



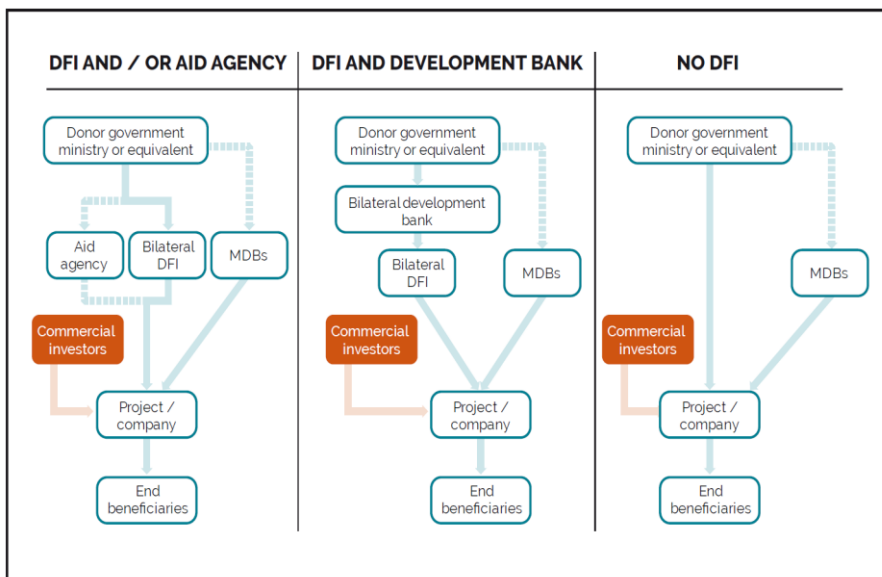




The model of blended financing adopted for a specific project is influenced by both the governance of development cooperation in the donor countries involved as well as market conditions in recipient countries.

In some countries, like Sweden, the Netherlands and the United Kingdom, DFIs are operationally independent of bilateral development banks and aid agencies.<sup>16</sup> In other countries, notably France and Germany, DFIs are embedded within national development banks, which act as an intermediary between the DFI and the government. Where DFIs are involved, they are typically provided with concessional finance by their government; these resources are either directly transferred or channelled through development banks. DFIs then blend this finance with their own resources and seek to use financial instruments to leverage further finance on a non-concessional (commercial) basis from the private sector to fund their operations.

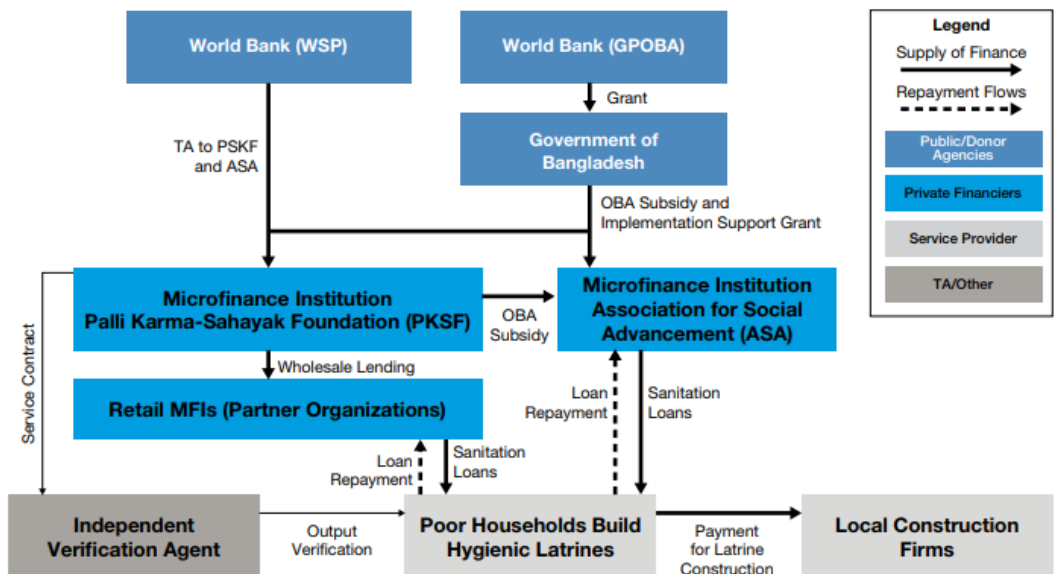
More infrequently, donor governments that have not established a dedicated DFI directly blend their own resources with private actors. In all instances, multilateral development banks may be involved in blended finance operations involving commercial finance.



Source: Organisation for Economic Co-operation and Development. 2018. *Making Blended Finance Work for the Sustainable Development Goals*, p66.

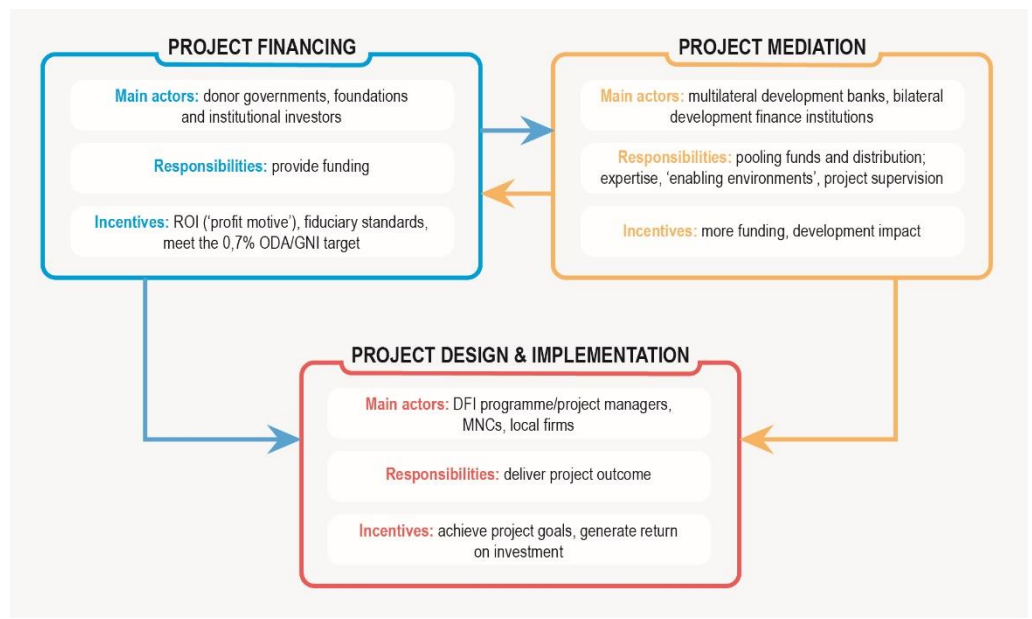
Once funds have been blended, the intermediaries – whether development banks or DFIs – provide equity, loans, guarantees or insurance to private sector projects and companies based in low- and middle-income countries, typically on non-concessional terms. At the project level, blended finance approaches and frameworks are tailored to specific contexts and markets. As such, a broad array of private sector stakeholders can be involved in different projects, including international banks and corporations, local businesses and even private investment from individual households.<sup>17</sup>

The structure for mobilising and delivering funds for a specific project can become very complex, as seen below in the schematic figure of a blended finance project in the sanitation sector in Bangladesh.



Source: World Bank Group. 2016. *Facilitating Access to Finance for Household Investment in Sanitation in Bangladesh*.

To make sense of these complex interactions, this paper breaks down blended finance initiatives into a schematic project cycle with three phases: project financing, project mediation, and project design and implementation. Project financing brings together donor governments, foundations and institutional investors to mobilise different sources of funding. These funds are then pooled in the project mediation stage by multilateral development banks or DFIs, who supplement existing financing, provide industry- or geography-relevant expertise and coordinate with recipient governments on issues relating to the enabling environment. DFIs also distribute funds and supervise projects during the implementation phase. Multinational corporations or local firms typically serve as implementation partners, receiving the pooled funds from DFIs and often designing specific projects in collaboration with DFIs. Depending on the nature of the project, the private sector may also be involved as direct beneficiaries of financing, such as where DFIs choose to invest in existing businesses based in low- and middle-income countries to support local employment.<sup>18</sup>



The rest of the working paper considers these three stages in more detail, giving particular consideration to integrity risks that might arise in each phase, before turning to possible mitigating measures. The focus throughout the paper is on multilateral development banks and bilateral DFIs. By deploying financial instruments to mobilise the private sector, these organisations serve as key intermediaries in blended finance by bringing together financiers (governments, foundations and private investors), structuring the transaction and shaping the project pipeline.<sup>19</sup> In doing so, they exert influence over every stage in the blended finance project cycle and are critical for risk mitigation. Oppenheim and Stodulka argue that relatively straightforward reforms by DFIs to improve transparency, refine evaluations and adjust incentive structures could not only reduce integrity risks but also have “an immediate and outsized impact on private capital mobilisation”.<sup>20</sup>

## The effectiveness debate

Evidence on the development impact of blending is scarce. Advocates of blending point out that it mobilises capital that potentially would not otherwise have been available. Nonetheless, critics point to issues of additionality, concerns around evaluation and lack of alignment with national development strategies.<sup>21</sup> Ultimately, the metrics to assess the benefits and impact of blended finance remain underdeveloped.<sup>22</sup>

### **Additionality**

Additionality refers to the amount of private finance “mobilised” by blending that might not have otherwise contributed to the SDGs. For example, funds from a Canadian pension fund that invests in renewable energy in emerging markets alongside the International Finance Corporation (IFC), whereby the IFC takes a subordinate debt position, might be counted as “mobilised”. However, this presumes that the fund would not have made the same investment had the IFC not taken the subordinate position. From an investor’s perspective, the decision to participate in a blended finance initiative might simply reflect the desire to further reduce the investment risk of an already commercially viable venture.<sup>23</sup> In addition, some DFIs consider crowding in other DFIs or donor governments (for instance, the IFC co-financing with French Proparco and Sweden’s Sida) as generating “additionality”, even though DFIs are mandated to make these investments and do not represent additional capital.

### **Alignment and evaluation**

On the project evaluation side, there is concern that blended finance initiatives prioritise return on investment over the development outcomes of the projects they fund, such as poverty alleviation.<sup>24</sup> Private sector entities have specific risk profiles in which they are willing to invest, and often that means investing in bankable projects in emerging, middle-income countries rather than in countries that would benefit most from the investment. As a result, projects might not align with pro-poor activities, instead focusing on middle-income countries and concerns of private investors.<sup>25</sup> Where blended finance disproportionately targets countries that generate borderline commercial investments anyway, then it is not “crowding in” the private sector to the places that could benefit most from their involvement.

## FINANCING

**Types of financial instruments used in blended finance include guarantees, grants, loans and other technical assistance.** Such instruments are designed to incentivise investors to make investments in low- and middle-income countries they might otherwise deem “too risky” for their specific asset class or portfolio preferences.

### Investment risks and integrity risks

Investment and integrity risks are two separate but related terms whose distinctions are important to understand how decisions to finance, mediate and implement blended finance projects are made. The IFC defines integrity risks as “the risk of engaging with external institutions or persons whose background or activities may have adverse reputational and, often, financial impact”.<sup>27</sup> This can include, but is not limited to, “corruption, fraud, money laundering, tax evasion, lack of transparency and undue political influence”.<sup>28</sup> Investment risk, on the other hand, refers to risks that could potentially threaten the likelihood of investors generating their targeted return.

These two ideas are not mutually exclusive. The risk to achieving a return on investment could be due to the absence of a robust mechanism to identify, prevent or curtail corruption, nepotism or bribery. If a project financed through blending, which is intended to crowd-in the private sector through the promise of returns, is subject to a lacklustre due diligence process, then the risk embedded in the investment has not been appropriately priced. If investors do not have confidence in the way partners in blended transactions manage integrity risks, then they will require more protection, perhaps through a guarantee of first loss, and the overall cost of the project will be higher and the principle of additionality will be jeopardised.

Further, the focus on external entities as the locus for integrity risks in the IFC’s definition (above) implies that integrity risks are not likely to be found within the multilateral development bank itself. While many multilateral development banks and DFIs have integrity systems in place, effective management of integrity risks requires recognising that everyone – including the multilateral development banks and DFIs – is vulnerable.

### **Different blended finance tools can effectively lower perceived investment risk to induce private investors to jointly finance a development project.**

Grants can be employed to reduce the interest rates on a loan provided by a commercial lender, reducing the cost of debt. Guarantees, also called risk underwriting, can “fully or partially protect the investor against various forms of [investment] risk, effectively reducing their risk to capital losses”.<sup>29</sup> An example would be a first-loss guarantee where the partner financier, traditionally a donor government or multilateral development bank, would agree to take losses sustained by the project up to a specific threshold, providing a risk cushion for private investors. Depending on the amount of the overall transaction volume covered by a guarantee, some investment tranches can be effectively “riskless”.

Alternatively, technical assistance in the form of advisory or preparatory services, training or other activities can supplement firms’ existing capabilities or lower transaction costs by improving the investment climate in which they operate. In blended finance transactions for infrastructure specifically, more than two-thirds of funding goes towards improving the enabling environment, with 38 per cent specifically for policy development and capacity building.<sup>30</sup> Thus, DFIs supporting blended finance projects often find themselves partially funding capacity building for recipient governments.

### **When choosing to invest in a project, institutional investors and governments alike may consider various criteria in their decision-making process, including environmental, social and governance (ESG) indicators.**

Investors can align their investment principles with a host of international frameworks, including the International Integrated Reporting Council, the Global Reporting Initiative, Sustainability Accounting Standards Board and the **UN Principles for Responsible Investment**.

## UN PRINCIPLES FOR RESPONSIBLE INVESTMENT

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the principles.
6. We will each report our activities and progress towards implementing the principles.

## Undue influence and tied aid

**Public and private investors have different incentive structures when it comes to financing development projects.** While non-commercial factors, such as corporate social responsibility, may play a role in private investors' decision to participate in blended finance projects, they are also typically looking for a return on their investment. DFIs and multilateral development banks may be similarly profit-oriented, but unlike purely commercial entities they have a distinct mandate related to development outcomes, whether this is improved literacy, lower infant mortality rates or better infrastructure in low- and middle-income countries.

Of course, bilateral DFIs draw much of their funding from their national governments, which often seek to further their own country's interests when providing development financing. For example, the Italian DFI SIMEST has a stated goal of "promoting the future of Italy", which in practice means that SIMEST generally makes investments in majority-owned Italian companies abroad.<sup>31</sup>

**As a result, there is need to ensure that DFIs are not subject to undue influence to pursue projects that prioritise the interests of private investors over intended outcomes or the interests of affected communities.** This risk is heightened where DFIs explicitly prioritise domestic companies, which threatens to turn blending into a new form of tied aid. Even where DFIs have a mandate to favour domestic firms, there need to be clear safeguards in place to ensure that blended finance programmes are not tailored to suit certain favoured firms as a result of collusion, behind-the-scenes lobbying or undue influence. Procedural transparency is therefore essential to ensure that external actors and affected communities understand why, when and how blended projects go ahead.

## MEDIATION

**Project mediation refers to the process of convening institutional investors and donor governments for the purposes of operational planning, providing technical expertise on project design and conducting ex-ante project assessments.** These tasks are typically undertaken by DFIs, but external accountants or consultants can also be involved.

## Collusion and bribery in procurement

**When it comes to selecting implementing partners for projects financed through blending, there are a number integrity risks to be considered.** In a non-blended context, governments will issue requests for proposals for a clearly defined project as part of a competitive bidding process. Some DFIs will simply advise on principles to follow for transparent tendering and leave the recipient government responsible for the overall process of procuring goods or services. In other cases, DFIs are more actively involved in designing and orchestrating the tendering process. Often in low- and middle-income countries, DFIs will facilitate the tender process from start to finish by providing technical assistance to lower the perceived investment risks and incentivise potential bidders. Transparency and monitoring of tendering processes are important to mitigate risks when they diverge from this model.

**The first potential divergence comes when companies approach DFIs with unsolicited project proposals.** In such scenarios, the challenge is to channel unsolicited proposals into transparent and competitive processes, offering other companies a chance of winning the tender while preserving the potential for innovation. Enacting a competitive tender in which the original project proponent has a fair advantage (e.g. the Swiss Challenge system, where the original proponent can countermatch lower-priced proposals) is one way to maintain transparency and ensure development outcomes.<sup>32</sup>

**If handled opaquely, unsolicited proposals can lead to over/underbidding for contracts, collusion to drive up prices or bribery to win a contract.** Given that companies approaching DFIs with unsolicited proposals are



potentially attempting to obtain preferential financial terms to enter a market using public funds as a form of subsidy, DFIs should insist on adherence to clear and transparent tender processes. As well as reducing the risk of corruption, ensuring a transparent tendering process can also minimise the distortionary impact of concessional finance on the broader market in a developing country.<sup>33</sup>

**Second, selection bias can emerge through repeated collaboration with the same implementing partners.** For example, some DFIs may perform less robust due diligence when working with known entities. Depending on the political culture in an operating country, tenders may have predetermined winners due to corruption and cronyism. While it may be beneficial for smaller DFIs to work with the same companies, since they may already know the client and their anti-corruption measures, lower scrutiny of proposals from known entities can increase integrity risks in the tender process.

The **Open Contracting Data Standard** is one tool that is being increasingly deployed to mitigate these, and other, concerns with procurement.

## Use of offshore financial centres

**The way financiers, multilateral development banks and DFIs or other donors channel funds to each other or to implementing partners can present another integrity risk, especially in the context of offshore financial centres (OFCs).** Of real concern is the use of OFCs by several bilateral DFIs themselves, especially in light of the fact that many DFIs have weak policies on the use of tax havens.<sup>34</sup> Some DFIs even continue to advocate for the use of OFCs as necessary to enable DFIs to play a “catalysing role in attracting institutional capital” due to the lax legal framework in these jurisdictions and the ability to pool capital in a “tax neutral” manner there.<sup>35</sup> OPIC, the US DFI, often requires borrowers to establish “an offshore vehicle to facilitate the loan financing”.<sup>36</sup>

**In light of the role tax havens play in facilitating tax avoidance and evasion and acting as conduits for the proceeds of corruption from low- and middle-income countries, DFIs’ use of OFCs is in opposition to their development mandate.** Moreover, the use of such jurisdictions constitutes an integrity risk in its own right, as it typically renders the investment more opaque, leaving little room for external scrutiny.

Interviews with bilateral DFI staff revealed that much of the work to develop assessment frameworks on OFCs is in progress, including investigations into allegations of tax fraud, the use of transfer pricing for tax avoidance and the use of shell companies to channel funds. In terms of enforcement, DFIs remain subject to national law enforcement agencies and must refer criminal enforcement cases there for prosecution.

## Money laundering, beneficial owners and political exposure

**A key step to reduce the likelihood of corruption during the project implementation phase is rigorous ex-ante due diligence of all investors, implementing partners and beneficiaries.** Over the coming years, blended finance is intended to stimulate greater participation of new investors, such as commercial banks, sovereign wealth funds and pension funds, in development assistance. In addition, the beneficiaries of this kind of development finance are increasingly likely to be private businesses.<sup>37</sup> In light of this, there is a need for comprehensive due diligence processes to vet potential private sector partners.

DFIs should seek to acquire a range of information on potential business partners, including politically exposed persons, criminal activities, civil proceedings and political influence. Moreover, a thorough review of ownership structures should identify the ultimate beneficial owners above a low threshold, as opaque corporate structures can be used to hide ownership and wealth, evade taxes, facilitate criminal activity and launder money.<sup>38</sup> Interviews with MDB and DFI staff indicated that some only verify the ultimate beneficial owner above a threshold of 20 per cent or even 25 per cent of ownership or control. For entities that present a specific risk of money laundering and tax evasion, good

## OPEN CONTRACTING DATA STANDARD (OCDS)

Devised by the Open Contracting Partnership, the OCDS seeks to provide a “common data model” in which all summary information on publicly-awarded contracts could be freely available for analysis by all relevant stakeholders. OCDS brings together (ideally) real-time information and provides a snapshot view of a project’s current state. Several countries and cities are already using OCDS to publish procurement information, including Canada, Colombia, Mexico, Moldova, Paraguay, the United Kingdom, Ukraine, and the cities of Mexico City and Montreal. For more information, go to [www.open-contracting.org](http://www.open-contracting.org).

practice suggests that either all owners should be verified or at least that the threshold should be much lower, around 10 per cent.

**Additional due diligence is warranted when investments involve offshore financial centres (“intermediate jurisdictions”)** to ensure that these arrangements are not designed to facilitate illicit financial flows. Where financial institutions are involved, there should be an assessment to determine if the institution’s existing anti-money laundering mechanisms are legally compliant and contextually appropriate.<sup>39</sup>

Compliance teams interviewed for this paper stressed that, for the purposes of due diligence, they do not treat projects financed with blending differently to other forms of development assistance. Generally, multilateral development banks rely on existing integrity and risk management mechanisms alongside best practice, including adherence to the **Uniform Framework for Preventing and Combating Fraud and Corruption**. Compliance staff at bilateral DFIs indicated they generally refer to best practice guidelines developed by the World Bank and Transparency International.

The Swedish DFI, Swedfund, for example, uses a quantitative process of risk mapping to determine integrity risks and then, in discussion with the implementing partner, establishes anti-corruption requirements for all clients on a project-by-project basis. Swedfund’s approach tends to be numbers-based and external, identifying the potential client as the locus of risk, which overlooks potential weaknesses in internal systems. Many integrity risks are not numerically quantifiable and, importantly, can actually arise from the DFIs’ behaviour through project selection and lax adherence to established ex-ante due diligence just as much as from clients.

## DESIGN AND IMPLEMENTATION

The final stage of the blended finance project cycle is project design and implementation.

### Fraud and embezzlement

**DFIs employ a range of measures to reduce corruption risks even before a project is cleared for funding. Such measures include contractually mandated integrity clauses and the development of corruption action plans.**

Integrity clauses are specific contract provisions that are required of the recipient government or private sector entity in order to continue receiving funds from the multilateral development banks, which are often disbursed in tranches. Integrity clauses can be applied down the chain to subcontractors of direct recipients as well, although tracing the line of subcontractors and assessing whether they are engaged in corrupt practices can be difficult. Nonetheless, with built-in audit checkpoints, these clauses can be an effective means of holding implementing partners legally responsible when fraud or embezzlement occurs. DFIs and multilateral development banks therefore need to regularly monitor investments to identify any audit issues and ensure business partners are meeting the agreed standards.

Corruption action plans lay out the substantive steps for the recipient to take, often with the support of technical assistance provided by the multilateral development bank or DFI co-financing the project. This can include hiring a chief integrity officer or putting into place a grievance mechanism that might mirror the multilateral development bank’s own.

**For all integrity risk management, DFIs need to be careful to not enter into a race to the bottom for compliance.** If companies and recipient governments are complying only superficially, then they might not be doing enough to actively change the day-to-day activities that allow integrity risks to arise in the first place.

Where multiple DFIs are co-financing a project, tension can arise regarding whose integrity framework to use. While several DFIs interviewed maintained

## UNIFORM FRAMEWORK FOR PREVENTING AND COMBATING FRAUD AND CORRUPTION

In 2006, the leaders of the African Development Bank Group, ADB, EBRD, EIB, Inter-American Development Bank Group, IMF, and World Bank Group agreed on a framework for preventing and countering fraud and corruption within their institutions. By agreeing to the framework, these institutions recognised that corruption undermines sustainable economic growth as well as posing a major obstacle to the reduction of poverty.

The joint agreed actions include: standardised definitions regarding corruption for investigation practices, strengthening information exchange with regards to appropriate confidentiality when connected with investigation and the general integrity due diligence principles when lending or investing with the private sector. As a whole, the framework assures the commitment of the multilateral development finance institutions to fight corruption and all fraudulent activities among themselves and the societies they affect.

that they do not compromise on their compliance procedures when co-financing, the reality is likely mixed as other interviewees acknowledged that often only one financial institution will do background assessments or monitoring of a given project. Several DFIs acknowledged the role of formal and informal collaboration among DFIs, and many expressed a desire for closer collaboration. While the major multilateral development banks have regular check-ins at annual meetings, smaller bilateral DFIs have fewer opportunities to engage with and learn from multilateral development banks and DFIs with more robust integrity management systems.

## A WORD ON INCENTIVES

**Both bilateral DFIs and multilateral development banks are financial institutions, and bilateral DFIs in particular operate in a broadly similar manner to private equity firms. This has implications for the way in which they incentivise their employees.** In addition, DFIs are meant to make investments in environments where traditional investors balk at the risk. Despite this, DFI investment officers are often evaluated using the same performance metrics as traditional investors (such as deal flow and ROI). Where the performance of investment officers is measured in terms of funds disbursed rather than development impact, they might be less likely to conduct thorough ex-ante evaluations of project proposals, opening them up to greater integrity risk because of lacklustre due diligence checks. In addition, interviewees from compliance teams cited difficulties in securing adequate human resources to thoroughly vet potential business partners.

**Incentive structures can also come into conflict where DFIs provide technical assistance in the same markets and communities in which they are executing deals.** If DFIs are responsible for both mobilising funding and working with the government on capacity building, conflicts of interest can arise. In these cases, DFIs are accountable both to recipient governments and to their own management teams. When conflicts between those accountability structures arise, the party providing financing (the management team) could potentially prevail at the expense of local interests and development impact.

## BETTER BLENDING: MEASURES TO IMPROVE TRANSPARENCY AND ACCOUNTABILITY

There are several measures which DFIs could take to improve transparency and accountability in development projects financed through blending. Tackling the integrity risks identified would help to appropriately deploy additional commercial finance, promote sustainable development and minimise the risk of losses due to corruption.

These measures fall in four broad categories: 1) disclosures; 2) standards and information sharing; 3) grievance mechanisms; 4) incentives and upward versus downward accountability.

### Disclosures

**The participation and feedback of local communities and governments on the receiving end of blended finance projects is crucial to ensure that commercial objectives do not take precedence over development outcomes.** At the country level, DFIs are not generally required to consult with recipient governments to ensure alignment between blended finance projects and national development strategies.<sup>40</sup> This contradicts the principle of national ownership of development assistance endorsed in the Paris Declaration on Aid Effectiveness, the Accra Agenda for Action and the Busan Partnership for Effective Development Co-operation. The result is that blended projects tend to favour donors' economic interests and western firms.<sup>41</sup>

**Discrepancies can also arise when DFI transparency and accountability standards are lower than those required by recipient governments' legal**

**frameworks.** A CSO representative interviewed for this paper emphasised this in the case of Mexico, where all large-scale infrastructure projects above a certain financial threshold are required to be implemented with the involvement of CSOs and in line with the Open Contracting Data Standard. When these kinds of projects are financed by DFIs, such transparency requirements do not apply, and more decisions are made behind closed doors.

**At the project level, better consultations with affected communities could help increase oversight and reduce integrity risks such as fraud, bribery and embezzlement.** Accountability to local stakeholders could be increased in a number of ways, from thorough ex-ante environmental and social impact assessments to the systematic involvement of local civil society groups in project monitoring. Greater transparency about ownership, objectives and results of blended finance projects can provide a baseline to assess development impact.

**Currently, downward social accountability is hindered by the lack of project information disclosed by DFIs. As a result, in practice, blended finance projects are considerably less transparent than projects funded using other forms of ODA.**<sup>42</sup> This reduces the accountability of DFIs, their investors and implementing partners to taxpayers, rival bidders, recipient governments and intended beneficiaries. DFIs can be more transparent in a number of crucial areas.

**First, procurement processes should be conducted in a fair and transparent manner,** with clear grievance procedures in place for bidders to file complaints if they suspect irregularities. To the extent possible, DFIs should adhere to the Open Contracting Global Principles in the OCDS. This is all the more important to avoid riding roughshod over recipient governments' efforts to improve integrity in their own public procurement processes

**Second, DFIs should be much more forthright in reporting project-level information.** The OECD acknowledges the need for greater availability of information about the transactions and development impact of blended finance projects.<sup>43</sup> The ITUC argues that, at a minimum, DFIs should make the following publicly available: ex-ante project evaluations, environmental and societal impact assessments, and ex-post evaluations.<sup>44</sup> In addition, disclosure could include a detailed project description, stakeholder engagement efforts, monitoring reviews and address of a country office where project documentation can be consulted. DFIs should also adopt country-by-country reporting standards for their investments, listing taxes paid, employees, assets, investees' names, type and amount of investment, name of other investors, and number and nature of complaints received.<sup>45</sup> Proactive disclosure of this information will facilitate oversight on the part of civil society and reduce the risk of corruption.

**Third, DFIs should disclose their clients' beneficial ownership information, as well as their own use of OFCs.** Given the detrimental impact of OFCs on low- and middle-income countries, the use of OFCs should be curtailed as much as possible and exemptions clearly and publicly justified. In general, rather than encouraging the investment community to use OFCs, DFIs should use their position to orchestrate a change in practice.

**Fourth, DFIs should provide more information on their management of identified incidences of corruption, action taken and investigative findings.** DFIs often point to the commercial confidentiality of investors and implementing partners as a reason they cannot make more information publicly available.<sup>46</sup> Nonetheless, given that DFIs deploy taxpayers' money to reduce the risk for private investors and firms to enter a market, these companies should be expected to adhere to the same transparency standards as other ODA recipients.

Indeed, information on the activities of these private entities needs to be made available to ensure that ODA being used in blending is complying with agreed standards of untied aid and that it is not generating any distortions in local markets.<sup>47</sup> Commercial confidentiality alone should not be a pretext for opacity, and firms' needs should be balanced against transparent and competitive processes to safeguard public resources. The OECD emphasises that "transparency regarding blended finance opportunities is decisive in establishing

fair competition” and that a lack of transparency can undermine the impact of blending on development outcomes and market growth.<sup>48</sup>

Not only will greater disclosure satisfy the public interest, but the academic literature indicates that companies that disclose more information about their integrity management systems enjoy increased investor confidence.<sup>49</sup> In fact, investors increasingly refer to information on firms’ integrity management as an indicator of both risk profile and “potential for long-term value creation”.<sup>50</sup>

## Standards and information sharing

**DFI due diligence standards should be brought in line with international best practices.**<sup>51</sup> Integrity due diligence should identify integrity risks related to a project and the entities involved, evaluate and assess these risks and monitor them over the lifecycle of blended finance projects. For all business partners and clients, multilateral development banks and DFIs should conduct a general risk review of politically exposed persons, criminal activities, civil proceedings and political influence. Next, they should review partners’ ownership structures to identify ultimate beneficial owners. Finally, when financial institutions or private equity funds are involved, it is necessary to conduct specialised reviews of these entities’ anti-money laundering frameworks. Thorough due diligence is an intensive process, and few DFIs enjoy the network and resources of the larger MDBs. This points to the need for institutionalised information sharing to ease the burden on individual DFIs.

Unfortunately, the lack of information exchange between multilateral development banks and DFIs has led to a capacity and capabilities gap between the institutions. On one hand, multilateral development banks do engage in information sharing activities, including exchanging lists of companies found to have acted corruptly, which are then mutually debarred from all multilateral development bank-financed operations. On the other hand, interviewees observed that DFIs tend to have less contact with their counterparts, resulting in less capacity to respond effectively to emergent integrity risks.

When different institutions use different standards, or perhaps lower standards than an in-country government receiving aid, companies may take advantage of this discrepancy to disclose less information or to engage in otherwise questionable practices. **DFIs should seek to systematically share information on existing mechanisms to mitigate corruption risks, as well as standards on issues such as due diligence, beneficial ownership, use of OFCs, disclosure regimes and so on.**

## Grievance mechanisms

**The establishment of independent grievance mechanisms is crucial to investigate and address reported wrongdoing** in all development projects, including those financed through blending. Such mechanisms should have the mandate to review DFI activities, but be operationally independent to avoid potential conflicts of interest. Furthermore, grievance mechanisms should be open to a range of stakeholders, including DFI employees, members of CSOs, affected communities and companies/suppliers participating in procurement processes.

**Particularly for intended beneficiaries, grievance mechanisms are a crucial pathway to express concerns;** this right to be heard is acknowledged in the Paris, Accra and Busan declarations. Independent grievance mechanisms are also valuable for DFIs, as they provide a channel through which to alert responsible bodies to wrongdoing that can threaten the integrity or success of a project. Despite this, a recent study of nine European DFIs found that only three had established independent complaint mechanisms.<sup>52</sup>

The absence of an independent complaints mechanism renders DFIs less accountable to affected communities and stymies their ability to respond effectively to allegations of corruption. **DFIs should therefore establish grievance mechanisms open to all relevant stakeholders in line with the principles of ownership, transparency and accountability espoused in the**

## MUTUAL DEBARMENT

Following the endorsement of the Uniform Framework for Preventing and Combating Fraud and Corruption in 2006, the focus of multilateral development bank anti-corruption efforts shifted to establishing a unified set of principles and guidelines to set out how the multilateral development banks’ integrity offices should conduct investigations. These efforts led to the 2010 Agreement on Mutual Enforcement of Debarment Decisions, which was based on the following six principles:<sup>26</sup>

- the adoption of harmonised definitions of prohibited practices
- the establishment of standardised investigatory procedures
- the creation of internal, independent investigative bodies and distinct sanctioning authorities
- the publication of written notices to entities and individuals against whom allegations have been made
- the use of the “more probable than not” standard when assessing alleged violations of integrity standards
- the recourse to a range of proportional sanctions to fit the nature of the violation

This collaborative process aims to increase the cost of corruption in development projects by preventing a company found to be using corrupt means by one development bank from obtaining contracts from another bank.

The list of cross-debarred firms is available at [www.crossdebarment.org](http://www.crossdebarment.org)



**Busan declaration.** These mechanisms should be free and easily accessible both on- and offline, accept complaints in local languages, clearly outline the criteria used to assess grievances and provide a means of tracking remedial action taken. Where appropriate, confidential reporting channels should be made available. Of crucial importance is the way these redressal systems are evaluated. Instead of viewing success as the number of cases going through the adjudication process, success should be defined in terms of remedial action for communities or otherwise improved local conditions.

CSO representatives interviewed consistently pointed to a lack of disclosure by DFIs on their management of identified incidences of corruption and frequently underlined the need for improved transparency around DFIs' integrity management systems. For their part, DFI staff interviewed were generally receptive to greater involvement of civil society as intermediaries between DFIs and affected communities. Making the redressal process itself and its outcomes more transparent would be a straightforward way to enhance civil society oversight, especially since CSOs often file grievances on behalf of local communities in the first place.

## Incentives and accountability structures

To date, minimal attention has been given to the risks that arise when commercial return profiles come into conflict with development goals. **DFIs could consider how internal evaluation metrics can be aligned at the project level with the achievement of predetermined development outcomes in line with specific SDGs.** Such outcomes should be verified by on-site monitoring, which includes external evaluations and feedback from communities affected by the project.

Finally, in line with the principle of national ownership of development, DFIs should scrap institutional preferences for multinational corporations from their own countries and conduct a thorough consultation with recipient country governments and communities during the design and implementation process to ensure alignment with national and local development strategies.<sup>53</sup>

## CONCLUSION

**Blended finance provides an innovative and potentially catalytic set of tools with the potential to crowd-in additional capital from the private sector to help achieve the SDGs.** Whether a first-loss guarantee or a technical assistance grant to improve the enabling environment in the recipient country, the diversity of blended finance tools can be applied on a case-by-case basis to enhance the commercial attractiveness of investments for long-term development in low- and middle-income countries.

**However, there remain many unanswered questions around the impact of blended finance on development outcomes, as well as on the integrity risks of blending different sources of finance.** Little is known about how much public capital is needed to mobilise a certain amount of private capital, and until consistent metrics are in place to measure and report additionality, quantifying the true impact of blended finance will remain difficult. Moreover, the focus on the return on investment risks encourages investment in middle-income countries with lower risk profiles. Low- and middle-income countries most in need of such investment may fall further behind as a result.

**This paper highlights four key areas where transparency and accountability of blended finance should be strengthened, with particular focus on the role of DFIs as project mediators.** It provides tangible recommendations for DFIs to improve their integrity management systems, ensure transparent and competitive tendering processes, conduct robust due diligence on potential partners, and develop open and accessible grievance mechanisms. It also stresses the need to ensure that blending is first and foremost about development outcomes; where the profit motive becomes the end of blending rather than just the means, the integrity risks outlined above are likely to be heightened.

**Ultimately, the issues outlined in this paper bring into sharp relief some of the tensions between the development mandate of donors and DFIs and the commercial interests of private investors they are seeking to incentivise.** The participation of new private sector players in blending and the greater number of layers of intermediation involved in these initiatives necessitates robust oversight. DFIs, as a central convening actor in blended finance mechanisms, should develop transparent and accountable integrity management systems to deal with these challenges. In this way, they can encourage more, and better, private investment in low- and middle-income countries, reducing the risk of development finance being exploited by dishonest brokers to the detriment of investors, taxpayers and intended beneficiaries.

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