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**WORKING GROUP ON THE ADDITIONALITY OF GRANTS IN THE FRAMEWORK OF
BLENDING MECHANISMS**

FINAL REPORT

- EXECUTIVE SUMMARY -

Resources for external assistance are scarce while financing needs have grown globally, a situation being exacerbated as a result of the financial and economic crisis. In the interest of beneficiaries, the EU as an important global player should strive to achieve a more comprehensive approach to accelerate access to financing, high leverage effect and more flexibility to adapt to changing conditions. While maintaining focus on sustainability criteria and the policy context, this reinforces the overarching objective of increasing aid effectiveness.

In this context, there have been attempts in the EU to develop **innovative loan grant blending (LGB) mechanisms to increase the leverage effect** of external assistance and **underpin EU external priorities, while ensuring coherence with EU strategy and policies**. The Council mandated an expert working group to further analyse these mechanisms. LGB arrangements combine flows with different financial terms and characteristics (e.g. grants, loans and guarantees) to gain leverage and thereby increase impact. Leverage can be both financial and non-financial. Financial leverage is the ratio of grants to non-grant investment in a project. Non-financial leverage refers to how LGB instruments can unblock, accelerate, improve quality or promote institutional change facilitating more, better and faster investment projects in support of EU policy goals.

LGB instruments can attract public and private finance into those areas of EU policy priorities to support by lowering the hurdle rate for financial feasibility as well as by reducing the overall risk associated with a project when and where possible (e.g. covering potential losses on specific risks, expanding services to low income groups, or addressing such diverse issues as tariff levels/affordability, the borrower's technical capacity, technological innovation, etc.).

In economic terms, **LGB instruments may be justified as corrective measures** in two main cases: market failures and higher socio-economic than financial returns, i.e. where external social and/or environmental benefits and costs differ from those accruing to local stakeholders of a project (positive externalities) or where the partner country's economic situation, stage of development and state of financial markets require financial support to sustainably enhance development. However, such forms of interventions should be selective and targeted to crowd in rather out other potential sources of finance for viable projects.

Blending may be justified in a wide variety of circumstances for either public or private sector projects. Hence the **criteria for decision making** to decide on whether a project or specific action is eligible for LGB support **vary by region, country, sector and project**.

Funding of **technical assistance (TA)** helps achieving **high leverage** in preparing, accelerating and improving the quality of investment projects suitable for LGB. TA can play a critical role notably at early stages in the project cycle. In the justification for TA, the way to consider and weigh parameters may therefore differ from the other forms of blending and depends on the type of technical assistance used.

There is **no “one - size - fits - all” approach** to blending. A careful balancing act is needed to capture potential benefits by maximising leverage whilst simultaneously meeting the needs of final beneficiaries and donors. LGB design needs to be tailored to the specific project objective that is being targeted. Decision making needs to take into account the multi-dimensionality of criteria for LGB justification and the wide variety of policy and economic contexts in which the EU supports projects in low and middle

income countries. Uncertainty and measurement problems in project outcomes and impacts hamper the elaboration of precise and quantifiable ex-ante decision criteria, but ex-post evaluation and feedback of lessons learned can improve future effectiveness. Ensuring consistency in LGB allocation is a difficult exercise. Nevertheless, some common principles/guidelines/directions can be identified.

Decision making criteria can be classified into **macroeconomic, and sector policy parameters and project related parameters**. While the macroeconomic and sector level criteria mostly apply to strategy/policy decisions, the project related parameters are specific to the context, project and promoter concerned.

Various country and sector level criteria could be taken into consideration in determining grant shares on a strategic level: the macroeconomic situation and outlook, poverty, indebtedness, the development of financial markets, access to international finance and good governance (both overall and at the specific sector level). All these criteria show significant variations across countries even within the same region. Their combination provides key information on the relevance of LGB. They constitute the environment of any project and are therefore essential for any decision making. Sector level criteria often relate to tariffs and affordability issues as well as to the regulatory framework and promoter capacity.

On the **project level**, it is important for each project to identify the **value added of LGB**. **This can have several dimensions both quantitative and qualitative**. This means that LGB instruments should only be put in place to achieve objectives which without them would not be addressed, would be addressed insufficiently or more slowly or when quality aspects of a project would be inadequately addressed.

The justification for and the proposed level of LGB support to be allocated to individual projects is helped by further **differentiating country-specific situations and a systematic comparison of the respective merits of projects**, i.e. their social and environmental impact alongside contributions to economic development and poverty reduction.

LGB mechanisms can only temporarily alleviate market failures whereas sustainable solution lies in legal and institutional reforms that systematically address market failures through regulatory or market mechanisms. LGB will also need to consider leverage and **support to a process of sector reform** or behaviour change consistent with the objectives and priorities of EU assistance. In this context, experience indicates that the grant share of LGB support should decrease as income levels, financial markets, regulation and institutional mechanisms converge towards sustainable levels and as market-based solutions develop for particular sectors.

The working group agreed on a **guidance template** for projects to be used in the context of LGB mechanisms.

WORKING GROUP ON THE ADDITIONALITY OF GRANTS IN THE FRAMEWORK OF BLENDING MECHANISMS

FINAL REPORT

1. INTRODUCTION

The ECOFIN Council decided in December 2008 to establish an "Experts Working Group on additionality of grants in the framework of blending mechanisms" (WG Blending). The Terms of Reference ask the group to first conduct an in-depth analysis to identify potential positive and negative effects of use of grants to complement to loans in blending mechanisms of external assistance. The group may also define parameters to assess added value and negative effects of use of grants complement to loans for projects financed by blending mechanisms. The group is also invited to formulate proposals how to improve the presentation of projects. The Commission, in close cooperation with the EIB, was invited to report to the Council.

The EU is the leading donor worldwide and is committed to increase its external aid effectiveness. This willingness is laid down in the European consensus on development adopted in 2006 stressing the need to improve aid co-ordination. It is in line with the Paris Declaration on Aid Effectiveness (2005) and the Accra Agenda for Action (2008) building on it.

In this context, blending grants with loans is not new to the international donor community. In the context of the global economic situation and difficult access to funds and financial markets, the debate on "blending" has recently intensified among donors, the European and International Financial Institutions (EFIs and IFIs), the OECD/DAC and bilateral finance institutions. This debate focuses mainly on

- how to increase the access for Low and Middle-Income Countries (LICs and MICs) to international investment flows;
- how to better support priority objectives of the EU through enhanced involvement of finance institutions;
- issues related to risk, creditworthiness, market distortion, effectiveness, coordination, visibility and conditionality.

In general terms, loan grant blending (LGB) arrangements combine flows with different financial terms and characteristics (such as grants, loans and guarantees) to gain leverage¹ and thereby increase impact. They combine market (or concessional) loans and other financial instruments with accompanying grant (or grant equivalent) components which may be in various forms. Their design needs to be tailored to the specific project objective that is being targeted.

¹ This can be achieved both in terms of leveraging additional funds to specific countries, sectors or projects with high positive externalities and in terms of leveraging increased political influence, thus encouraging improved policy and institutional developments.

This document recalls the objectives of LGB and outlines some parameters whose consideration could help the EU enhancing consistency in the allocation of LGB instruments to projects and avoiding decisions which could lead to a waste of resources and unequal treatment. The focus is on the medium to long term financing of investments.

2. OBJECTIVES OF BLENDING

Resources for external assistance are scarce while financing needs have grown globally, a situation which is being exacerbated ensuing from the fall-out of the financial and economic crisis. These circumstances call for finding more efficient ways of using available resources and for achieving higher "leverage effects" of external assistance through blended instruments where LGB instruments attract public and private finance into those areas of EU policy priority. In the interest of beneficiaries, the EU as an important global player should strive to achieve a more comprehensive approach to accelerate access to financing, high leverage effect and more flexibility to adapt to changing conditions. While maintaining focus on sustainability criteria and policy context, this reinforces the overarching objective of increasing aid effectiveness.

From an EU perspective, external assistance should support EU external priorities and policies. These priorities are both "regional" and "sectoral" and include the dissemination of EU policies and standards, such as promoting the EU's environmental standards. While full grants have been provided in the past by donors, there is an evolution to combine grants with other instruments provided by finance institutions to enhance the leverage effect of assistance and to underpin the EU's external priorities.

Summarizing, the EU pursues the following objectives through blending of grants and loans:

- Achieving EU policy goals more effectively, i.e. increasing “aid effectiveness” and "aid coherence";
- Optimising financing packages for beneficiaries and therefore enhancing credibility and leveraging resources;
- Promoting donor cooperation in particular between European aid actors;
- Enhancing the visibility of European aid.

To unfold its potential, actors should develop a shared vision on blending as well as blending criteria, instruments and delivery mechanisms. For this purpose it is important to highlight the value added of blending mechanisms, e.g. in terms of their capacity to improve the allocation of scarce resources and reduce the use of pure grants in areas where loans or blended instruments are preferable.

LGB is used to close the gap between pure grants and loans or more market-condition based aid; it contributes to aid effectiveness by promoting a flexible and efficient allocation of resources addressing the financing needs of priority activities and projects in an optimised manner, by tailoring the blending instruments to the activities they support (in terms of the amount of donor support, the type of blending instrument that is chosen, etc.).

Moreover, an enhanced use of LGB may provide discipline to donors, by encouraging them to justify the use of budgetary funds and strengthen the supervision on project impacts as well as to recipients, by providing more latitude to introduce performance incentives.

Finally, improving aid effectiveness calls for increased donor coordination. Achieving enhanced donor co-ordination at European level would reinforce the position and visibility of EU donors vis-à-vis recipients as well as vis-à-vis other donors/IFIs. Participation of non-EU finance institutions, as contributors or lenders, could be encouraged, notably to benefit from their specific know-how or to enhance partner countries ownership. The possibility for non-EU institutions to participate and submit projects, together with EU finance institutions acting as "lead financier", to these EU blending mechanisms can be an opportunity to levy more resources and to benefit from their specific know-how.

3. STRENGTHS AND POTENTIAL WEAKNESSES OF BLENDING

Generally speaking, LGB instruments can leverage additional funds by lowering the hurdle rate for financial feasibility as well as by reducing the overall risk associated with a specific project (e.g. addressing such diverse issues as tariff levels/affordability, the borrower's capacity, technological innovation, etc.). Their optimal use will therefore depend on an analysis of the specific factors that either limit access to financial resources or would make the cost of capital unsustainable for the borrower. Such analyses from the IFIs are fundamental for deciding on the appropriate support to be included in LGB financing packages for specific projects.

In economic terms, LGB instruments may be justified as corrective measures in two main cases: market failures and higher socio-economic than financial returns, i.e. where external social and/or environmental benefits and costs differ from those accruing to local stakeholders of a project (positive externalities) or where the partner country's economic situation, stage of development and state of financial markets require grants to sustainably enhance development.

The decision-making concerning the allocation of support should consider four main components: (i) whether or not to provide an element of LGB financing, (ii) the form of LGB, (iii) its magnitude and (iv) the timing of the support.

It is evident that, given the intrinsic nature of LGB (providing customised solutions in different forms to address different situations), there is no "one - size- fits - all" approach to blending. This is also reflected in the feed-back from Member States. The situation varies on donor side as well as on the recipient side as regards political priorities, local situations and risks and stages of economic development and maturity. It further varies based on the specific sector and type of project/programme that is being considered, as the risks to be mitigated and obstacles constraining access to finance or reducing the sustainability of an endeavour will vary.

Strengths of blending

Blending offers clear benefits for donors (here used in a wider sense including finance institutions) and recipients alike from different perspectives related to strategic and policy aspects as well as to financial and operational ones.

a) Strategic and policy

- **Policy leverage:** Blending loans and grants can provide “policy leverage” on the definition of sector policies and projects. It thus allows focussing the use of resources on the regions and sectors or projects the EU find most important or most in need and which are not fundable on market conditions, thus allowing for higher overall development impact. Via its influence through LGB (and an ensuing higher leverage on policy dialogue and accompanying measures), donors may enhance the recipient’s policy in priority areas such as protection of the environment or governance. For countries with relatively good access to capital markets (middle income countries (MICs) and emerging markets), policy leverage comes mainly from the donor support element. However, for countries which do not have access to capital markets (low income countries (LICs)), LGB mechanisms bring significant value. For these countries, blending can achieve much higher leverage from relatively small resources. Blending can thus leverage additional financial flows to support investments that are deemed to be of priority European interest.
- **Supply of public goods:** The project may have positive externalities (such as social or environmental). The grant can be designed to “buy” the public goods that are “produced” by the project, and compensate for the additional cost they involve. LGB instruments are important tools to realise projects which are unlikely (if at all) to raise considerable user-charge revenue. This is particularly the case for social projects whose financial viability is not sufficiently attractive for financial institutions. A project may have a positive overall social return, while not being financially sustainable due to an insufficient financial return; in that case LGB financing is necessary to make the project feasible. Alternatively, a project may be initially designed with potential detrimental environmental effects (e.g. a fuel power plant); in that case LGB set up can finance the extra cost needed to redesign the project towards more environmentally friendly projects (e.g. wind farms)².
- **EU Visibility:** LGB can facilitate joint interventions by the various grant donors and finance institutions within the EU and thereby represents a powerful means to structure and co-ordinate European development assistance. Multilateral and bilateral donors and finance institutions within the EU can play an essential role in joining forces to improve the visibility of the EU’s donor operations through improved coordination on key policy messages, higher financial volumes (both overall and of single operations), increased and more visible transfer of know-how, and/or increasing concessionality. This enables to reach the critical financial mass and ensure the strategic consistency which is a necessary condition to achieve major and highly visible policy initiatives.
- **Concessionality:** Some countries are more in need, but are highly indebted and face restrictions (e.g. IMF concessionality requirements) in obtaining more loans due to high debt service and the Debt Sustainability Framework thresholds. However, meeting these constraints with LGB is costly in terms of leverage. Therefore, in several cases highly concessional instruments (e.g. IDA loans) or stand alone grants (or LGB co-financing with these instruments or grants) might be more cost effective and suitable than LGB.

² However, the provision of donor support in particular to private companies to pay expenses to mitigate negative environmental costs should be carefully assessed in line with the polluter-pays-principle.

b) Financial

- **Financial leverage:** LGB instruments potentially allow making available more financial resources to support investments that are deemed to be of priority European interest or to have desirable impacts (e.g. environmental, social, or development objectives) and that, without them, would not happen or happen more slowly or at a prohibitive cost to the partner country. LGB may also help to crowd-in private investments to make projects bankable by covering certain risks with donor support elements.
- **Risk mitigation and borrowing costs:** Blending can help (if designed accordingly) to mitigate risks associated with a country, sector or specific project for the lender which will hence be able to achieve a broader country and project coverage. Lower country or project risk will show in increased access to funding and lower borrowings costs for the beneficiaries and thereby enhance the financial and economic feasibility of projects. Support provided for risk cover, such as equity or risk-sharing in the form of guarantees can enhance the credit quality of a project and make it more bankable thus enabling and/or accelerating its implementation.
- **Flexibility:** The amount of the donor support can be tailored to fit the precise needs of each project on a case by case basis. Blending offers the full range of financing terms between the two extremes of the spectrum, i.e. 100% grant (or other form of donor support) to 100% loan, instead of having to choose on a binary option, either pure loan or a grant alone.

c) Operational

- **Financial discipline:** The combination of donor support with financing from financial institutions can improve the financial discipline of a project and its promoter during the project preparation, implementation and management.
- **Efficient administration and monitoring:** The donor can to a large extent rely on the project management expertise of the loan provider and reduce its administrative burden while still supporting a wide range of projects according to given priorities.
- **Project acceleration:** LGB may help to get a project off the ground, quicker than would otherwise be the case. LGB allows the necessary loan funding volumes to be provided together with an adequate level of subsidies commensurate to the financial strength of the project. In many cases, financial institutions have only limited or no own resources, particularly for certain upstream activities such as technical assistance (TA) for project preparation or capacity building.
- **Project quality:** The donor coordination automatically built into joint LGB structures helps to guarantee the quality of projects as well as of the project documents submitted to the donors for approval.
- **Donor coordination:** In line with the Paris Declaration on Aid Effectiveness (2005), coordination among (European) bilateral donors and finance institutions avoids duplication of efforts and has the potential to increase efficiency, in exploiting individual strengths of financing partners while increasing the financial envelope and spreading the operating risk. Improved donor co-ordination through the blending of

loans and grants may facilitate also the effectiveness and efficiency of aid for the recipient of funds as it may reduce contact points, administrative steps and procedures. Another strength consists in the capacity to “pool” activities within a project that would otherwise be pursued and financed separately into a more coherent, integrated project or programme.

- **Knowledge transfer and demonstration effect:** LGB support under the form of technical assistance can improve the return of investments in better designing the investment and/or reducing its maintenance cost and by providing knowledge dissemination. It can be provided in the form of feasibility and other studies for project preparation or consulting and training components. More far-reaching, well-designed LGB funded projects can be replicated by finance institutions and by other promoters as best practice.

Potential weaknesses of blending

Even though blending carries clear benefits, there are also potential general as well as specific weaknesses of loan-grant blending.

a) Economic risks

- **Crowding out other possible financing sources:** A bankable project can be financed by commercial banks, other finance institutions or direct borrowing on financial markets. LGB mechanisms improve the terms of the financial package for the beneficiary. LGB should therefore be avoided in case sufficient funds from other sources would be available. This risk of crowding out of other possible sources of finance is particularly relevant in countries where financial markets are sufficiently developed.
- **Market distortion:** LGB may give the beneficiary an unfair advantage that prejudices its local and international competitors. Donors must demand adequate documentation from IFIs to be assured that there is no risk of market distortion for the specific projects considered.

b) Financial

- **Excess concessionality:** Certain projects may be of elevated interest for several donors – both multilateral and bilateral -, due to the risk profile, the geographical region or the sector of the project. Depending on the form of LGB, the level of concessionality may not be very transparent. In case of important projects, beneficiaries may use their good position to play off donors against each other so as to maximise donor support. This is not necessarily an argument against blending per se, but rather an indication of the need for donor coordination as well as for transparent mechanisms leading to efficiency gains in project design.
- **Risk of imprudence:** The availability of some donor support for a certain project may be an incentive for a country (or a private promoter) to stretch the limits of its indebtedness beyond the economically sensible and prudent. This may in particular be the case for prestigious and big projects whose economic viability is fragile but in the interest of powerful domestic stakeholders.
- **Insufficient risk provision:** For instruments that provide risk mitigation (such as loan guarantees), the risk is not suppressed but transferred to another actor (e.g. the EU).

The associated risk needs to be properly assessed and reflected in the budgetary allocation so as to avoid unforeseen and additional costs.

c) Operational

- **Loss of control or visibility for individual donors:** Depending on the form and set-up of LGB, single donors may feel to loose control over the use of funds as they may disagree with certain (aspects of) projects for political and/or economic reasons. In particular in the context of joint financing, the visibility of the donors may be reduced compared with a direct project contribution which may represent a deterring element.
- **Potential slow-down of decision-making:** The pooling of funds from different partners often brings with it more co-ordination not only because of the higher number of involved parties but also because of diverging internal rules and procedures. Disagreement on conditionality between donors may also be an issue. This may generate, in particular at the initial phase, additional administrative costs and/or delays in the decision making procedure. These costs and delays are generally mitigated by economies of transaction costs and costs potentially incurred due to non-coordination. Also, given the thorough process through which projects are approved, in which both donors and IFIs are involved, the positive effects on project quality should be noted.

4. FORMS OF BLENDING

Different forms of blending can be considered at project level. All have various advantages and disadvantages in particular regarding potential market distortions and need to be assessed depending on the project features and circumstances. It is a general challenge to ensure that the actual benefits are being passed through to the final beneficiaries. It should also be noted that the budgetary treatment in terms of commitment and payments may differ between the different forms of grants used in blending arrangements.

A widespread use of donor support is technical assistance which is less likely to cause additionality problems or market distortions, when used for project preparation, as the service usually would not be provided without support. Also measures in response to temporary shocks, which lead to e.g. a moratorium of repayments are hardly market distorting. Other forms of LGB like direct grants or interest rate subsidies can create a stronger risk of crowding out private finance. Care is therefore needed to identify the type of LGB and its modalities which are least distortive. Avoiding disincentives for collecting fees if a project is expected to derive financial returns is also an important element in LGB decisions.

The main forms of LGB are presented and briefly discussed in Annex I.

5. KEY PARAMETERS FOR THE USE OF BLENDING

When discussing parameters for decision-making, two levels can be identified: (i) the level of programme definition and, (ii) the specific decision on each project. While the macroeconomic and sector level criteria mostly apply to the former, the project related matters are relevant for the latter. However, the macroeconomic and sector parameters were still worth being assessed since they constitute the environment of any project and were therefore essential for any decision making. This chapter endeavours to provide

some guidance towards a more coherent decision making process by identifying a broad set of criteria.

In general, donor support cannot be the sole catalyst for undertaking a project but they must be necessary to achieve concrete objectives. The principle of subsidiarity should apply, i.e. LGB should focus on objectives that could not be achieved otherwise. To this end a number of criteria and parameters need to be examined in order to decide on whether a project or specific action is eligible for LGB support, the relative proportion of donor support, the form of LGB support and its mechanisms (conditions, timing, etc.). As discussed above, blending may be justified in a wide variety of circumstances for either public or private sector projects and hence these criteria will vary by region, country, sector and project.

In theory blending arrangements could range between the two extremes of 100% grant support (or other form of support – see annex 1) to 100% loan on commercial terms. In practice, LGB requires a bankable project which allows a level of debt or other finance that is both sustainable for the borrower and justifies the transaction costs of setting up the financial package for all parties involved.

A careful balancing act is often needed to capture the potential benefits of blending and to maximise the leverage as well as to simultaneously meet the requirements of donors and the needs of recipients. Decision making needs to take into account the multi-dimensionality of criteria for LGB justification. Uncertainty and measurement problems in project outcomes and impacts hamper the elaboration of precise and quantifiable ex-ante decision criteria, but ex-post evaluation and feedback of lessons learned can improve future effectiveness. The different finance institutions are bound by the eligibility criteria in their mandates and have developed internal criteria for assessing the quality of projects. Ensuring consistency in LGB allocation is therefore a difficult exercise.

5.1. Macroeconomic and sector policy parameters

Macroeconomic conditions can limit access to external funds (affordability at a macro level). They are foremost important considerations on a strategic and programme design level. The environment in which a programme or project will be implemented has therefore to be assessed prior to an informed decision even though the LGB support for a specific project should not be decided solely because of its geographical location or the sector it belongs to.

Apart from more strategic conditions and overarching principles for assistance³, various country and sector level criteria could be taken into consideration in determining the eligibility and justification for LGB support: the macroeconomic situation and outlook, poverty, indebtedness, the development of financial markets, access to international finance and the support to a process of sector reform or behaviour change or the sector performance. All these criteria show significant variations across countries even within the same region. Their combination should however provide key information on the relevance of setting-up a blending financing mechanism.

³ An example for such a principle is good governance. Usually donors require a certain degree of good governance not only for being eligible at all, but also for the aid level and modalities of aid.

Macroeconomic conditions: The overall framework needs to be carefully assessed, in particular if and when it concerns a public promoter. It is important to consider the budgetary and economic outlook in order to assess the sustainability of the country's fiscal situation. On this basis, a first assessment can be made regarding the size of donor support in the context of LGB. Macroeconomic conditions evolve over time and shock situations (such as for instance the current crisis or natural disasters) are indeed difficult to predict and so is the ensuing impact on the country in question. Finally, depending on the sector under consideration, the overall level of economic development of the country and the political risk regarding investments in the country affect the project assessment and its financing.

Indebtedness: High levels of indebtedness is a feature of many developing countries and an accepted criterion for donor support for public investments (or projects that fulfil a public need, independently of its funding modalities or of the status of the project promoter, e.g. in the case of Public Private Partnership-financed projects).

Although being more in need of additional investments, highly indebted poor countries (HIPC) face restrictions in obtaining more loans due to a high debt service and due to the Debt Sustainability Framework (DSF) thresholds. Also in less poor countries with high public debts, the DSF might imply caps on the volumes of lending to these countries. Sufficient financing to meet a country's development needs without undermining debt sustainability might only be available with blending. Moreover, potential liability through state guarantees for loans should be taken into account when assessing the indebtedness of the country. However, indebtedness cannot be the sole criterion since it might not target the countries most in need.

Poverty level: The level of poverty (e.g. measured by income per capita and/or income distribution) can have a considerable impact on the design of the project and its financing structure. It can therefore be an important argument to allow a higher donor support for projects in the poorest countries. Governments in low income countries may have difficulties to finance projects, notably those with externalities or poverty reduction objectives where the project's financial return will not allow covering the costs. This does not exclude that projects in certain sectors and/or under certain conditions and/or with certain project executing agencies can be profitable regardless of the poverty level of the country. Hence, a country being poor does not necessarily imply incapability of respecting debt obligations at national level. Unnecessary donor support could be counterproductive by distorting market signals and undermining the quality of project selection, as well as by obstructing the development of the private sector. Thus, LICs might deserve more external financing, but not necessarily grants in all cases. Evidence shows that the majority of countries with a high inequality of income distribution are MICs. Poverty reduction could thus equally be an issue in some MICs and not only in LICs. LGB instruments should therefore not be excluded in these countries if a core objective of a project is poverty reduction. In general, poverty reduction is less likely to justify blending mechanisms with a significant grant element in developed and emerging market economies with sufficient access to international capital markets. However, in these countries, project-level criteria may still justify the use of LGB.

Development of financial markets: Access to project finance is often hampered by the lack of development of domestic and regional capital markets. Indicators (such as stock market capitalisation/GDP, bond market issuance) could be relevant parameters to determine their lack of depth and development. However, too high donor support bear the risk of crowding out private sector financing by domestic and external lenders, even in LICs, and might send wrong signals in terms of potential nascent competitive

environment. Therefore, to the extent that market failures, like poorly developed financial and legal systems, prevent access to domestic or international finance, support to the development of the financial sector may have positive externalities on the rest of the economy. Good examples are the support of the development of local credit systems and the provision of risk capital to SMEs.

Access to international financial markets: Most LICs are effectively cut off from the international capital markets, and the few that have access face high risk premia on market borrowing. To the extent that these premia reflect the perceived country risks including the business environment by international lenders, LGB mechanisms for external assistance to these countries can act like a bridge to fully-fledged market participation. Particular attention seems warranted in case of non-sovereign project promoters that carry an investment grade and have access to the capital market.

Support to a process of sector reform or behaviour change / Sector performance: It is to be noted that the situation of economic sectors differs between countries. This refers to the state of development, the regulatory framework and other issues. LGB could also consider to leverage and support a process of sector reform or behaviour change consistent with the objectives and priorities of EU assistance. Within each group of countries, it should be envisaged to identify strategic/priority sectors that would be derived from EU and beneficiary countries' priorities. Applicable forms of blending may differ depending on the sector considered. In this context, experience indicates that the grant share of LGB support should decrease as income levels, financial markets, regulation and institutional mechanisms converge towards sustainable levels and as market-based solutions develop in those sectors under consideration. Where these adjustments do or not sufficiently occur, LGB support should be reconsidered since it could be a sign of limited transition impact or weak commitment.

Against this complex background, the EU external assistance context has increasingly pooled countries in **groups** to which envelopes have been pre-allocated. In general, depending on the assistance envisaged, these groups are based on economic (HIPC countries, LICs, IDA eligible countries, etc) or regional political features (candidate and potential candidate countries, Western Balkans, Neighbourhood, Africa, etc.).

The relevance of the parameters differs across the various country groups and over time. In general, these parameters should be taken into consideration in the LGB justification even though they do not as such justify or prevent the use of such instruments.

5.2. Project related (micro economic) parameters

LGB mechanisms can only temporarily alleviate market failures whereas sustainable solution lies in legal and institutional reforms that systematically address market failures through regulatory or market mechanisms. The justification for and identification of the level of LGB support to be allocated to each project could be helped by a systematic comparison of the respective **merits of projects**, in particular their externalities and social and environmental impact as well as their contribution to economic development as well as poverty reduction. On the other hand, LGB should address certain **risk aspects** such as financial risks, specific project implementation risks and their mitigation measures, while avoiding crowding-out, market distortions and moral hazard effects.

Given the scarcity of resources, it is important to ensure an efficient and optimal use of funds. In this context, it seems vital, for each project under consideration, to identify the **value added of LGB** as opposed to a pure loan or a grant alone. This means that LGB

instruments should only be put in place to achieve objectives which without them would not be addressed would be addressed insufficiently or more slowly or quality aspects of a project would be inadequately addressed. This can have several dimensions: quantitative (increase in the flow of loans/guarantees to a sector over what the market would achieve), qualitative (e.g. a bank starts financing start-ups, companies with less than 3 year record or substantially reduces collateral requirements) and acceleration (when the activity is started and terminated faster than without donor support). LGB may also have a catalytic effect e.g. pilot projects may trigger similar but fully bankable projects in the future. In other words, LGB mechanisms should enable **financial leverage** (allow crowding in other financing sources to make a project happen,) or **non-financial leverage** (positive externalities, improved quality of the project).

Even though this is also true to some extent in the case of a simple loan, it is important that blending should only be used in situation where the promoter of the project displays sufficient **ownership** of the project and is not simply acting to “capture” donor support. In addition, the tailoring of a financing package of a project should demonstrate **consistency of the project objectives** as regards each LGB component. Ideally, an **incentive** structure should be incorporated in LGB mechanisms to ensure systemic change and a sustainable achievement of the objectives. In addition, transparent procurement procedures should be included and be coherent with EU standards.

Against this background, the following parameters seem to be of particular importance in this respect⁴.

- **Financial viability and profitability:** The financial profitability of the investment can be assessed by estimating the financial net present value (FNPV) and the financial rate of return (FRR) of the investment. These indicators show the capacity of the net revenues to remunerate the investment costs, regardless of the way these are financed. Experience suggests that this is less likely to be the case for projects with commercial outputs whose sales ensure a revenue stream than for projects in “social” sectors.

In order to determine the size of the donor support, in a first step, the funding gap could be established. For a project to be eligible for LGB support, the FNPV should be negative and the FRR should thus be lower than the discount rate used for the analysis. In simple terms, the funding gap corresponds to the share of the discounted cost of the initial investment not covered by the discounted net revenue of the project (i.e. the financial internal rate of return (FRR) of the project is lower than the weighted average cost of capital of otherwise available funding ($FRR < WACC$)). In a second step, the decision on the share of the funding gap to be covered by the donor support will have to be assessed taking into account various parameters, in particular the socio-economic value of the project (i.e. when the economic rate of return (ERR) of the project is greater than its financial rate of return ($ERR > FRR$)). Nevertheless, LGB should, to the extent of possible, in principle address impediments to projects that are expected to become commercially **sustainable** over time.

- **Affordability:** This criterion is linked to the relative wealth of the country or region concerned, that is to say the capacity of the users to pay. In order to enhance allocative efficiency, the charging system should reflect the marginal production cost. However,

⁴ While the public or private nature of a promoter may sometimes change the conclusion regarding the use or targeting of donor support, these criteria should be read as applying in general.

when the affordability of tariffs is considered, countries may wish to cap the level of charges with a view to avoiding a disproportionate financing burden for the users, thereby insuring that the service or good is affordable also for the most disadvantaged groups. This aspect is in particular more relevant in LICs and as regards the provision of basic goods such as water, energy but also basic social infrastructure (such as health, education, social housing).

- **Externalities:** Projects may generate positive externalities. LGB, if designed properly, may help optimising these externalities in particular in the social sector or the environment and climate change area. The areas where positive externalities are realised should be in line with key EU priorities and policy objectives. Similarly, externalities may also mean economic benefits across the border or of a regional scope which are not in the remit of the financing promoter but in the interest of the region. Donor support is justified to counter the potential under-provision of national investments. This is the case e.g. in transport and trade infrastructure, harmonisation of standards, non local pollution, biodiversity, infectious diseases, research etc.
- **Public or merit good characteristics** If a project generates outputs with public or merit good characteristics (e.g. flood control, sanitation services, climate change mitigation and adaptation), market forces would not lead to sufficient provision of goods and services. In this case, donor support is justified in so far as it corrects this insufficiency.
- **Capacity building:** The capacity of public entities in setting up appropriate policies for a sector and the capacity of promoters to implement projects is a limiting factor in achieving long-term development impacts. Blending can help through support for capacity building at different levels, i.e. not only for direct recipient, but also for other relevant stakeholders who can contribute to strengthening a sector, e.g. regulators. It should be ensured that the capacity built is actually relevant and used throughout the whole life of the projects (or ideally even for follow-up projects implemented by the same promoter). Blending can also improve financial sustainability not only by reducing the cost of capital to a project, but also through dialogue with recipient concerning sustainable cost recovery (e.g. leading to improved tariff policies or tax collection system).
- **Improving project quality:** A limiting factor to the flow of funds in sectors that are priority to pursue EU objectives is often the lack of well-designed investment programmes and projects. Blending can have a positive effect through support for the design of investment strategies and for project preparation.
- **Innovation potential:** Market participants may be too risk averse to fund local innovation provided by a given project (e.g. research, technology transfer). This may be linked to the uncertain future revenues and/or the country environment of the project. While this may be an argument for LGB instrument to cushion the perceived risk, care must be taken to avoid market distortions, as grants may support “losing horses”.
- **High financial intermediation costs:** LGB instruments can be used when the perception of risk and transaction costs on the part of financial markets may be too high (e.g. financial services to SMEs, farmers etc.), when financing institution’s knowledge of a sector is limited or when the actors in a sector have limited knowledge of ways to access funding (e.g. tolled roads, public transport, ports).

The case of Technical Assistance

Stricto sensu, **technical assistance** can not be considered as blending but is used very often in the context of LGB. TA can be provided during the project preparation as well as during project implementation.

TA can be used to

- Support improved policy-making at the sector level and to strengthen monitoring and enforcement mechanisms that ensure their implementation.
- Improve the definition of investment programmes at sector level and to define sustainable cost recovery strategies for their sustainability.
- Strengthen the planning and implementation capacity of project promoters.
- Improve project quality by financing studies or supporting the involvement of relevant stakeholders (e.g. final users, particularly poorer communities) in project design and implementation.

In the justification for TA, the way to consider and weigh parameters may differ from other forms of blending and depends on the type of technical assistance used (studies, capacity building, assistance to project implementation, etc.).

6. CONCLUSIONS

The EU is committed to contribute to the general effort of enhancing aid effectiveness and donor co-ordination amid growing global needs and challenges. Blending loans and grants has proven to be a very effective and efficient way to combine forces and to leverage scarce resources so as to achieve policy and economic objectives. Until recently EU external assistance has been mainly delivered in the form of grants. This report provides the economic and political arguments as well as the underlying conditions underpinning the case for blending loans with grants and other forms of donor support.

LGB constitutes an innovative mechanism to increase leverage effect of external assistance to enhance support to EU external priorities. In the current context of scarcity of resources (also exacerbated by the financial and economic crisis), LGB mechanisms should benefit both beneficiaries and donors in helping to achieve easier and faster access to financing, high leverage effect and more flexibility to adapt to changing conditions. Additionally, while optimising financing packages for beneficiaries, LGB is instrumental for increased donor cooperation and helps enhancing the visibility of European external assistance. While maintaining focus on sustainability criteria and the policy context, this reinforces the overarching objective of increasing aid effectiveness.

Parameters to be considered refer to two levels in the decision making process, namely the more general programme definition and the specific LGB justification for a single project. While the macroeconomic and sector level criteria mostly apply to the programme level, they still constitute the environment of any project and are therefore essential for any decision making.

Each project has to be assessed on a case-by-case basis. There is a universe of possibilities and projects, hence not all of the criteria mentioned in this report will and should apply in the same way and to the same extent in each case. However, the report aimed to provide guidance for a proper ex-ante assessment of donor support request. This being said, to be eligible for LGB financing, a project must have passed the usual project appraisal hurdles.

Notwithstanding the multi-dimensional aspect of the decision making for LGB support justification, it is necessary to be able to weigh the various parameters against each others. A careful balancing act is often needed to capture the potential benefits of blending and to maximise the leverage as well as to simultaneously meet the requirements of donors and the needs of recipients. Against this background, the expert working group produced a guidance template for projects to be considered in the framework of LGB mechanisms (annex II).

FORMS OF BLENDING

Different forms of blending can be considered at project level. The main forms are briefly discussed in the following:

- **Direct investment grants:** This instrument provides direct finance for specific components of a project. They are the straightforward approach for assistance targeted at meeting redistributive objectives (pro-poor pro-growth development) or in cases where a significant cross-border externality of the investment under consideration justifies grant coverage of part of the costs. For projects which can derive positive financial returns and do not target these objectives, standard grants are not appropriate in order not to undermine efforts of e.g. collecting fees.
- **Conditionality / performance based grants** (such as Output Based Aid – OBA) are grants whose disbursement is linked to compliance with ex-ante defined conditions or service level performance targets. Their use becomes more pertinent the higher the donor support and are particularly justified in countries with weak governance where even marginal impacts could bring rewards in the overall business environment and where the use of such instruments can be a mechanism to align interest of the beneficiaries with the overall policy objectives pursued. Certain investment grants to projects can be put within this category which highlights the importance of an underlying policy linked to clear medium-to-long term objectives for the programme, and the adequate involvement of the beneficiary parties.
- **Interest rate subsidies:** The donor support serves to cover part of the interest payments. The partner country or project promoter thus receives a subsidised loan at below market interest rates rather than a separate loan and grant. Interest rate subsidies – like investment grants - are used to enhance the concessionality of a financing package, e.g. to comply with debt sustainability requirements. If transaction costs for obtaining a credit are relatively high, donor support could be used to reduce part of these transaction costs without entering the lending market itself (increase transparency, evaluate collateral, or assist in paperwork). On the other hand, they may present a distortion effect, if access to financial markets or to un-concessional lending from other EFIs is warranted for the project promoter, as they directly reduce private and public sector loans' competitiveness. Furthermore, interest rate subsidies may lead to uncertainty on whether the donor support completely reaches the borrower over the life of the loan (e.g. in case of anticipated or accelerated repayment).
- **Loan guarantees** offer the lender recourse in case of default. In underdeveloped markets, capital preservation is a crucial factor for investors. Sharing the risk (losses) via loan guarantees, might entice lenders to open their financing for a specific country/sector/niche of companies. Losses, hence payments, materialise only ex-post, when real defaults occur – which probably means overall a higher gearing ratio in most cases. This assumes particular relevance in case of portfolio loan guarantees where added diversification further reduces the cost of risk coverage, thus optimising the budgetary impact. With a guarantee (provided free of charge or at a relatively low

price to the lender), the interest rate charged to the borrower will be lower than without; from this perspective the effect of a loan guarantee can be similar to an interest rate subsidy. It may also help to lower collateral requirements. Loan guarantees can be combined with grant support to address particular market failures.

- **Structured finance - first-loss piece:** Donor interventions can play a significant role in structured finance projects. They are essentially needed for investing into the highest risk tranche of the structure (first-loss piece), thereby leveraging additional funding from international and bilateral development banks as well as the private sector. As for risk or mezzanine capital, the implied donor support element needs to be determined with care so as to optimise the participation of other financing partners and to allow for the crowding-in of private sector financing. In this context, it can be advisable to maintain some risk sharing with the project promoter even for the first lost tranche to ensure the required alignment of interest. The assumption should be that a finance institution investing its own money in the first-loss piece should aim at generating a return, while the donor support element should enable such institution to take an additional risk.

While not being forms of blending in the narrow sense, two other types of support are used widely in the context of loan-grant blending mechanisms:

- **Technical assistance** can be provided during the project preparation as well as during project implementation. It is a convenient way of providing clearly targeted donor aid to add value. The assistance can also include the financing of experts to improve efficiency of a project and/or to facilitate a know-how transfer in certain areas. TA for project preparation is less likely than other forms of LGB to cause additionality problems or market distortions depending on the ratio between TA and loan. However, efforts should be made to ensure that the knowledge acquired through this process is maintained and spread also after the completion of the project. In several cases, the possibility to finance such a project component with donor fund is considered to be a desirable incentive for the promoter to accept implementation guidance.
- **Risk capital:** This use entails equity or quasi-equity investments which usually carry high risks. Compared to typical grants, risk capital investments must always be made under the assumption that such investment may generate a return. Risk capital offered (in particular) to SMEs and infrastructure projects is justified, as due to limited spreading of risks, internationally unconnected local markets would require higher risk premia than more developed markets. Risk capital can be offered either *pari passu* with other investors, where risks and remunerations are equally shared among investors, or on a *non pari passu* basis. The first approach is best suited in situations where there are other market operators willing to bear the underlying risk, but only on a limited scale. The second approach is most suitable in situations where market operators are reluctant to bear a particular type of risk and the donor support element should be used to carve out part of the risk. In this context, attention should be paid to prevent that too favourable conditions crowd out private sector financing, hamper financial market integration and more generally bias investment incentives. Thus, the implied support needs to be chosen with care.

There are also some features of loans which have positive effects for the recipient:

- **Grace periods** delay the inception of the debt servicing. They are suitable for projects with a long investment phase and/or which have low or no returns in the early years but positive returns in the medium to long term. The grace period should generally not exceed the possible beginning of receipts.
- **Long maturity** of a loan is suitable for investments with continuous long-run returns. With the extension of the maturity, the annual returns of such an investment come closer to the necessary annual repayment needs. Most infrastructure investments would fit to this form of benefit.
- Loans increase ownership of the beneficiary and exert discipline on the recipient in particular when providing transparent payback conditions and clear prior commitments. Nevertheless, **flexible modes** of repayments stipulated in the loan agreement might in certain circumstances be appropriate for responding to temporary shocks affecting a certain investment or a whole country. However, if the returns of the investment are private this loan feature would reduce risk management costs and could imply competition problems.

The above listed forms of LGB can be provided in different contexts depending on the project promoter, public or private or both joining together to meet individual and common objectives. While largely political and macroeconomic considerations apply more in the case of public promoters, it is more microeconomic and financial considerations for private promoters. In case of mixed financing, the private partner, bearing part of the costs, might have no direct financial advantages but may enjoy indirect returns; e.g. in terms of image and externalities. The public partner, when successfully attracting additional private financing, may benefit in terms of efficiently achieving development objectives and enhancing sustainability through increased ownership and follow-up.

Furthermore, blending can take place in different set-ups:

- **Parallel co-financing** of a project or programme, or part of one, is a financing procedure in which several funding partners find ways of contributing to different activities within the same project, but under different modalities. The donors' contributions (grant and loan components or other form of support) are kept separate, often to have closer control on the process and to ensure better, separate visibility for the donor.
- **Joint co-financing**, where the donors' contributions are pooled together to jointly support a project or a programme. This is particularly appealing to the borrowers which are likely to be faced with less diverse procedures and conditions, as well as for the donors which can mutually rely on each other for some aspects of the project appraisal and development.

Guidance template for projects in the context of LGB mechanisms

A. GENERAL PROJECT INFORMATION

I. Project description	<p><i>This part should provide general information on the project and its rationale, including:</i></p> <ul style="list-style-type: none"> – <i>the name of the project,</i> – <i>details on the project promoter/beneficiary (name, status, activity, etc.),</i> – <i>the geographical and sector coverage,</i> – <i>the description of the project (the total amount of the project, its objectives and their relation to EU objectives, the expected outcome, etc.),</i> – <i>the link to related projects.</i> <p><i>In this section, other related project features should be presented such as assessing the possible cross-border impact as well as the expected development impact and demonstrating beneficiary's ownership of the project (e.g. in line with domestic strategy, etc.).</i></p>
II. Macroeconomic and sector parameters	<p><i>These parameters (presented in chapter 5) are intended to set out the environment in which the project will be implemented. These should be outlined here only to the extent they are relevant for the LGB support justification. This part should also include an ex-ante assessment of market conditions, subsidiarity aspects and potential crowding out of other sources of financing.</i></p>

B. PROJECT RELATED PARAMETERS

III. General LGB request information	<p><i>This part outlines the type of LGB support requested, the amount of donor support requested (both in absolute and relative⁵ terms).</i></p>
IV. Financing plan	<p><i>This section should include financial details on:</i></p> <ul style="list-style-type: none"> – <i>the main financial indicators (FNPV, IRR, etc.),</i> – <i>the total contribution of each lender and donor (both in absolute and relative¹ terms), including their timing,</i> – <i>and the other sources of financing.</i>
V. Grant request justification	<p><i>This part focuses on non-financial information on:</i></p>

⁵ As a percentage of the project total financial costs.

	<ul style="list-style-type: none"> – <i>conformity with instrument/policy general strategy/objectives/orientations,</i> – <i>how will the grant help remove barriers and accelerate project completion?</i> – <i>what are the expected externalities in macroeconomic or sectoral and other terms (domestic/sectoral/trans-border, etc.)?</i> – <i>will the grant support help capacity building?</i>
VI. Value added of the grant	<p><i>This section should include:</i></p> <ul style="list-style-type: none"> – <i>An indication of quantitative aspects of the value added of the grant?</i> – <i>How the grant support will help improving the project quality?</i>
VII. Risk assessment	<p><i>This part is intended to identify the project related risks that might be encountered. It shall also outline how potential risk such as crowding-out, market distortions, moral hazard effect and specific project implementation risks have been taken into account and how these risks will be mitigated.</i></p>

C. PROJECT IMPACT AND IMPLEMENTATION

VIII. Project implementation, monitoring and evaluation	<p><i>This section should provide information on the schedule of key milestones in the project implementation, such as:</i></p> <ul style="list-style-type: none"> – <i>the indicative dates of the project feasibility/appraisal process,</i> – <i>the dates of the various lenders' management approval,</i> – <i>the date of the signature of the contract,</i> – <i>the expected timing of the start,</i> – <i>the end of project implementation.</i> <p><i>If possible a precise project implementation schedule should also be included.</i></p> <p><i>Key information on project monitoring and assessment as well as evaluation cycles should also be provided.</i></p>
IX. Project sustainability	<p><i>Under which conditions will the project be sustainable when the grant support expires?</i></p> <p><i>Should there be any incentives to enhance the sustainability of the project?</i></p>