of financialisation or securitisation; in many developing countries, access to formal or even informal banking facilities can be limited, making it harder for individuals and business to access credit and other financial services, or indeed to put money into savings. This creates barriers to growth and development as enterprises in particular can struggle to raise investment finance to grow and scale up their business.

3. De-risking Private Investment

Such barriers to drawing in increased and appropriate finance can be addressed through the de-risking, one of the opportunities offered by blended finance. The OECD offers a good rationale for grants to de-risk investment. They note that "investments in developing countries with important public good dimensions may be backed by a sound business case but cannot necessarily be financed by commercial investors due to high risks associated with projects or uncertainty related to returns. In these cases, public support can be used strategically through blended finance to improve the 'risk-return' profile of investments in developing countries and make them more attractive to private investors".[4]

According to surveys by OECD and the European DFI Association (EDFI), 167 facilities have been set up between 2000 and 2016, with a total of USD 31 billion in commitments. The number of facilities launched has increased steadily, as almost three times more facilities were established between 2009 and 2016 than over the previous 8 years.[5] It is important to note that concessionality is not simply providing subsidies or grants to projects, not least because of the risk this would pose to distorting local markets. Indeed, there are a range of different instruments used to apply concessionality. Most commonly these include grants, concessional loans, credit and risk guarantees, credit lines, and technical assistance. Loans in this context are typically provided with low interest rates, flexibility in requirements for collateral, long periods of maturity, and use of extended grace periods (See the side bar 1 'IFC Housing Finance in West Africa' for a blended finance model).

There are also additional concessional instruments that may be deployed, including first-loss equity tranches, equity swaps, hedging of interest rates or currency fluctuations or volatility, as well as deeply subordinated debt.[6] We argue that the effective use of blended finance to de-risk, in combination with opening up the investment opportunity to diaspora investors, will help achieve an accelerated investment ecosystem for missing middle enterprises. The accompanying chart sets out blended concessional finance for new projects in 2017.



Source: DFI Working Group on Blended Concessional Finance for Private Sector Projects Joint Report (2018:13)]

Side Bar 1: BLENDED FINANCE IN ACTION

CASE STUDY: IFC HOUSING FINANCE IN WEST AFRICA

PROJECT DESCRIPTION: The International Finance Corporation (IFC) provided financing to CRRH, a mortgage financing company serving eight countries in the West African Economic and Monetary Union (UEMOA). The project aims to scale up an emerging market in bonds supporting housing finance. IFC is purchasing local currency bonds issued by CRRH at longer maturities than the company has been able to issue, starting with 12 and 15-years tenors, but eventually reaching 20 years. IFC's presence pioneers these long maturity local currency bonds for housing finance, helps crowd in private sector finance into the market, over time establishing the viability of long maturity housing bonds market for UEMOA.

RATIONALE AND USE OF BLENDED CONCESSIONAL FINANCE: IFC utilized concessional funds from the IDA Private Sector Window (PSW) to reduce project risks associated with providing local currency financing. IFC doesn't have access to the local CFA Francs at adequate volume, tenors and pricing through normal channels, such as commercial swap markets. The PSW will allow IFC to economically obtain the domestic currency funds and thereby fulfil its role in strengthening the emerging long-term housing finance market. Over time, the long-term bond market should become viable without IFC or PSW participation, with funding coming from local investors, including institutional investors.

EXPECTED IMPACT: Housing is a major development challenge in the UEMOA countries, which face a housing shortage of 3.5 million units. Fewer than 7 percent of households in the region, can afford to buy their own home. There are many obstacles to expansion of the mortgage market within UEMOA. Banks generally have short term liabilities (deposits) which limit their ability to lend long term, and they have difficulty obtaining external long-term funds in local currency without stronger local capital markets. Currently mortgage financing for housing more broadly within West African countries is quite limited, with short tenors (average under 8 years). Greater access to longer tenor mortgages would help increase the affordability and availability of housing and contribute to economic growth and job creation.

[Source: DFI Working Group on Blended Concessional Finance for Private Sector Projects Joint Report, October 2018 Update]

While different models of varying levels of complexity are used by providers of blended finance to assess real market prices and develop appropriate packages of blending, there are some common underlying principles, foremost of which is the concept of 'minimum concessionality'. This means concessional financing should be applied at the lowest level possible, for the shortest time possible, so a not to distort the market concerned, a stylised version of which model is shown in the accompanying

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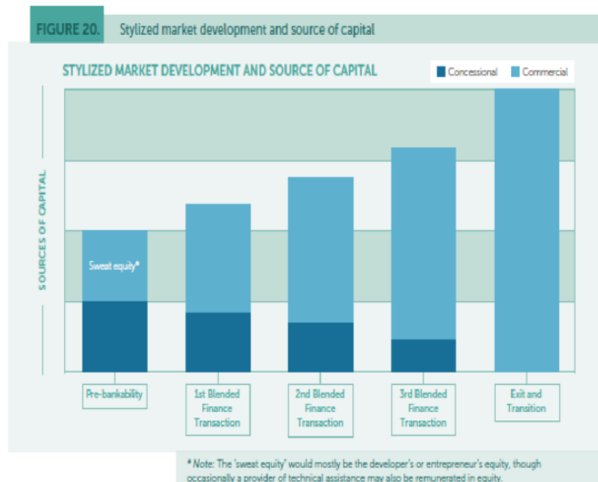
[4] OECD 2018 p.6
[5] OECD/EDFI (forthcoming) p.11
[6] See, inter alia, DFI Working Group on Blended Concessional Finance for Private Sector Projects Joint Report (2018); UNCDF 2018; OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the Sustainable Development Goals (2018)

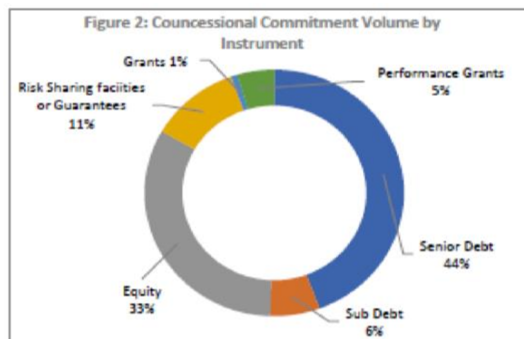
graphic. As can be seen from the graphic , the aim is to use concessional financing to draw in and increase private investment initially, whilst phasing out the concessional financing over time.[7]



Source: 'Blended Finance in LDCs', UNCDF, 2018:57

4. The numbers behind blended Finance – the Numbers

The chart illustrates the breakdown of the volume of different types of concessional finance committed in 2017-2018.



Source: ibid

As can be seen, the largest component in this mix was senior debt, followed by equity. The smallest components were grants (1%) and performance grants (5%).

We conclude this section by stressing that growing the grant margin to enable more pipelines for 'missing middle' enterprises, will enable governments and other DFIs to draw in more private investment capital. In particular, they should adopt more of a venture capital approach to blended finance, with philanthropy acting as a form of angel investment in these higher-risk markets. Additional interventions may also be needed, not least technical assistance and even policy advocacy to improve the policy environment in a given country to drive up private sector investment. Certainly, this blended finance model can be enhanced by attracting diaspora finance, both through using ODA to de-risk finance, and also with first losses from DFIs and Impact Funds, rather than private diaspora investors.

The next section focuses on the potential but untapped role of DDI within the blended finance eco-system

Side Bar 2: BLENDED FINANCE IN ACTION

According to Convergences' database of financial commitments, blended finance has mobilized over USD $134 billion in capital towards sustainable development in developing countries to date.

While blended finance has gained increased attention in recent years, it is an approach that has been leveraged for some time, which is reflected in the number of transactions and total deal volume to-date. The blended finance market is substantial and growing, and is comparable to other important markets. According to the GIIN, impact investing assets under management in 2018 were around $230 billion, while, according to the OECD, official development assistance (ODA) to developing countries in 2017 was around $145 billion.

[Source: https://www.convergence.finance/blended-finance]

5. Who 'Does' Development? The Role of Diaspora Resources in Development

In terms of aid flows, multilateral institutions (such as the World Bank or UN agencies) provide the largest sources of development funding; Northern governments also provide significant amounts of funding on a bilateral basis. The world's largest bilateral donor is the EU, with an annual budget for development and humanitarian relief of approximately €50bn in 2018.[8]

These bilateral aid flows are, however, outstripped by flows by diaspora and migrants. Globally, according to the International Organisation for Migration (IOM), approximately 250m diaspora and migrants worldwide remitted nearly USD $0.5 trillion, supporting around 1 billion people.[9] World Bank figures show

[7] This should be understood as an idealised situation; in some LDC markets and sectors, concessionality may be required for a longer period, in order to facilitate the entry of private investment capital. Setting the right level of concessional finance for the right period thus presents one of the biggest challenges for blended finance providers; if the level is set too low, the project will struggle to draw in private investment capital, while if it is set too high it risks subsidising activities unsustainably and/or distorting the market (UNCDF 2018).

[8] EC DEVCO 2018
[9] IOM 2018

that African diaspora and migrants remitted over USD $87 billion to Africa through formal channels alone.[10]

While these remittances can be viewed as private consumption, over 50% of all monies remitted to the developing world are used to support development outcomes – food security, housing, education, health, and livelihoods.[11] This does not include other ways in which diaspora and migrants deploy their financial capital: investing in countries of origin/heritage and transit; encouraging import-export of goods between these countries; and the mobilisation of relief and other resources in times of emergency. Moreover, these contributions also tend to be counter-cyclical - increasing at times of crisis, where traditionally the private sector can be prone to capital flight and disinvestment.[12] The World Bank also estimated that 20% of remittances are targeted towards investment of some kind – making that in the African context around USD $17.4 billion of DDI, given the remittance figures of USD $87 billion.

Diaspora investors and entrepreneurs may well have access to better local market information, or are better able to navigate cultural, language, and legal barriers to doing business in countries of origin. They are also likely to have a different perception of investment risk in such countries, and may be prepared to wait longer to see a return on their investment (thus representing a form of 'patient capital').

6. Harnessing Diaspora Finance as Part of Blended Finance

African governments are increasingly engaging and mobilising their diaspora to contribute to national development agendas. This takes the form of policies and initiatives encouraging diaspora to invest in their country of origin, particularly in land, real estate and property, as well as SMEs. Several countries, such as Ethiopia, Nigeria, and Kenya, have launched bonds that are targeted (at least in part) at their respective diasporas to raise money for infrastructure and SME sector projects

Bonds have great potential to raise finance for development investment from the diaspora, especially for the 'missing middle', although anecdotal evidence from existing schemes and from diaspora investors themselves suggests that there are at least three enabling factors and/or barriers to diaspora take-up of bonds.[13] The first of these is the importance in trust and credibility in the institutions issuing the bonds (typically governments or national banks), which can be a challenge for some diasporas, either due to political differences or perceived instability.

The second relates to the proposed return on investment and the way in which this is packaged and marketed to diaspora investors. While these may be willing to receive a slightly lower return, over a longer period, than traditional private sector investors, they will still expect a return. Some bonds are paid out in local currencies, and this can be more attractive to some diaspora investors as they will have a need for local currency transactions in the short and medium-term. Indeed, there is a strong argument for local currency issues or returns as this can be a significant mechanism to support local capital market growth. The risk-reward profile of the investment must therefore be attractive to diaspora investors with differing appetites for risk.

The third relates to the scale of the project; diaspora investors may be less likely to invest in large, ambitious infrastructure projects, as opposed to medium-sized or smaller schemes, because of concerns about viability and also the difficulty of relating individual investments to the finished project – it is arguably easier to 'see' your investment in, for example, a hospital wing than in a large dam. Key to success in addressing these challenges is also marketing different structured investment products that target different groups of diaspora investors, with differing appetites for risk

In light of these factors, a greater diversity of bond term options would help make potential diaspora bond issuances marketable to a wider spectrum of diaspora investors. More options regarding bond maturity, fixed vs. floating rates, frequency of interest payments, and minimum purchases may make such issuances more appealing to a wider spectrum of diaspora communities. Low minimum purchase requirements may be particularly important for less-established diaspora communities.

While much of the focus has been on diaspora bonds, these are only one example of financial instruments or products targeting the diaspora. Other instruments include sovereign wealth funds that are also open to diaspora investors, as in the case of Rwanda's *Agaciro* sovereign wealth fund, diaspora mutual funds (although these latter are still in the initial phases of development), and social enterprise funds. As an example of the latter case, the Indian Diaspora Initiative (IDI), established by the Calvert Foundation and USAID, sells investment notes to the Indian diaspora in the U.S., the proceeds of which are channelled through Indian financial institutions to be placed with local social enterprises. The goal of this model is to provide scalability for the entire Indian social enterprise sector.

[10] World Bank 2017. If informal channels are included, such as people carrying cash on their person, or collecting charitable funds through faith groups, the real figure is likely to be significantly higher, perhaps even $120bn USD per annum.

[11] Ibid.

[12] See, inter alia, Mohapatra, Sanket, George Joseph, and Dilip Ratha, 2009, "Remittances and Natural Disasters: Ex-post Response and Contribution to Ex-ante Preparedness," Policy Research Working Paper No. 4972(Washington: World Bank).

[13] See, inter alia, Commonwealth Foundation Diaspora Investor Series for Ghana, Kenya, and Nigeria (2018)

7. Conclusion

This Briefing Paper proposes that diaspora financial contributions – both in terms of remittance flows and also other types of targeted investments in countries of origin or heritage – could form an important part of the blended finance options available to developing countries, especially LDCs in Africa, as well as DFIs and multilateral agencies. Aside from notions of a 'diaspora discount' (in itself a form of concessionality) there is very real interest and demand from diaspora investors seeking opportunities in their countries of origin or heritage, and diaspora capital tends to be more patient capital.

Two key barriers exist to increasing diaspora investments as part of development finance that need to be addressed. The first of these is a lack of clear pathways for investment for diaspora investors with limited investment capital and/or limited investment knowledge. While experienced diaspora investors with significant investment capital are more likely to take advantage of upcoming opportunities in emerging markets in countries of origin or heritage, those with smaller means or less experience of doing so may be put off by the perceived complexity of doing so.

The second of these relates to risk (and by extension, trust and credibility). How can diaspora investors, especially first-time investors, manage the risks of investment, or for that matter have trust that they will make a return, even over more 'patient' time frame?

The challenge is how to build trust and credibility among potential diaspora investors. There appears to be a gap in the marketplace in this regard, and judicious use of blended finance to develop investment envelopes could both be used to draw in additional private and diaspora investment capital. Moreover, doing this would also have the benefit of providing a demonstration effect that promises to crowd in further private sector – and diaspora – investment capital.

Diaspora financial capital will also need to form part of the financing mix in order to achieve SDG targets by 2030. We propose that innovative use of blended finance with new

philanthropic models, and financial instruments designed to attract diaspora financial capital, such as diaspora bonds or other products that leverage remittances (such as AFFORD's RemitPlus™ products), can help harness diaspora capital – and build trust and credibility among diaspora and the broader private sector – to develop new models of public-private-partnership that will be needed to achieve ambitious SDG poverty reduction targets.

Blending has already shown significant success, however, a real step-change can be achieved by breaking down the traditional silos existing between ODA, philanthropy, and private investment. The following recommendations would significantly help in facilitating this process:

- Governments, Multilaterals, DFIs, philanthropists, civil society, and the private sector should adopt a broader view of how financing for development in LDCs is conceived and implemented in blending finance.
- Governments and philanthropic foundations should consider increasing the deployment of grant financing components as part of blended finance packages, at least in initial phases, in order to pull in additional investment – especially patient capital - from other sources, including diaspora investors.
- Governments, Multilaterals, DFIs, and philanthropists should be more innovative and flexible in how they deploy Official Development Assistance (ODA) and grant funding in order to fulfil its potential as investment capital, especially in emerging and frontier markets.
- DDI is a potentially valuable but untapped component in blended finance packages. Financial institutions, Multilaterals, DFIs, and the private sector should develop a broader range of investment products targeting diaspora investors, including diaspora bonds, mutual funds, and social enterprise funds.

About AFFORD and its Role in Developing Diaspora Finance

AFFORD was established in 1994, with a mission "to expand and enhance the contributions Africans in the diaspora make to African development". It mobilises the financial, intellectual, and political assets of the diaspora and channels them to drive economic growth and social development in Africa. Priority projects and activities are focused on diaspora contributions to job creation through African enterprise development.

AFFORD has played a key role in presenting solutions and programmes bringing together diaspora and important institutional stakeholders in order to maximise the impact of diaspora financial and skills investment into Africa, estimated at around US$17.4 billion in 2018.

Our extensive knowledge of diaspora investments, remittances, and fund structures, include the written project evaluation and replication plan on 'RemitPlus™ Diaspora Finance Report (2011)', which provided outlines for African Diaspora Bond, Diaspora Mutual Fund, Diaspora SME Fund, and Diaspora

Bank Accounts. That 2011 report influenced many processes, policies and practices including the:

- AU Global African Diaspora Summit (2012)
- UN High Level Dialogue on Migration (2013)
- Addis Ababa Action Agenda on Financing for Development (2015)
- Joint Valletta Action Plan (2015);
- Target 10.7 of Sustainable Development Goals (2015);
- Paragraph 35 and 44 of the recently concluded UN Global Compact for Safe, Orderly and Regular Migration (13 July 2018); Plus
- The £2.9 million diaspora finance element of the Comic Relief/UKAid funded Common Ground Initiative (CGI) Programme, the largest diaspora finance programme to date, which is creating new investment and financial instruments, as well as a philanthropy/giving platform through which diaspora investment and resources can be mobilised and scaled to support wealth and job creation in Africa.

Supported by Comic Relief/UKAID

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