DONOR COMMITTEE FOR ENTERPRISE DEVELOPMENT

WORKING PAPER

Donor engagement in Innovative Finance: Opportunities and Obstacles

PRIVATE SECTOR ENGAGEMENT WORKING GROUP

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DCED

The Donor Committee for Enterprise Development

Donor engagement in Innovative Finance: Opportunities and Obstacles

Private Sector Engagement Working Group

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The DCED is the forum where donors, foundations and UN agencies share experience, innovations and effective practice in private sector development (PSD). Increasingly, donors are engaging directly and strategically with the private sector, as partners in achieving a wide range of development outcomes – including PSD.

In 2017, DCED members have formed a Working Group on Private Sector Engagement (PSE), to support donors in the institutional changes needed to engage business as a strategic partner. These include building staff capacity for PSE and developing appropriate ways to design and implement different engagement strategies. So far, the work of the group includes a categorisation of PSE strategies, peer learning activities on different aspects of PSE, and a practical framework on how to mitigate the risk of negative market distortion in PSE. This report represents a first effort to review options for donor engagement in the area of innovative finance.

Any feedback on this report and suggestions of future work can be shared with the DCED Secretariat at admin@enterprise-development.org. For more resources on private sector engagement, please refer to the DCED knowledge page on the theme: www.enterprise-development.org/implementing-psd/private-sector-engagement

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Key take-aways

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 billion in capital for development to date; *'Impact Investment'* (a way of deploying funds), with an estimated market size of USD 228 billion 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).

Several obstacles however prevent donor agencies from effectively grasping the opportunity that innovative finance presents for development. These can be grouped in four categories:

1. **Definitions and discourse: The growing importance of innovative finance approaches in donor strategies and budgets has not yet been matched by a corresponding clarity and consistency of definitions.** For example, there are many different views on whose or what finance is being blended in Blended Finance and on what qualifies as Impact Investment. Results-Based Finance means different things to different people. If donors are to accelerate learning on effective practice, they will need to develop a shared understanding and precise use of terminologies. To facilitate this, the first part of this paper reviews key conceptual differences and disagreements.

2. **Effectiveness and evidence on results: A brief review of key publications reveals that evidence on results is similarly fragmented and generally scarce.** The increase of development funds available to private investors may even lead to negative market distortion, if provided on the wrong terms and not matched by investable opportunities. Emerging data on finance leveraged, information on changing investor perceptions as well as case studies however provide an encouraging basis for future work. There is also a growth in initiatives to support effective results measurement across different innovative finance approaches and instruments.

3. **'Best fit' roles for donors: Rapid expansion of engagement in innovative finance has led to shift in responsibilities of both donors and development finance institutions (DFIs), and there is a need for a more strategic understanding of the roles best played by donors.** For example, some donors now use grants as risk mitigation instruments and are lending to, or investing in, business without involvement of their DFIs. Other roles could include research aimed at conceptual development and on the effectiveness of specific approaches and instruments; and building the pipeline of investable projects through traditional private sector development approaches.

4. **Capacity for performing new roles**: 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 other organisations to address these obstacles. Examples include deepening understanding of specific financial instruments among donor staff; expanding on the DCED's work on how to mitigate the risk of negative market distortion; and facilitating exchanges with DFI networks on how to calibrate new donor roles and responsibilities.

Introduction

Achieving the Sustainable Development Goals (SDGs) will require private sector know-how, capabilities and financial resources.[1] Donor agencies therefore seek to engage the private sector for development results, in two major ways: (1) Engaging, primarily large and international, companies around their business activities in developing countries; and (2) mobilising private capital for development purposes, to complement public financing.[2] While the DCED has so far primarily focused on the former, this paper represents a first step to explore concepts around leveraging private finance.[3]

The basic logic behind approaches to mobilise private finance is simple: investments beneficial to economic, social and environmental development often don't happen because financial service providers and businesses expect high levels of risk or low returns; they may also not have the right knowledge or capacity for operations in low-income countries. By mitigating risk and removing constraints, donors aim to encourage commercial investment into development at scale.

However, despite the current interest in this field, definitions of specific approaches are often left vague and unclear, while their effectiveness is still largely unproven. There is a surprising range of possible meanings of terminologies and the common discourse often ignores important differences. This is a problem if donors wish to accelerate learning and exchange on effective practice.

In order to facilitate informed discussions, this paper critically reviews four concepts that frequently feature in current discussions: Innovative Finance (often used as an umbrella term for approaches to leverage additional finance as well as other practices), Blended Finance, Impact Investing, and Results-Based Finance. The following aspects are explored:

1. A generic description of each concept, based on key elements occurring in different definitions;
2. Important differences between existing definitions and terminologies;
3. How each concept relates to other concepts around innovative finance; and
4. Whether there is evidence that it works.
5. The paper concludes with a summary of key issues for donors considering expanding the use of innovative finance.

The paper also briefly explains terminologies related to selected financial 'instruments' and 'investment vehicles' used in approaches to leverage private finance.

A caveat is that reviewing concepts around leveraging finance for development is a moving target: Definitions in leading organisations such as the OECD are still evolving, and "experienced financiers from (…) development finance institutions and private investors are feeling their way into … unfamiliar territory"[4]. This review should therefore be seen as an assessment of the current state of the art.

The **summary graphic** below illustrates definitions of the selected key concepts and contested issues in a simplified way.

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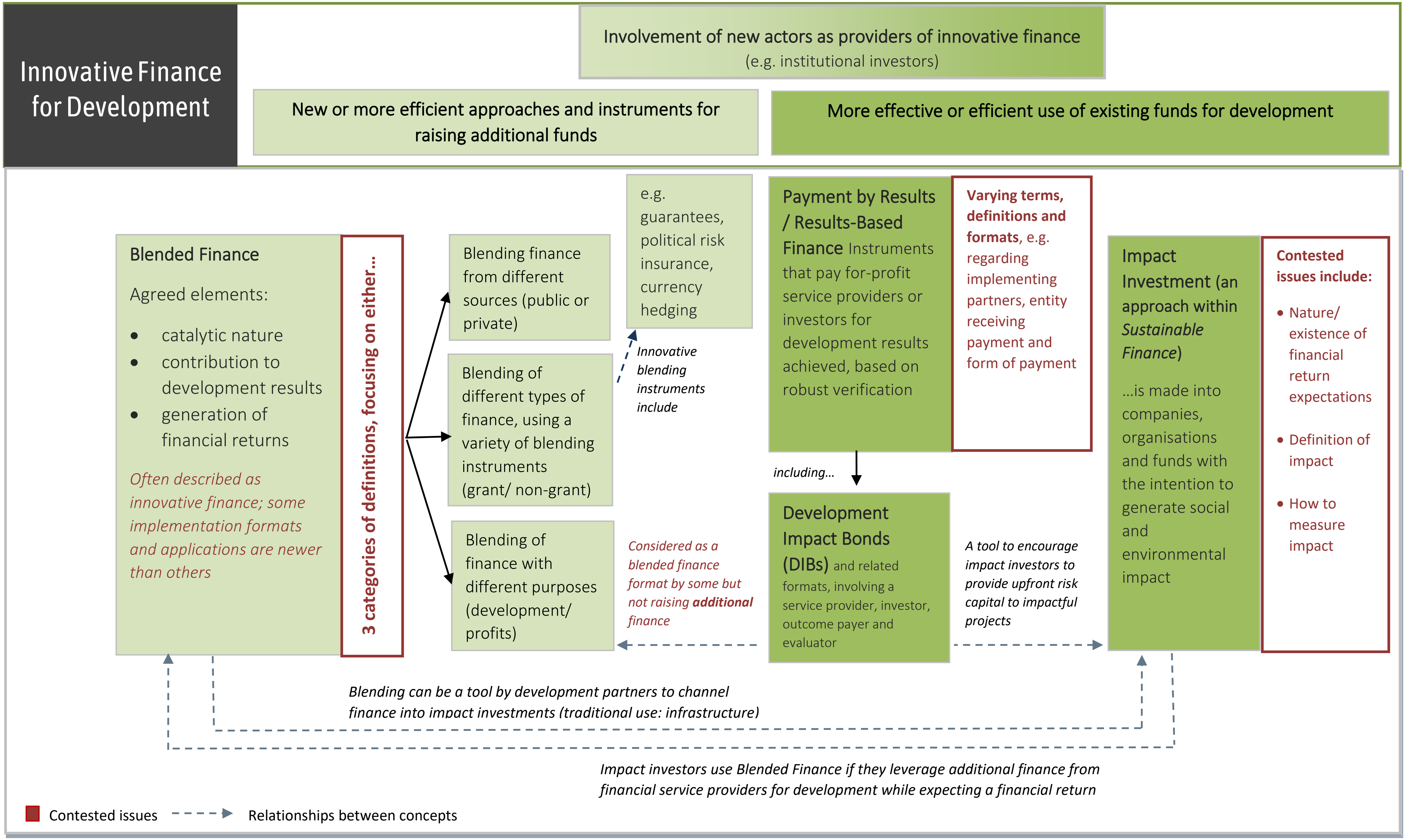
[1] OECD and WEF (2015): A how-to guide for blended finance.
[2] A categorisation of different strategies for engaging the private sector, including leveraging private finance, is available here (DCED, 2017).
[3] This paper uses the terms raising, leveraging, mobilising and encouraging finance as synonyms.
[4] Paddy Carter (2016): Maximising bang for the buck: Risks, returns, and what it really means to use ODA to leverage private funds, OECD Development Matters Blog.

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.



1. INNOVATIVE FINANCE

WHAT IS INNOVATIVE FINANCE?

Innovative Finance refers to a range of strategies to make effective use of, and/or generate, financial resources to achieve international development goals. Yet, there is no agreed definition of Innovative Finance[5], which 'has come to mean many things to many people'[6]. Indeed, it comprises a 'heterogeneous mix' of innovations in raising public or private finance, and in how traditional aid funds are spent on the ground.[7]

WHAT ARE DIFFERENCES IN COMMON DEFINITIONS?

Most definitions are relatively vague in nature and may comprise a wide range of activities. Most include a combination of some of the elements listed in the graphic below, each of which represent vast areas of practice, and are defined in various ways. Other sources include aspects that are explicitly excluded by other definitions; this is illustrated in the two separate columns of the graphic on page 8.

In sum, important differences in views include:

- **The nature of finance and innovation:** Innovative Finance may refer exclusively to the generation of additional finance or also to a more effective use of existing funds; many, but not all definitions of innovative finance include both options. The generation of additional finance may refer to public finance, private finance, or both. There is a wide range of ways in which 'innovation' is defined, both in the case of mobilising additional finance and in making more effective use of existing aid funds; it is generally used to refer to something new, something in which we do not have much experience.
- **The providers of innovative finance:** Some argue that public sector organisations have to be involved in Innovative Finance mechanisms; other sources say that various actors, such as philanthropic organisations, can provide Innovative Finance.
- **Target locations**: According to some sources, a defining aspect of Innovative Finance is a focus on international transactions; for others, it can also serve for domestic resource mobilisation; and
- **Target sectors**: Some organisations see health as the exclusive focus of innovative finance, although most of the current literature takes a broader view.

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[5] OECD (2014): Development Cooperation Report 2014. Mobilising Resources for Sustainable Development, Chapter 5. UN DESA website: Innovative Finance
[6] UNDP (2012): Innovative Financing for Development: A New Model for Development Finance?.
[7] Ibid.

Graphic 1 - Different definitions of Innovative Finance (IF)

Defining elements of IF:

Nature of 'finance'

Innovative Finance refers to new ways to generate *additional* finance (e.g. OECD, 2009)

Leveraging additional public finance

Leveraging additional private finance

Innovative finance also refers to more effective use of *existing* development funds (e.g. World Bank, 2010)

Form of 'innovation'

Generally new or more efficient approaches: Leveraging public or private finance in 'new and more efficient' ways (Danida, 2016) or through 'non-traditional spending approaches' (OECD, 2011),

New instruments: Using new financial instruments (not grants, loans) (World Bank, 2010), instruments with innovative features (UN, 2012), or new asset types (Innovative Financing Initiative, 2014)

New actors:

- Involving new sources of funding, e.g. commercial investors (Innovative Financing Initiative, 2014) or emerging donors (World Bank, 2010)
- Engaging investors as partners, beyond the financial transaction (World Bank, 2010)

Application to new markets/ contexts (Innovative Financing Initiative, 2014; UN, 2012; McKinsey, 2013)

Mechanisms to achieve better results (Danida, 2016; World Bank, 2010)

Reduced delivery time or costs (World Bank, 2010)

Providers of finance

Public sector organisations have to be involved in Innovative Finance mechanisms (e.g. OECD, 2009)

Other actors, such as philanthropic organisations, can also provide Innovative Finance (e.g. Rockefeller Foundation)

Locations and sectors targeted

Innovative Finance has a focus on international transactions (e.g. OECD, 2009)

Innovative Finance can also include domestic resource mobilisation (e.g. Devex, 2017).

Innovative Finance has been exclusively health-related (Leading Group on Innovative Financing for Development)

Innovative finance targets all sectors *(most of the literature)*

In practice, Innovative Finance is often used as a catch-all term to describe, among others, Blended Finance, Impact Investing and Results-Based Finance. These are three potentially related but fundamentally different concepts, each of which represent large fields of practice. Broadly speaking,

- Blended Finance relates to approaches for *raising or leveraging* additional finance for development purposes using a wide range of financial instruments;
- Impact Investing largely focuses on how private capital is *deployed; and*
- Result-based Finance may refer to a specific group of financial *instruments* for encouraging a more effective and efficient use of private finance and implementation capacity towards the SDGs;

These concepts, and different views on their definition and innovative aspects, will be explored in more detail in the following sections.

Box 1 - Financial instruments – a brief overview

Discussions on Innovative Finance often feature references to financial 'instruments' or 'products' used to mobilise private investment. Some common instruments are explained below:

- **Lending or debt instruments** provide borrowers with upfront funding in exchange for repayment of this funding along with interest, based on fixed timeframes and interest rate terms.
- **Equity investment** refers to the injection of capital into a business meaning that the investor owns part of the company and participates in gains or losses. Equity can help a company grow and reduce risks of other investors and lenders. **Venture equity** is typically targeted at small, early-stage firms with high-growth potential. **Quasi-equity** is a type of loan which typically combines a fixed interest rate with a variable form of return for the lender, tied to the performance of the business.
- **Mezzanine finance** is a collective term for hybrid forms of financing that combine elements of debt and equity. Mezzanine investments generate returns that are higher than bank lending rates and lower than the returns required by most equity investors. As an example, mezzanine finance may take the form of subordinated debts, whereby a lender may convert a loan into an equity share if the loan is not paid back.
- **Risk mitigation instruments:**
    - **Guarantees** reduce risk and mobilise commercial lending or investment by promising to repay all or some of the project's value to the lender or investor in the case of default. As such, guarantees vary in their cover percentage and can be directed at loans or equity investments; they can be given to individual financial intermediaries or a portfolio of multiple intermediaries; and they can cover political, commercial or other types of risk.
    - **First loss capital** makes a public entity the first to take losses if a business is unable to pay back investors.
    - **Political risk insurance** protects businesses against failure to repay a loan as a result of political events such as civil unrest by paying out all or a portion of the losses arising. As opposed to guarantees, which target financial intermediaries, insurance is directly taken out by businesses.
    - **Currency hedging** refers to an agreement that protects the borrower against changes in exchange rates; for example, an agreement may convert one type of currency to another at an agreed rate regardless of prevailing market exchange rates over the agreement period.
- **Structured products:**
    - Structured products include **securitisation,** which refers to the practice of aggregating pools of assets that generate a predictable cash flow (such as loans) into a new tradeable asset, which is

then divided up and sold to investors with different risk-return expectations. The pooling of assets is usually done through Special Purpose Vehicles (see Box 2 on Investment Vehicles).

- **Concessional Finance:** Concessional finance refers to grants or grant-equivalent instruments (e.g. interest rate subsidies) as well as any of the financial products above offered on terms more favourable available from commercial banks. Providers of concessional finance can be governments or private organisations. Examples of concessional finance other than grants include soft loans with preferential interest rates or longer repayment periods; buying shares of a business while expecting a lower return than commercial providers; or risk mitigation products provided at a lower fee and/or with a higher coverage than by commercial providers.
- **Results-Based Finance:** Results-Based Finance refers to instruments through which implementers or investors of development projects are paid for results achieved rather than activities (see section 4).

Sources and more details: *WRI (2012): A Glossary of Financing Instruments; EBRD (2013): DFI Guidance for using Investment Concessional Finance in Private Sector Operations; EPS PEAKS (2014): Financial instruments for Private Sector Development;* Danida *(2016): Private Capital for Sustainable Development; EC (2014): Mezzanine Finance;* Sida (2016): *Evaluation of Sida's use of guarantees for market development and poverty reduction;* ODI (2014): *Guarantees for Development;* OECD (2014a): *Guarantees for Development;* OECD (2018): *Making Blended Finance work for the Sustainable Development Goals.*

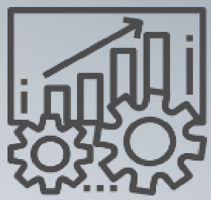
Box 2 - Investment vehicles used for channelling finance

Depending on factors such as the financial instruments used, the investment strategy and objectives, providers of Blended Finance in particular may use different types of investment vehicles or facilities to channel capital. For example, organisations may provide equity and debt for structured funds, or grants for project preparation facilities.

- **Pooled funds***:* Pooled funds are those that pool together the capital of many investors and authorise a professional fund manager to invest the funds according to an agreed strategy and criteria. Pooled funds enable investors to share the risk, reduce transaction costs for themselves and benefit from the professional expertise of the fund manager. A related frequently used term is 'Special Purpose Vehicles', which are created as a legal entity through which investors can pool their assets.
- **Structured funds***:* Structured funds divide risks across several parties by using a 'waterfall' structure of opportunities for investors with different risk/return profiles. The overall risk is divided into tranches, each with different degrees of 'seniority' (e.g. order of repayment or return allocation in the event of losses, bankruptcy or sale). Examples include several structured funds by KfW e.g. the Green for Growth Fund or Sanad Fund.
- **Donor development funds***:* Donor development funds adopt commercial fund approaches to channel concessional capital into investment opportunities with high developmental impact but also higher level of risks and potentially lower returns (e.g. DFID Impact Fund).
- **Project preparation facilities:** A variety of initiatives created to respond to challenges linked to the lack of market-based finance to early stage projects, innovation and market infrastructure supporting project development and capacity building on the demand side, or providing patient, higher risk capital, or both (e.g. Global Innovation Fund).

Source and further examples: Danida (2016)

2. BLENDED FINANCE



WHAT IS BLENDED FINANCE?

Blended Finance is generally defined as an approach for leveraging additional finance by combining finance of different sources, types and/or purposes. Commonly agreed elements are its catalytic nature, contribution to development results as well as generation of financial returns.[8] The three variations in definitions identified can however result in important implementation differences.

WHAT ARE KEY DIFFERENCES IN COMMON DEFINITIONS?

Graphic 3 (page 12) summarises different views on whose and what types of finance are being blended in Blended Finance. [9] They broadly fall into three categories:

1. Blending can refer to the combination of finance from different sources, including:

- **Blending public with private finance:** Most definitions of blending focus on the combination of concessional funding from public entities with commercial capital from the private sector.[10]
- **Blending finance from different public sources:** In some definitions, blending refers to the combination of finance from public sources only, such as an ODA grant to trigger a loan from another public institution.[11] Blended Finance definitions by most DFIs are explicitly about the combination of concessional funding by public agencies with resources from DFIs.[12] Others note that at least in practice, blending approaches by public grant makers, such as the EC, have mostly mobilised additional funding from DFIs rather than from the private sector.[13] Indeed a recent survey finds that only about 27% of capital leveraged through concessional blending operations is private sector capital. [14]

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[8] Joan Larrea (2016): Sizing Up 'Blended Finance': A Guide to a New Financing Approach to Fuel Sustainable Development.
[9] Some of these are also proposed by Oxfam and Eurodad (2017): What it is, how it works and how it is used.
[10] Jack Aldane (2017): Blended finance: can the new rules avoid market distortion?.
[11] Eurodad (2013): Private Finance for Development Unravelled. Assessing how Development Finance Institutions work, by Maria José Romero and Jan van de Poel.
[12] EBRD, 2013: Private Sector Roundtable DFI Guidance for Using Investment Concessional Finance in Private Sector Operation; European Commission (2016): Evaluation of Blending. Final report; DFI Working Group on Blended Concessional Finance for Private Sector Projects (2017): Summary Report.
[13] Danida (2016): Private Capital for Sustainable Development Concepts, Issues and Options for Engagement in Impact Investing and Innovative Finance.
[14] Convergence (2018): Leverage of concessional capital. Data brief.

- **Blending finance from different private sources:** Some recent definitions that focus on the purpose of finance used in blending operations (see below) also consider combinations of finance from exclusively private sources, either commercial or philanthropic.[15]

2. **Blending can refer to the combination of different types of finance, whereby different financial instruments are used to leverage non-grant finance.** Depending on the definition, blending instruments may include:
    - **Concessional vs non-concessional blending instruments:** For some, blending is a way of using concessional finance instruments to mobilise investments.[16] Others, however, feel that concessional finance is not a defining criterion for blending.[17] Instead, investments could also be mobilised through non-concessional finance. (see also Box 1 for more information on concessional and non-concessional financial instruments)
    - **Grant-equivalent vs risk mitigation and other financial instruments:** In most definitions, blending refers to the use of an upfront grant (or grant-equivalent instrument) to leverage additional non-grant finance.[18] The European Commission, for example, considers blending as a mechanism to combine EU grants with loans or equity from public or private financiers.[19] Blending instruments however increasingly include risk mitigation tools (e.g. guarantees, first loss covers) and other financial instruments.[20] Blended Finance is also increasingly provided through complex structured funds involving multiple investors (see also Box 2 above).[21]

3. **Blended Finance can refer to the combination of funds that differ in their purpose:** The most recent OECD definition of blending no longer emphasises the source or types of finance used. Instead, blending is seen as a way of using funds with a development purpose (from either public or private sources) to mobilise funds with a commercial purpose (from either public or private sources) and redirect it to support development outcomes. Specifically, blending is defined as the

> *"strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries. Additional finance is commercial finance that does not have an explicit development purpose (…) and development finance is public and private finance that is being deployed with a development mandate."*[22]

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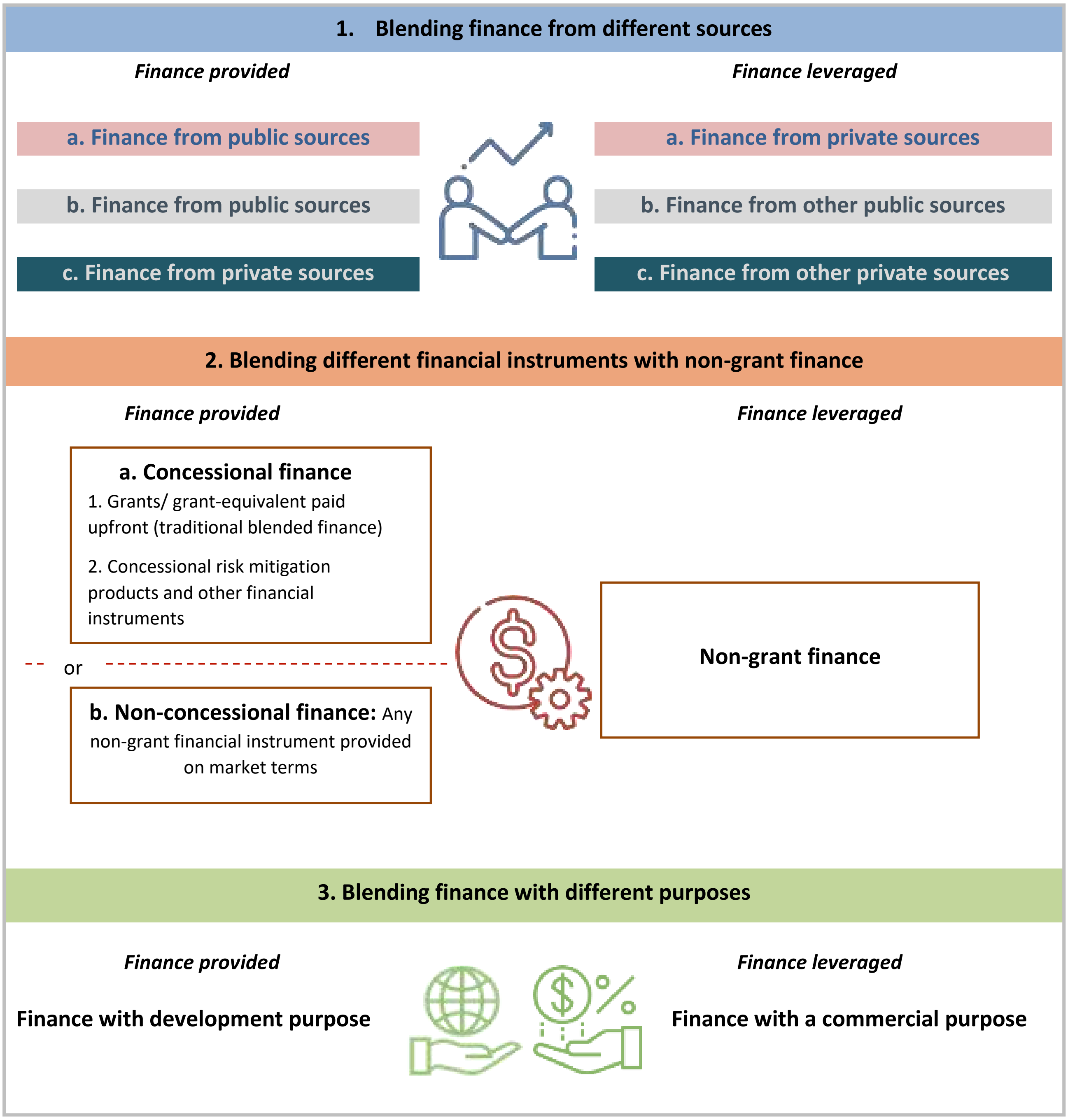
[15] OECD (2018): Making Blended Finance work for the Sustainable Development Goals; OECD and WEF (2015).
[16] Danida (2016); EBRD (2013); and IFC (2017): Blended Finance at IFC.
[17] OECD (2018).
[18] Evidence on Demand (2014): TOPIC GUIDE: Blended Finance for Infrastructure and Low Carbon Development, by Shakira Mustapha et al.
[19] EC (2015): Guidelines on EU blending operations.
[20] OECD (2018); Danida (2016).
[21] Danida (2016).
[22] OECD (2018).

Graphic 2 - Who's and what finance are being blended in Blended Finance? Possible combinations proposed by different definitions



DOES BLENDED FINANCE QUALIFY AS INNOVATIVE FINANCE?

While Blended Finance is generally considered as an innovative way of mobilising funds for development purposes, the approach itself is not new.[23] It is therefore useful to recognise that specific forms and applications of blended finance are newer than others and may benefit from particular attention in research on effective practice. They include:

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[23] e.g. CGAP (2018): Navigating the Next Wave of Blended Finance for Financial Inclusion.

- Non-traditional blending instruments: For example, OECD (2018) notes that an innovative way to mobilise private capital is to replace grants and loans with new types of financial instruments. These include guarantees, securitisation, currency hedging and political risk insurance[24]; and
- Blended Finance initiatives that are rolled out in new markets or involve new types of private investors, including institutional (i.e. non-bank) investors such as pension funds, or philanthropic investors.

DOES IT WORK?

According to OECD data, 17 of 23 DAC members are now engaging in Blended Finance and have succeeded in mobilising growing amounts of private capital for development: Between 2000 and 2016, a total of 167 facilities that engage in blending were launched, with a combined size of USD 31 billion by development finance providers.[25] Convergence, a blended finance platform, estimates that such facilities have mobilised over USD 126 billion in capital towards sustainable development in developing countries to date, and that each dollar of concessional blending capital has mobilised on average $4 of commercially-priced capital.[26] Similarly, according to OECD data, development finance interventions have mobilised USD 151.5 billion from the private sector between 2012 and 2017.[27] Guarantees was the set of instruments that mobilised the most (42% of the total).

Survey data from impact investors further show that blended finance can be an effective tool to de-risk transactions and 'attract funding for large-scale, high impact investments'[28]. Given that blended finance can lower risk of private investors, it may also catalyse greater investment outside of blending operations.

Yet, while a growing number of case studies[29] are emerging, the latest OECD flagship report on blending finds that the evidence base is still limited.[30] This is similar to other recent reviews: Oxfam and Eurodad (2017) highlight that there is "a significant lack of data and evidence about blending projects".[31] Others highlight in particular the lack of data on poverty impacts[32]; for example, evaluation of the EC's blending facilities finds a "modest track record" of projects in the area of poverty reduction.[33]

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[24] OECD (2018).
[25] Wiebke Bartz-Zuccala and Haje Schütte (2018) Partnership Models in Blended Finance: An overview, Presentation on behalf of OECD at the Swiss Sustainable Finance Conference, January 2018.
[26] Convergence: Webpage on Blended Finance. Section on the Market Size of Blended Finance; Convergence (2018): Leverage of Concessional Capital.
[27] OECD (2019)
[28] GIIN (2018): Annual Impact Investor Survey 2018.
[29] See for example the case studies published by Convergence, https://www.convergence.finance/knowledge
[30] OECD (2018). For case studies on the potential impact of blended finance, see this chapter here.
[31] Eurodad and Oxfam (2017): Blended finance. What it is, how it works and how it is used.
[32] Harpinder Collacott (2016): What does the evidence on blended finance tell us about its potential to fill the SDG funding gap?, OECD Development Matters Blog, 2016.
[33] European Commission (2016).

This aligns with data showing that private investments mobilised through Blended Finance primarily target middle-income countries and developing countries with lower levels of poverty.[34] The OECD's latest summary of amounts mobilised from the private sector through development finance interventions confirms that only 9% of the amounts mobilised went into projects in Least Developed and other Low-Income Countries. 72% of finance mobilised went into financial services, energy as well as industry, mining and construction sectors; only about 5% went to agriculture.[35] These findings suggest that more efforts are needed to understand both investment barriers and effective instruments to mobilise investments that benefit low-income populations.

There are also likely to be conceptual and methodological reasons for the current lack of evidence on results: Oxfam and Eurodad reckon that the lack of impact data could be "partly explained by the lack of a common language and understanding of blending." [36] OECD (2019) also highlights the need for more robust monitoring systems and appropriate evaluation methods for specific blending instruments.[37]

In scaling up their support to blended finance, especially in low-income countries and sectors, donor agencies also need to carefully consider potential adverse effects on markets: High spending and capital mobilisation targets in the face of a limited number of investable opportunities may lead to a downward spiral in the terms used to attract investors. Heavily-subsidised investors that have turned to blending facilities for soft money may crowd out non-subsidised actors from the market.[38] This is closely related to concerns that blended finance vehicles often too easily assume additionality, i.e. that an investment would not go ahead without their subsidy. Danida (2016) finds that there is a need for further work to strengthen assessments of additionality.[39]

[34] Harpinder Collacott (2016).
[35] OECD (2019): Amounts mobilised from the private sector by development finance interventions 2012-2017.
[36] Eurodad and Oxfam (2017).
[37] OECD (2019a): Blended Finance Evaluation: Governance and Methodological Challenges.
[38] For more considerations around how to mitigate the risk of market distortion in private sector engagement in general, please refer to DCED (2018): Minimising the risk of negative market distortions in private sector engagement. A practical framework.
[39] Danida (2016).

3. IMPACT INVESTING

WHAT IS IT?

Impact Investing refers to investments made by investors with the intention to achieve development impact, typically alongside a financial return. Impact Investing is a sub-set of *Sustainable Finance* (sometimes also referred to Responsible Finance), which is an umbrella term for “any investment approach integrating environmental, social and governance factors (ESG) into the selection and management of investments.”[40] While some debates on impact investing definitions persist (see below), it is generally seen to go beyond most other Sustainable Finance approaches by intentionally contributing to positive social and environmental impact rather than avoiding harm and managing ESG risks.[41] Impact investors can be large institutional funds, foundations, governments or high net worth individuals. Recipients of investment may be small start-ups, profit-making social enterprises, mature companies or funds.[42] Synonyms of Impact Investing include Social Impact Investing and Social Investment.[43]

WHAT ARE DIFFERENCES IN COMMON DEFINITIONS?

While there is growing agreement about the broader framing of Impact Investing[44], the “boundaries demarcating what constitutes, and what does not constitute, Impact Investing still remain fluid”.[45] A reason for this is that Impact Investing “brings together concepts and language from different disciplines such as finance, business, social services and evaluation”; different organisations are therefore “introducing new terms or using the same terms in different ways.”[46]

A widely cited definition of Impact Investment by the Global Impact Investing Network (GIIN) includes four defining elements, as described in Table 1 below.[47] While most elements are largely agreed in principle, detailed criteria for distinguishing impact investments from other investments are still subject to debate. In particular, there are differences in views regarding the financial returns expected by investors, and the definition and measurement of impact.

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[40] Swiss Sustainable Finance Glossary; for a similar definition, see the EC website; for a detailed categorisation of different sustainable finance approaches, refer to University of Zurich (2021).
[41] See for example the IFC impact principles website and the impactgarden.org website.
[42] DCED (2016): Results Measurement in Impact Investing: A preliminary review, by Donna Loveridge.
[43] OECD (2015): Social Impact Investment. Building the evidence base.
[44] OECD (2015).
[45] Danida (2016); see also OECD (2015).
[46] DCED (2016).
[47] Global Impact Investing Network (GIIN) website.

Table 1 - Agreed and contested issues around the definition of Impact Investing

	Defining elements of Impact Investing according to GIIN	**Other views**	
		Agreed issues	**Contested issues**
	Intentionality: Investors intend to achieve a positive social or environmental impact.	Intentionality features in most definitions. [48]	Intentionality is difficult to define in practice.[49]
	Investment with return expectations: Impact investments are expected to generate a financial return on capital or, at minimum, a return of capital.	Return expectations are included in most definitions of Impact Investing. [50]	According to a few sources, some impact investors do not seek any financial return.[51]
	Range of return expectations and financial instruments: Impact investments target financial returns that range from below market (concessionary) to market rate. Investments can be made in all forms, e.g. fixed income securities, venture capital, or private equity.	Widely agreed by those that expect impact investments to have financial return. In practice, WEF (2013) argues that many impact investors target market returns, even if they accept lower returns. [52]	There has been "considerable debate" regarding risk-return profiles and it is still unclear where the "lower and upper bound of returns should stand" in order to consider an investment as an impact investment. [53]
	Impact measurement: Investors measure and report the social and environmental performance of investments, ensuring transparency and accountability.[54]	Wide agreement among in principle among proponents of Impact Investing[55] in order to distinguish Impact Investing from traditional investment – but still aspirational in practice, with much debate on practical issues	*Definition of impact:* Views on impact can differ substantially, including eligible impact sectors, target countries and populations, and impact thresholds. *Measurement of impact:* Given the different views on what constitutes impact and the wide variety of investors, "there is little consensus on what to measure and how."[56]

[48] OECD, 2015.
[49] Ibid.
[50] Ibid.
[51] Joan Larrea (2016).
[52] WEF (2013): From the Margins to the Mainstream Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors.
[53] Joan Larrea (2016).
[54] GIIN website.
[55] Danida (2016)
[56] Ibid.

HOW DO BLENDED FINANCE AND IMPACT INVESTING RELATE TO EACH OTHER?

Blended Finance and Impact Investing used to be largely separate fields but now seem to be converging.[57] Traditionally, many Blended Finance operations have focused on large infrastructure investments, whereas impact investment has tended to focus on smaller investments in SMEs that benefit the poor as consumers, producer or employees. Increasingly though, two possible areas of convergence can be observed:

- **Donors can use Blended Finance to mobilise Impact Investments:** According to the GIIN Blended Finance Working Group, Blended Finance can be used to channel additional finance into Impact Investments: it is a "strategy that combines capital with different levels of risk in order to catalyse … market-rate-seeking capital into impact investments".[58] This is for example the case in funds, which have an explicit focus on mobilizing private finance for investing in impact-relevant projects (for examples, click here.)

- **Impact investors may themselves use blending to leverage additional finance:** Some impact investors may use guarantees, equity or concessional loans to encourage financial providers to cater to underserved clients. Based on GIIN's definition this approach can qualify as Blended Finance, if impact investors seek a financial return.[59] On the other hand, where impact investors seek to leverage additional finance but don't expect any financial return, their approach would not qualify as Blended Finance.[60] Examples of both scenarios can be viewed here.

  GIIN's 2018 Impact Investor survey notes that blended finance "has attracted increasing interest as an impact investment approach: …Seventy-five percent of respondents have either participated in a blended finance deal or plan to do so."[61] Similarly, a 2018 review of blended finance finds that "impact investors account for approximately 40% of private investors in blended finance deals", although the report also notes that "these investors vary significantly in the degree to which they will prioritise social or environmental returns over financial returns."[62]

DOES IMPACT INVESTMENT QUALIFY AS INNOVATIVE FINANCE?

As noted in section 1, impact investment is often referred to as an innovative financing approach. This aligns with several definitions of innovative finance, e.g. those that consider mechanisms for achieving better results, in this case by deploying funds into impact-oriented companies; or definitions that refer to attracting new participants to the market, e.g. institutional impact investors.

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[57] Danida (2016).
[58] GIIN webpage on the GIIN Blended Finance Working Group.
[59] Ibid.
[60] Ibid.
[61] GIIN (2018).
[62] Convergence (2018a): The State of Blended Finance 2018.

DOES IT WORK?

With a market size of USD 228 billion in 2018,[63] compared to ODA worth USD 146.6 billion in 2017[64], it is clear that Impact Investing has the potential to be a major catalyst in achieving the SDGs. The impact investment market also shows clear signs of growth, with many new players entering the industry: 50% of the impact investors surveyed by GIIN in 2018 made their first impact investment in the past decade, 'indicative of the ongoing entry of new players'. In addition, impact investors that have also been surveyed five years ago have grown their impact investing assets at 13% per annum, and 'have done so in part by expanding into regions, sectors, and asset classes that have historically been less popular'.[65]

More effort is however still needed to understand the actual development results of impact investment. So far, the evidence on results of impact investment "is limited to impact reports by individual investors, case studies and anecdotal evidence."[66] However, many donors and impact investors already work intensively on developing common principles for results measurement, in order to allow for more systematic measurement and comparison of results. Examples of such initiatives will be further explored in section 5.

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[63] GIIN (2018).
[64] http://www.oecd.org/development/launch-of-oda-figures-2017-france-april-2018.htm
[65] GIIN (2018).
[66] Ibid. For examples of case studies, see the GIIN website here: https://thegiin.org/case-studies/

4. PAYMENT BY RESULTS AND RESULTS-BASED FINANCE

WHAT IS IT?

Payment by Results is an "an umbrella term for initiatives that pay upon accomplishment of results rather than efforts to accomplish those results".[67] Payment by Results is increasingly applied to development projects but remains controversial. Often, Payment by Results and Results-Based Finance are used interchangeably,[68] others propose more distinct definitions (see below).

Three common elements appear in definitions of results-based payments:[69]

- The disbursement of funds is tied to the achievement of clearly specified results, rather than to inputs or activities.
- The recipient has space to decide how the results are achieved, thus creating ownership, and allowing for flexibility and innovation.
- There are robust mechanisms for verifying results as the basis for disbursing funds.

WHAT ARE DIFFERENCES IN COMMON DEFINITIONS?

There is no international consensus on the definition of terminologies used in the context of Payment by Results, such as Results-based Finance, Pay-for-Performance or Performance-based Incentives.[70] Sometimes, different terminologies are used interchangeably, in other cases the "same types of approach …are …defined, and implemented, in many different ways".[71] A recent review of evidence even suggests that "two people arguing about PbR [Payment by Results] may not recognise the other's working definition of PbR."[72] As such, it can be more helpful to frame PbR as a 'principle rather than a strict payment model'.[73]

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[67] USAID (2018): Pay for Results in Development. A primer for practitioners.
[68] Urban Institute (2016): Results-Based Financing Approaches Observations for Pay for Success from International Experiences, by Matthew Eldridge and Rebecca TeKolste; Gustaffson-Wright (2018): Davos: Is paying for results with blended finance ready to take off?
[69] DFID (nd): Payment by Results; Sida (2015): Results-Based Financing Approaches – What are they?; USAID (2018).
[70] Sida (2015); DFID (2013): Evaluation of Payment by Results: Current approaches, future needs; DIE (2013): Results-based Financing. Evidence from performance-based financing in the health sector, by Amanda Melina Grittner.
[71] DFID (2013).
[72] Paul Clist (2018): Payment by Results: What is the evidence from the first decade? Blog post on Oxfam from Poverty to Power Blog, based on: Paul Clist (2018): Payment by Results in development. Evidence from the first decade, Development Policy Review.
[73] OECD (2018b): A results agenda for the 2030 Agenda: New approaches for changing contexts. Key messages from the workshop.

Some key differences between approaches include:

- **The implementing partner:** Apart from to private for-profit providers, implementing partners may be private non-profit organisations or sub-national government entities.

- **The entity receiving payment:** According to DFID (2015), there are three categories of Payment by Results instruments, depending on who receives payment from the outcome funder: [74]
    - **Payment to a service provider, through Results-Based Finance:** In Results-Based Finance the payment is made to a service provider.
    - **Payment to a partner government, through Results-Based Aid**: Payments from funders to a partner government are typically described as results-based aid, rather than Results-Based Finance, although a number of hybrid schemes exist. [75]
    - **Payment to a private investor, through Development Impact Bonds (DIBs):** In this case, "investors provide upfront capital for the delivery of services by an implementer, and then are repaid with a premium if successful by an outcome funder upon achievement of results".[76] As much of the current interest in results-based payment is focused on Development Impact Bonds, DIBs and related formats are explored in more detail in Box 3 below.

- **The format of payment:** USAID, 2018 distinguishes between four formats that involve results-based payments to an organisation or entity, rather than an individual. In addition to **development impact bonds**, they include:
    - **Performance-based contracts**, which are grant agreements between funders and implementers, or funders and governments who subcontract a service provider. They can include public-private partnership contracts.[77]
    - **Prizes, or financial rewards,** which are given to competitors after successfully accomplishing a pre-defined result; and
    - **Advance market commitments,** which are agreements to guarantee a price or market for a product after its development. They have been traditionally used in the health sector, e.g. to promote the development of vaccines.[78]

- **The results level triggering payment:** Payments can be made for final outcomes, intermediate outcomes, or outputs depending on the risk sharing between implementers, outcome funders, and in the case of DIBs, investors. It is also possible for part of the financing to be results based while other parts are traditional input financing.[79]

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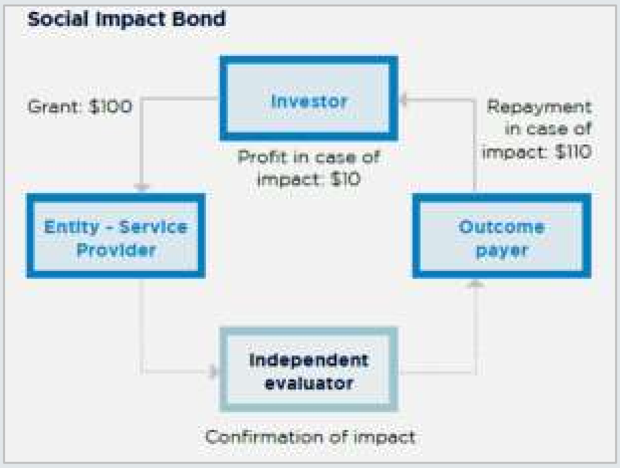
[74] DFID (2015): Evaluating Development Impact Bonds, by Roger Drew and Paul Clist.
[75] DIE (2013).
[76] USAID (2018).
[77] Danida (2016).
[78] USAID (2018).
[79] Sida (2015).

Box 3 - Development Impact Bonds

Development Impact Bonds have their roots in Social Impact Bonds. These are partnerships aimed at improving the social outcomes for a specific group of beneficiaries by paying investors in social service providers for results achieved. In DIBs, the concept is applied to developing countries, and donor agencies or foundations typically act as the main outcome payers. Note that impact bonds are not technically bonds, which are formal contracts to repay borrowed money to an investor with interest at fixed intervals; instead, the financial return will vary and is tied to the performance of the service provider (University of Oxford).



There are some definitional and practical differences in the field of impact bonds, such as the nature of implementing partners, the type of finance provided by the investor, and the structure of incentives. For example, IDB (2017) differentiates between *Social Impact Bonds* (as per the graphic above); *Social Impact Incentives*, whereby the implementer is a social enterprise which receives a loan from an investor and a financial reward from an outcome payer for results achieved; and *Social Success Notes*, whereby an investor provides an interest-free loan to a social enterprise and is paid a financial reward by an outcome payer if results are achieved.

HOW DOES PAYMENT BY RESULTS RELATE TO BLENDED FINANCE AND IMPACT INVESTING?

There are different views on whether results-based finance can qualify as a blended finance instrument. A scan of the literature reveals several references to results-based finance as a blending instrument.[80] In particular, Development Impact Bonds are frequently described as a blended finance structure.

This is however not fully in line with the widely established definition of blended finance as a catalytic approach for raising additional finance for development: While DIBs are a way of mobilising private capital towards impactful projects while generating a financial return, the fact that donors pay back investors in full for results achieved means that DIBs "are not really generating leverage in the sense of (…) bring(ing) in additional money"; in the end, it is the outcome payer who funds the programme.[81] The only leverage effect that may occur is the achievement of higher effectiveness and implementation efficiency as a result of shifting financial risk to private investors. According to some sources, it could thus still be argued that DIBs qualify as blended finance.[82]

Overall, it may however be clearer to conceptualise results-based finance as a set of instruments to encourage the use of private finance or implementation capacity for SDG-relevant projects. Private finance may come from impact investors, charitable and/ or primarily financially motivated mainstream investors.[83]

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[80] See for example the Blending for Agriculture website.
[81] Lukas Freiburghaus et al (2017): Blended Finance. How blended finance can close the prevailing investment gap and allow social enterprises to grow.
[82] Ibid.
[83] DFID (2015) and University of Oxford, Government Outcomes Lab (2018): Social Impact Bonds. An overview.

DOES RESULTS-BASED FINANCE QUALIFY AS INNOVATIVE FINANCE?

As a relatively "new way of delivering development finance, and an effort to make financial flows more result-oriented, Results-Based Finance typically features prominently in the innovative finance discourse".[84] A few exceptions exist; for example, OECD (2009) excludes innovative delivery mechanisms, including those based on results, from their innovative finance definition.[85]

Empirically, the Innovative Financing Initiative observes an increased use of results-based and other instruments through which the private sector shares the risks and rewards from development.[86] However, established financial instruments, applied to new markets or involving new investors, "still constitute nearly 65% of the innovative financing market".

DOES IT WORK?

Overall, two recent papers on Payment by Results conclude that the evidence base is thin.[87] According to USAID (2018), there are few studies on the longer-term impact of Payment by Results programmes and more longitudinal and intensive research is needed. [88]

Based on a review of DFID's Payment by Results portfolio, Clist (2018) concludes that there is some evidence of successful, small projects. These have been implemented as an element of a larger programme. Yet, there was no basis to assume that Payment by Results would "fundamentally change the range of project success or failure." The author however raises the possibility that donors' administrative requirements have so far prevented them from implementing the idea well. Payment by Results might only work well if recipients were indeed given "enough time, space and incentive to find the best way to achieve an agreed goal." [89] In practice, donors are used to unilaterally setting metrics and validating performance, so the idea of sharing performance and financial risk, as well as the determination of metrics and performance, is new and potentially challenging for donors.[90]

A key lesson for donors is that a number of conditions need to be met for the approach to add value:[91]

- Payment by results is not adequate for solving complex, systemic or non-tangible issues.
- Payment by results requires a precise understanding of how much the outcome should cost in order to avoid paying either too much or too little. This is only possible if sufficient evidence exists on effective activities to achieve the desired outcomes, so that implementers can estimate the costs of delivering services and donors can adequately price the contract.
- As payment by results requires an independent third party to verify results, these costs need to be carefully weighed against potential benefits.
- The verification of results has to be technically feasible and affordable.
- Payment by Results should not be used as a mechanism to push recipients beyond what they want to do, but to incentivise and support the effective delivery of agreed results.

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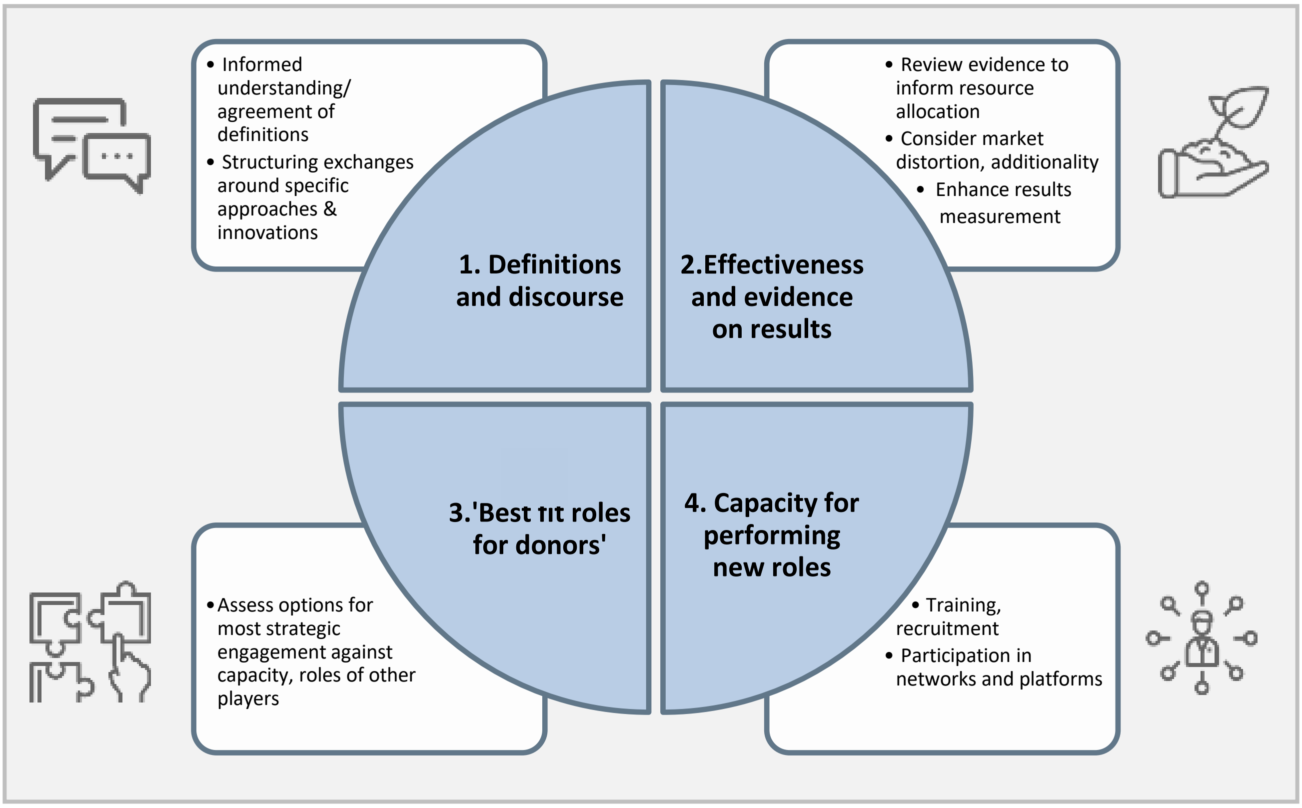
[84] Innovative Financing Initiative (2014): Innovative Financing. For Development: Scalable Business models that produce economic, Social, and environmental outcomes.
[85] OECD (2009): Mapping Innovative Finance for Development Mechanisms, by Elisabeth Sandor.
[86] Innovative Financing Initiative (2014).
[87] Paul Clist (2018); USAID (2018).
[88] USAID (2018).
[89] Paul Clist (2018).
[90] USAID (2018).
[91] This list of conditions and considerations is based on OECD (2018b) and National Audit Office (2015): Payment by Results. Analytical Framework for Decision Makers.

5. LOOKING AHEAD: KEY ISSUES FOR DONORS

The review above points to four key implications for donor agencies seeking to increase their engagement in innovative finance, summarised in Graphic 4: Sharpening definitions and discourse; strengthening effectiveness and evidence on results; reviewing 'best fit' roles for donors; and enhancing the capacity of donors for performing new roles. These apply to innovative finance in general, as well as specific work through Blended Finance, Impact Investing and Results-Based Finance. This section briefly discusses each of these key issues, as well as possible roles for the DCED in addressing them.

Graphic 4 - Key issues for donors reviewing their engagement in innovative finance



DEFINITIONS AND DISCOURSE

Innovative finance is clearly a broad field involving different communities of practice and a wide range of stakeholders using different definitions; this makes agreement on a single definition of innovative finance unlikely. A key implication for donor staff is to enter discussions with an informed understanding of the diverse approaches that innovative finance may refer to. Real progress in agreeing shared definitions will be more realistic for specific approaches including Blended Finance, Impact Investing and Results-Based Finance. For example, the 2018 Tri Hita Karana Roadmap on Blended Finance supported by OECD and others recognises the need "for a common language… in order to deliver the financing needs to support the fulfilment of the SDGs. "[92] OECD also plans to work on a 'common lexicon' on the measurement of impact investment.[93]

In addition to generic definitions, knowledge exchange and research on effective practice will need to be structured around specific instruments and implementation formats, based on a clear categorisation. For example, GIIN has compiled an interesting resource on key considerations when using different blended finance instruments.[94]

2. EFFECTIVENESS AND EVIDENCE ON RESULTS

Evidence on the effectiveness of Blended Finance, Impact Investing and Results-Based Finance in mobilising private finance and achieving pro-poor results is relatively scarce and fragmented. Of course, the rationale for engaging in innovative finance is still compelling. In practice, however, this means that scaling up resource allocations to innovative finance should be informed by a careful consideration of risks and benefits, and of how to maximise learning from experience gained.

Across different communities of practice in innovative finance, there is already an increased emphasis on strengthening impact assessment:

- The OECD's new Blended Finance Principles recommend that all blending operations should be monitored based on clear results frameworks;[95] following up on this, the Tri Hita Karana Roadmap on Blended Finance highlights the promotion of "measurement and monitoring of the impact of blended investments towards the SDGs" as a priority action area.[96]

- Similarly, efforts are ongoing in the Impact Investing community[97] to work towards better and more standardised impact measurement and management, even though this is still at a nascent stage.[98] A leading initiative in this field the Impact Management Project (IMP), a multi-stakeholder forum of more than 200 organisations to debate and find consensus on impact measurement and management issues.[99] IMP partners include OECD and the Global Impact Investing Network (GIIN), which works on building the evidence base on impact investment and has developed practical

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[92] Tri Hita Karana Roadmap for Blended Finance (2018): http://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/Tri-Hita-Karana-Roadmap-for-Blended-Finance.htm
[93] OECD Social Impact Investment Initiative webpage: http://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/social-impact-investment-initiative.htm
[94] GIIN (2018): A resource for structuring blended finance vehicles.
[95]OECD (2018a): OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the Sustainable Development Goals..
[96] Tri Hita Karana Roadmap for Blended Finance (2018): http://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/Tri-Hita-Karana-Roadmap-for-Blended-Finance.htm
[97] For a more detailed review of current initiative, please refer to OECD (2019b): Social Impact Investment 2019. The Impact Imperative for Sustainable Development.
[98] DCED (2016).
[99] The Impact Management Project website: https://impactmanagementproject.com

tools.[100] OECD has announced a work programme over 2019-2020 which includes the establishment of a results measurement framework for impact investment, improving the standardisation of impact metrics and working towards global consensus for impact measurement standards.[101]

In the near term, donors would also benefit from more systematic and instrument-specific reviews of evidence. In the area of blending, for example, questions include

- when it is appropriate to use which blending instruments;
- whether different instruments such as traditional grants or the use of risk mitigation tools lead to different outcomes; and
- success factors in mobilising private capital in low-income or fragile contexts.

Another priority that applies in particular to blended finance is to avoid market distortion by offering finance when it is not strictly needed or on the wrong terms. Providing the right subsidies or incentives will likely require assessments by investment specialists of the investment case and local context. By refraining from strict spending or resource mobilisation targets, donors can avoid adverse incentives.

3. 'BEST FIT' ROLES FOR DONORS

As a result of the Innovative Finance agenda, both donors and DFIs have begun to adapt their roles and relationships with each other. A few trends can be observed across different donor countries:

- **DFIs have gained in importance in the development landscape**: Countries that did not have DFIs before are setting one up (e.g. Canada), some countries are creating new DFIs (e.g. US), and many donors are increasing the amount of capital provided to DFIs (e.g. DFID, Norway).

- **Donors want DFIs to mobilise capital**: In addition to their traditional role as direct lenders and investors into companies and projects, DFIs are increasingly asked to mobilise private finance. They can do so by acting as asset managers and co-investors in aggregated finance vehicles.[102] In reality, however, most DFIs are not yet structured to mobilise private finance at scale. Their business model is still largely focused on using their own capital to arrange deals and making them a success, rather than crowding in private investors. Still, a few DFIs (e.g. FMO) and multilateral development banks (e.g. IFC) have a relatively stronger and growing track record in deploying capital to mobilise private sector finance.[103]

- **Donors use traditional financial instruments in new ways and are testing new instruments:** Agencies are testing ways to "convert grants into financing and investment instruments or risk mitigation instruments"[104], such as guarantees, to mobilise private finance, including from institutional investors. This may be done to fill in gaps while domestic DFIs are not yet geared up for mobilising substantial amounts of private finance, or because the agency seeks a longer-term role in innovative finance. Some donors also act as direct lenders or investors into companies and

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[100] GIIN website: https://thegiin.org/imm
[101] OECD Social Impact Investment Initiative webpage: http://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/social-impact-investment-initiative.htm
[102] Danida (2016).
[103] Convergence (2018); exchange with Fulvio Capurso, DFID.
[104] Ibid.

funds, including impact investors, rather than delegating this to DFIs. In addition, grants are applied in new ways through Impact Bonds or Impact Incentives, where donors acting as outcome funders share financial and performance risk with private investors.

Overall, donors are still exploring how to best engage in innovative finance work. A particularly important issue will be to identify the most strategic role in relation to other players, including Development Finance Institutions. A number of specific engagement options have been identified by Danida (2016)[105] and adapted and added to in **Table 2** below.

- **Some of options listed below are in traditional 'donor territory'**; these usually demand less in-house technical expertise in innovative finance, and are in line with donors' usual risk appetite.
- **Other options represent largely new roles for donors and either overlap with traditional 'DFI territory' or could possibly be more effectively played by DFIs in the future**. They require not only new technical expertise but also institutional capacity to manage (rather than just minimise) risk – which many donor agencies don't have. For example, "commercially-oriented fund managers may have specialised skill sets (e.g. emerging markets, asset management) and more experience working with private investors" than development agencies, making them more likely to succeed in crowding in private capital.[106] Regional development banks in particular may also have an added value in identifying and arranging new deals. As such, identifying the most strategic division of responsibilities with DFIs and other market players, will require donors to answer key questions including:
    - What are the technical and procedural requirements for taking on new roles in innovative finance and how can they be met, if at all?
    - Is there a need and added value to act as a direct provider of innovative finance temporarily or in the long term, to complement DFI work?
    - What are the most effective approaches and instruments to encourage DFIs to mobilise more private finance, instead of, or in addition to, direct engagement of the donor agency?; and
    - How can any donor engagement in innovative finance be coordinated with DFIs? How can experiences and lessons be shared based on a common language?
- Due to the current lack of evidence around the effectiveness of most innovative finance approaches, any substantial and direct engagement of donors (e.g. as in option 6 below) has to be seen as experimental in nature and should be accompanied by a focus on documenting results and lessons learnt.

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[105] Ibid.
[106] Convergence (2018).

Table 2 - Options for Donor Engagement in Innovative Finance (IF)

Traditional vs. new roles and required expertise	Blended Finance	Impact Investing	Results-Based Finance
Traditional donor role; limited expertise in IF required; low risk	**1. Commission research to advance conceptual development and review the effectiveness of innovative finance, e.g.…**		
	• …experience in using different blending instruments • application of blended finance to low-income/ fragile regions; or • needs analysis of fund manager skills	…case studies on how donors add value to impact investments 1) without providing capital; 2) different types and amounts of capital. [107]	• …longitudinal studies on the impact of results-based finance; or • comparative analysis of Development Impact Bonds, Impact Incentives and Success Notes
Traditional donor roles; good knowledge in IF required; low risk	**2. Engage in platforms and networks for knowledge exchange and learning, e.g.…**		
	… the GIIN Blended Finance Working Group[108] and Convergence	…the Impact Management Project	the Development Impact Bond Working Group, including governmental and private donors and others
	3. Promoting transparency and developing tools and standards on effective practice, e.g. by…		
	• encouraging and incentivising donor-supported blending vehicles and impact investment funds to publish performance results. • Strengthening tools and standards for impact assessment • strengthening efforts to avoid market distortion through public subsidies		
Traditional donor role; limited expertise in IF required; medium risk	**4. Build the local market of investable projects through traditional private sector development (PSD) work, e.g. by…**		
	…using market development programmes to bring more businesses and projects to an investment-ready status	…facilitating an enabling environment for impact investing, e.g. allowing institutional investors to invest in small, high-risk projects[109]	…providing business support services to social enterprises who may act as implementers and recipients of results-based finance

[107] DCED (2016).
[108] For a list of members in the working group, see the appendix in GIIN (2018).
[109] DCED (2016a): How to create an enabling environment for inclusive business? Learning from experience and debates in private sector development.

Non-traditional donor role… ...but mainly requiring general PSD knowledge; low risk	**5. Mobilise investors through non-financial approaches, e.g. by…**		
	• working with field offices, local business networks, contracted projects, or sector experts to identify bankable, higher impact businesses in which to invest • hosting awareness raising events or webinars to publicise investment opportunities and facilitate networking between experienced investors and newcomers • Commissioning attractive communication materials on successful examples of private investment into inclusive businesses and development projects • funding capacity-building initiatives targeting local financial institutions in low-income countries to enable them to better identify, structure and co-finance deals that mobilise private finance		
Non-traditional donor role; requires strong technical expertise in IF and, for blending vehicles, reflection on the division of tasks with DFIs; high risk	**6. Act as co-investors of co-funders of existing innovative finance vehicles to take practical action while drawing on the experience of others and maximising learning, e.g. by…**		
	…co-investing in existing blended finance vehicles or impact investing funds, or their own countries' DFIs		… contributing grant funding to pooled outcome funds, prize competitions or intermediary funds for advance market commitments
	7. Take the lead in setting up, funding and/or managing new funds or vehicles for leveraging private finance, e.g. by		
	…setting up a blended finance facility	…creating programmes to provide loans or equity directly to impact investors	…acting as sole outcome funder in development impact bonds or similar formats

4. CAPACITY FOR PERFORMING NEW ROLES

Danida (2016) points out that "it is likely that development agencies will need to build their own internal capacity for innovative finance".[110] Many development practitioners are unfamiliar with concepts from the world of finance and lessons on effective practice. Specific technical expertise is often particularly lacking in the areas of legal advice and leadership for new programmes in innovative finance. Even donor-funded blending facilities do not always have private sector and investment specialists on their teams.

While some agencies have begun to recruit from the financial sector for specific technical roles,[111] **a key barrier is that they can generally not match the salaries and bonuses paid in the financial sector**.

[110] Danida (2016).
[111] DCED (2017): How donors can make the transition to strategic private sector engagement. Programming innovations and organisational change.

Ultimately though, donor agencies may need to consider special career tracks in order to bring in development professionals who are "multilingual in that they …[work] effectively across business, government, philanthropy and civil society."[112]

Meanwhile, there is a growing number of training offers, tools and services for donor staff on different aspects of innovative finance.[113] For example, the blended finance platform Convergence offers a range of services including training events and webinars, and documents lessons on effective practice. GIIN offers training on impact measurement to impact investors and fund managers. Participating in relevant networks and platforms on blended finance, impact investing and results-based finance (see the examples in section 2 in the table above) can also help to "produce knowledge and track experience in these fields".[114]

While not the focus here, DFIs also face similar challenges as their role is shifting from providers to intermediaries of finance. New staff skills are therefore likely to be required to support their changing business model, including in relationship building and outreach efforts to institutional and other investors.

OPTIONS FOR ENHANCING DONOR ENGAGEMENT IN INNOVATIVE FINANCE

There are several options for how the DCED and other organisations could work with donor agencies to address the key issues identified, and that are not yet (fully) addressed by existing initiatives.

First, there is potential for activities to fill knowledge gaps and strengthen capacity within donor agencies on Innovative Finance. These could include:

1. Developing an analysis of how innovative finance fits into the overall toolbox of different private sector development approaches used by donors.

2. Deepening knowledge on specific financial instruments and investment vehicles used in blending operations, specific formats of results-based finance and impact investment through workshops or webinars with technical experts.

3. Expanding on the DCED's existing work on how to mitigate the risk of market distortion in private sector engagement[115] to review mitigation strategies for specific innovative finance approaches and instruments in more depth.

4. Facilitating exchanges between the Private Sector Engagement Working Group and DFI networks such as the Association of European Development Finance Institutions (EDFI) on the most strategic division of roles and responsibilities (especially on categories 5 – 7 in the above table of possible donor support to innovative finance).

5. Commissioning a needs assessment on skills and procedures in donor agencies to engage effectively in innovative finance.

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[112] Danida (2016).
[113] A list of training providers on private sector engagement is available at https://www.enterprise-development.org/training-offers-on-private-sector-engagement-and-partnerships/
[114] Danida (2016).
[115] DCED (2018): How to minimise the risk of negative market distortion in private sector engagement. A practical framework.

Second, there is a need for additional activities to help to advance the field of innovative finance as a whole. Examples include:

6. Commission reviews of the effectiveness of different approaches and instruments for leveraging private finance, for example (a) success factors for attracting capital to low-income and/ or fragile contexts (b) the comparative results achieved through different financial instruments in blended finance; (c) the advantages and disadvantages of different implementation formats of development impact bonds; or (d) a review of experience in non-financial approaches for leveraging private finance. If data on effectiveness is not available, research could explore why this is the case and what would need to happen to change it.
7. Building on the DCED's experience in Results Measurement, commission a needs assessment on capacity and procedural requirements in blending facilities and impact investors to engage in effective results measurement.

Conclusion

This review has shown that innovative finance is linked to a various related, but distinct, concepts and approaches, characterised by vague and inconsistent terminologies as well as limited evidence on results on poverty reduction. Yet, donors are rapidly increasing resources allocated to innovative finance. Indeed, recent estimates show that innovative finance approaches have a strong potential to mobilise private capital for development, and that there is growing investor interest in deploying capital towards sustainable development.

There is therefore an urgent need to exchange experience and lessons learnt on the how donors can most effectively and strategically engage in innovative finance. This will only be possible based on a shared understanding of key approaches and if structured around specific implementation formats. This paper outlines the specifics of the challenge, and provides a basis for donors to move forward with more clarity and purpose.

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