# Financing Policy Brief Series – Recommendations for FfD4

# Increasing access to finance for small and medium-size enterprises:

# The role of blended finance

Discussion Paper prepared by UN Capital Development Fund (UNCDF)

## Key messages

This paper explores how to scale blended finance to increase access to capital for small and medium-size enterprises (SMEs), especially in the least developed countries (LDCs) and other highly vulnerable countries. Key messages include:

* SMEs are central for job creation, economic growth and progress on the SDGs in LDCs. However, they face immense challenges in accessing finance, with only 17% of SMEs in LDCs having access to credit, with even lower access for SMEs led by women and in the important agriculture sector.
* Blended finance could contribute to unlock more private capital for SMEs, including especially the use of guarantees, however there are relatively few examples of large, scalable blended finance initiatives targeting SMEs.
* To scale up blended finance for SMEs, there is a need to:
  + Build strategic partnerships with local financial institutions to yield positive demonstration effects and ensure sustainable private capital flow;
  + Increase availability of concessional capital that can be used for blending with private capital;
  + Consider establishing a global blended concessional finance hub to design initiatives that seek to mobilize private capital at scale for LDCs, including through greater pooling of concessional resources, uniform standards and use of portfolio approaches to increase diversification and reduce risk;
  + Improve impact measurement and transparency to make a stronger development and financial case for using blended finance.

## Problem statement

* Micro, small and medium-sized enterprises (MSMEs) account for 83% of total employment in the LDCs compared with 63% in other developing countries.[[1]](#footnote-1) On average, formal SMEs contribute around 40% to GDP in emerging economies.[[2]](#footnote-2) These numbers are significantly higher when informal MSMEs are included and tend to be higher in LDCs.
* Agenda 2030 recognizes the crucial role of SMEs with a special target on increasing access to finance for SMEs.[[3]](#footnote-3) Progress on this target remains slow. Only 15.7% of SMEs in sub-Saharan Africa countries and 17% in LDCs have a loan or line of credit. The global average is 44.2%.[[4]](#footnote-4) Financing challenges are even more acute for SMEs in critical sectors like agriculture and for women and youth-led SMEs.
* Without sufficient finance, SMEs are unable to grow and contribute to job creation, economic growth and SDG solutions. For LDCs to accelerate SDG progress, their economies need to grow a minimum 7% per annum, which would double their GDP every 10 years.[[5]](#footnote-5) Average GDP growth for LDCs was 4.4 per cent in 2023.[[6]](#footnote-6)

* SMEs in LDCs face several financing challenges:
* **Accessibility:** Many SMEs are caught in a “missing middle” trap, i.e., they are served neither by commercial banks nor by microfinance institutions[[7]](#footnote-7). This includes start-ups and early-stage growth SMEs that have limited or no access to initial risk-tolerant capital.
* Low savings rates[[8]](#footnote-8) and underdeveloped financial, especially capital, markets limit the availability of long-term finance to SMEs in LDCs.
* Complex loan application procedures and requirementsfrom local financial institutions and lack of sector-specific lending products makes access difficult.
* Servicing SMEs is costly for local banks, which also are risk averse and therefore often prefer to finance large corporates. They are often also required to invest in government issued securities, which further limit their ability to finance SMEs.
* MDBs and DFIs finance SMEs through local financial intermediaries. However, they face limitations to invest in countries with low or no credit ratings, and especially in the relatively risky SME segment. For example, IFC’s overall direct investments into LDCs have stagnated and stood at $790 million in 2022.[[9]](#footnote-9)
* **Affordability**: Whenever SMEs in LDCs are able to access capital, they are faced with prohibitively high interest rates, high collateral requirements and high minimum loan sizes due to perceived or real risk by financial institutions.
* Low sovereign credit ratingis one key factor affecting access to and cost of SME finance.
* **Blended finance** can help crowd in private finance for SDG-positive SMEs. Blended finance is a structuring approach that uses “catalytic capital from public or philanthropic sources to increase private sector investment in sustainable development”.[[10]](#footnote-10) In blended finance, providers of concessional capital take “first loss” positions and agree to absorb early losses, protecting more conservative investors, such as MDBs/DFIs and commercial institutions .
* Blended finance has not lived up to the hopes that it would help move SDG finance from billions to trillions. Between 2016 and 2018, around $7.6bn or 6% of private finance mobilized through blended finance went to LDCs. Between 2019 and 2021, this increased to $21.7bn or 16%; however, these resources were concentrated in a small number of large projects in a few countries.[[11]](#footnote-11)
* The limited progress of blended finance in LDCs can be attributed to several factors. Geopolitical and macroeconomic instability have led private investors to demand higher financial returns, forcing blended finance promoters to re-evaluate investment theses, risk-return expectations and concessionality levels. Additionally, stakeholders frequently highlight complexity and time to design blended finance structures, as well as limited pipeline of investment-ready SMEs and projects in LDCs as deterrents to private investors’ engagement.
* Another barrier to scale blended finance is the uneven application of impact measurement and disclosure requirements in reporting development and financial results. This limit understanding, trust and interest of stakeholders in using blended finance.

## Policy solutions

A number of actions could be pursued to increase blended finance for SMEs:

1) **Increase concessional capital dedicated to blended finance for SMEs in LDCs**:

* Allocate more development and climate finance to be used with the aim of unlocking private finance.
* The IMF is re-channeling at least $100 billion of Special Drawing Rights (SDRs) to vulnerable countries. It could be explored if some of these resources may be used innovatively to help unlock private finance for SMEs.[[12]](#footnote-12)
* In the Pact of the Future, governments commit to increased use of debt swaps for the SDGs. Debt swaps could be used to channel resources towards credit lines or guarantees for increased SME lending.

2) **Establish a Blended Concessional Finance Hub**: Financing SMEs and other projects in LDC markets often requires taking on more credit risk than local banks are willing to do.

* UNCDF was established by the UN General Assembly as a mechanism to support countries, primarily LDCs, to develop their economies. It aims to mobilize and catalyze additional financial resources and, being funded by grants, it can absorb losses through its balance sheet The capabilities and structure of UNCDF could be used and scaled to channel optimally concessional resources into blended finance operations, especially those targeting the LDCs.
* UNCDF could serve as a neutral broker, using donor resources to structure blended finance vehicles at arm’s length based on uniform standards and consistent methodologies, facilitating MDB and DFI blended finance contributions, and maximizing private sector participation. If donor resources are pooled, a Global Blended Concessional Finance Hub can be created to partner with MDBs and DFIs, and to optimize the development impact of Official Development Assistance. For example, within a blended finance debt fund, the Hub would take a first-loss position, MDBs and DFIs would provide junior debt, and the private sector would provide senior debt. The Hub would engage in capital market development, ensuring that both the junior debt and the senior debt are listed instruments, thereby allowing both the public sector and the private sector to circulate their capital.
* Its role as a provider of catalytic financing (grants, concessional credit and guarantees) to support early-stage growth SMEs could be scaled up to complement the more semi-commercial and commercial financing provided by other development finance actors.[[13]](#footnote-13) The increased use of concessional guarantees could be especially useful as they tend to have a higher mobilization effect than other blended finance types.[[14]](#footnote-14)

**3) Harness the potential of local Financial Service Providers (FSPs).** Governments, DFIs and donors in many LDCs have invested to capitalize local financial institutions and funds, but capital flows to SMEs are still limited.

* While blended finance may help to unlock these domestic resources, Governments and Central Banks should complement this by also considering relevant policy measures, including e.g. greater flexibility in loan loss provisions and classification of loans; reduction of collateral requirements; set targets for deployment of funds; provide tailor-fit financial products with special concessional financing terms; include technical assistance linked to government funded facilities to build capacity of borrowers and local financial institutions.

**4) Focus on mobilizing private capital at scale** by establishing market-recognized standards and consistent methodologies to reduce complexity, time and transaction costs when designing blended finance structures.[[15]](#footnote-15) Using structured funds and adopting portfolio approaches for aggregation and risk pooling across sectors and countries could also help attract mainstream investors to place capital in SME-focused blended finance vehicles.[[16]](#footnote-16)

**5) Improve Impact Measurement and Transparency:**  There is a need to know more about what works and where blended finance can be improved in terms of financial performance and development impact. A greater focus on standardized impact measurement[[17]](#footnote-17) and on increased transparency of development and financial results could help counter perceived risks of investors, strengthen accountability to shareholders and taxpayers, and generate more interest and deployment of blended finance.

**6)** **Leverage the UN development system (UNDS)** to complement other actors in making blended finance work better where it is most needed. The capabilities of the UNDS to identify, support and provide initial risk capital to develop pipelines of investment-ready SMEs and SDG projects, and its role in creating broader enabling environments, could be better linked to the investment capabilities of MDBs and DFIs.

## Specific recommendations for FFD4

To enable greater access to finance for SMEs through blended finance approaches, the following could be considered for the FFD4 outcome document:

* **Recognize the gap in the development finance architecture** that result in a lack of capital for SDG-positive SMEs, including start-ups and early-stage growth companies, and other small and mid-size investments, especially in the LDCs and other frontier markets.
* **Recommend greater use of blended finance solutions** to mobilize private finance for SMEs, especially in LDCs and other frontier markets. Commit to increase the amount of concessional resources dedicated to drive blended finance solutions, especially for guarantees.
* **Propose establishing a *blended concessional finance hub*** to design initiatives that seek to mobilize private capital at scale for LDCs, including through greater pooling of concessional resources, uniform standards and methodologies, and use of portfolio approaches to increase diversification and reduce risk.
* **Use blended finance to leverage resources of local financial institutions** through the provision of de-risking mechanisms that can address accessibility and affordability challenges e.g. high collateral requirement and high interest rates to unlock more domestic capital for SMEs.
* **Promote development and application of uniform standards** and consistent methodologies for the design of blended finance structures to reduce complexity and increase efficiencies, in order to attract investors to place capital in SME-focused blended finance vehicles. This would include more standardized impact measurement and greater transparency requirements, to ensure investments deliver intended development outcomes, while also increasing information about the financial performance of blended investments.

1. [SG DPoA report](https://documents.un.org/doc/undoc/gen/n24/120/24/pdf/n2412024.pdf) [↑](#footnote-ref-1)
2. <https://www.worldbank.org/en/topic/smefinance> [↑](#footnote-ref-2)
3. SDG 9.3.2 - Proportion of small-scale industries with a loan or line of credit [↑](#footnote-ref-3)
4. World Bank, processed by Our World in Data - [Share of small-scale industries with a loan or line of credit, 2023 (ourworldindata.org)](https://ourworldindata.org/grapher/smalsmall-scale-industries-loan?tab=chart&region=Africa) [↑](#footnote-ref-4)
5. Jeffrey Sachs presentation, Second Committee UNGA, October 7, 2024; See also SDG target 8.1 [↑](#footnote-ref-5)
6. [SG report on Follow up to the Fifth United Nations Conference on the Least Developed Countries](https://documents.un.org/doc/undoc/gen/n24/120/24/pdf/n2412024.pdf) [↑](#footnote-ref-6)
7. See for example: [210707\_Runde\_Supporting\_Sub-Saharan\_SMEs\_0.pdf (csis-website-prod.s3.amazonaws.com)](https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/210707_Runde_Supporting_Sub-Saharan_SMEs_0.pdf?VersionId=cbppgk5HzqGe0qOfQ4dMsRvZ9D1.Jz6X) [↑](#footnote-ref-7)
8. The domestic savings rate in Africa in 2023 was 5% of GDP, down from 18% in 2015, Economist 21 Sept 2024 [↑](#footnote-ref-8)
9. [Creditor Reporting System](https://stats.oecd.org/Index.aspx?DataSetCode=crs1), OECD [↑](#footnote-ref-9)
10. <https://www.convergence.finance/blended-finance> [↑](#footnote-ref-10)
11. UNCTAD 2023, LDC Report 2023 [↑](#footnote-ref-11)
12. See example of the green investment facility Ireme in Rwanda - [https://www.imf.org/en/News/Articles/2023/06/21/pr23224-rwanda-partners-euro-300m-financing-prvt-investment-climate-resilience-rsf-imf](https://eur03.safelinks.protection.outlook.com/?url=https%3A%2F%2Fwww.imf.org%2Fen%2FNews%2FArticles%2F2023%2F06%2F21%2Fpr23224-rwanda-partners-euro-300m-financing-prvt-investment-climate-resilience-rsf-imf&data=05%7C01%7Ccasper.sonesson%40uncdf.org%7Ccb8ac9f633524e96462508dbdee9974b%7Cb3e5db5e2944483799f57488ace54319%7C0%7C0%7C638348867064329855%7CUnknown%7CTWFpbGZsb3d8eyJWIjoiMC4wLjAwMDAiLCJQIjoiV2luMzIiLCJBTiI6Ik1haWwiLCJXVCI6Mn0%3D%7C3000%7C%7C%7C&sdata=7AgjAGaxNlGBpyztV7gOgrGLxWrWEqvMWQXyqqlXhrA%3D&reserved=0)

    See 2024 [LDC Ministerial Declaration paragraph 27](https://www.un.org/ohrlls/sites/www.un.org.ohrlls/files/ldcs_ministerial_declaration_2024.pdf) [↑](#footnote-ref-12)
13. The concept of a Stretch Fund” was introduced in 2019 by Lee / Preston to fill a gap in the development finance architecture to finance early-stage firms, high-risk tranches in capital structures, etc. Lee & Preston, 2019 – “The Stretch Fund – Bridging the gap in the development finance architecture” [↑](#footnote-ref-13)
14. See “Blended finance in Sub-Saharan Africa: SME Financing”, Convergence 2024. [↑](#footnote-ref-14)
15. See “Blended Finance Best Practice – Case Studies and Lessons Learned”, which argues that market-recognized standard blended finance structures can be key to attract more investors and scale the use of blended finance. [↑](#footnote-ref-15)
16. Ghosh, Arunabha, and Nandini Harihar. 2021, [Mitigating Climate Change Finance Risk for Developing Nations (ceew.in)](https://www.ceew.in/publications/mitigating-climate-change-and-clean-energy-finance-risks-for-developing-nations) [↑](#footnote-ref-16)
17. The Donor Committee for Enterprise Development Standard, the International Finance Corporation-hosted Operating Principles for Impact Management, and the Global Impact Investing Network’s Impact Reporting and Investments Standards are examples of key efforts to harmonize impact measurement across investors. [↑](#footnote-ref-17)