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Development Finance Institutions: New directions for the future

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Agence française de développement

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Development Finance Institutions

New directions for the future

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Abstract

In an evolving development landscape, the urgency for Development Finance Institutions (DFIs) to innovate, adapt and deliver is intensifying. In this context, four discussions – focusing on DFIs' additionality and ability to mobilise to private finance, their risk policies, and their development impacts – have become pivotal. They frame the dominant discourse around DFIs' identity, purpose and priorities, and have captured the international community's focus.

This paper argues that the advantages and drawbacks of this discourse need greater consideration. Positively, it ensures constant emphasis on the continuous refinement of key operational areas and upholds important discussions on the principles and challenges inherent to the DFI mandate. However, by focusing so intently on these four debates, the discourse overshadows the need to explore fresh meanings and avenues and so limits adaptability. It risks too great an emphasis being placed on optimising existing operations rather than re-evaluating foundational objectives and mandates. While providing a structured, well-established framework for operations, it falls short in suggesting alternative worthwhile pathways for the future. Consequently, DFIs find themselves enmeshed in debates and discussions that impede their flexibility, creativity and explorative capabilities, as well as such possibilities as enhanced coordination in collective action. Essentially, this tunnel vision confines strategic perspectives and has become an impediment.

To navigate these challenges, this paper adopts a qualitative approach – an unusual but much needed approach in the study of DFIs. Rather than accepting the structure of the prevailing discourse, it seeks to highlight its limiting effect on the strategic thinking of DFIs and suggests that DFIs should reflect more on their core purpose, essence and direction. To support this process, the paper proposes a 'strategic compass' which highlights four cardinal directions: aiding the SDG transition, championing trailblazers in business and finance, fostering a holistic business and finance ecosystem, and embracing digital and environmental transitions. To serve both emerging and in particular challenging 'frontier' nations effectively, DFIs must re-envision their overarching aims and strategies. They need to be prepared to be pioneers, to foster collaboration over competition, and gain more robust support for change from their political stakeholders. Complacency or delay, which risk relevance, are not options.

Keywords

Development Finance Institutions, mobilisation to private finance, risk policies, development impacts, framework for operations, DFIs mandate and strategic perspectives

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Introduction

1. Fit for the future?

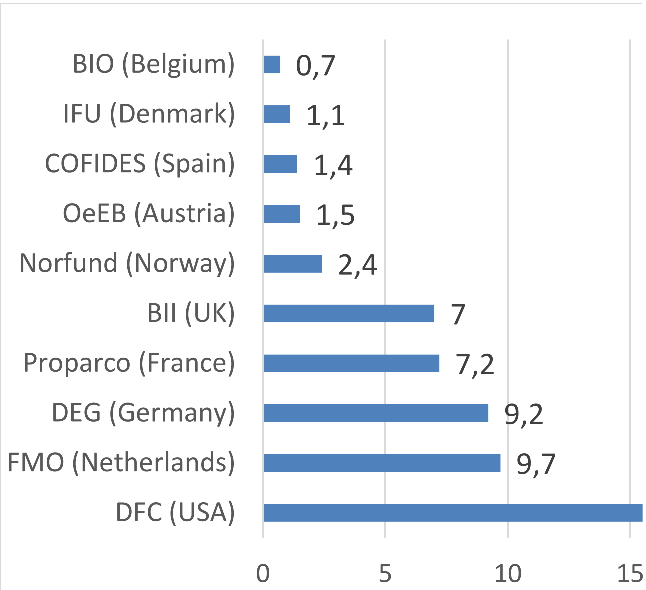
In 2023, over 500 Development Finance Institutions (DFIs) and Public Development Banks (PDBs) operate around the world to support private sector initiatives in developing and emerging economies (Institute of New Structural Economics at Peking University 2017). While PDBs generally are wholly government-owned and broadly focused, DFIs are predominantly held by public shareholders (i.e., ownership can include private interests) and perform a more specialised developmental mission focused on the private sector. DFIs obtain their funding from various sources including government contributions, international donors, capital markets and private investors. Ranging greatly in size and scope but often focused on development sectors (e.g., infrastructure, energy, financial systems, agribusiness, healthcare and education) where private lending or investment is insufficient, including in high-risk geographical regions, DFIs supply a mix of loans, guarantees, equity investments and other financial products to address market gaps and mobilise private investment.

Ideally, loans are provided at competitive rates, often with long repayment periods, and guarantees to other lenders may cover a portion of risk on loans to certain businesses or sectors. Through equity, some DFIs also invest directly in companies or investment funds, which not only provides capital but may also improve business practices. With mandates that include environmental, social and governance (ESG) responsibilities, many DFIs also provide capacity-building and technical assistance to help businesses improve their operations, meet higher industry standards, or achieve specific development outcomes. Given their links to governments, DFIs can also play a role in influencing policy.

A fundamental distinction can be made between multilateral and bilateral DFIs: the former are owned by multiple member countries and the latter – most often and often most substantially – by one country. Some DFIs operate globally, often with varying mandates and focus areas, and others operate in specific geographical regions. Some are registered as banks and subject to national and international banking regulations. In addition, in circumstances which may be contested, some entirely private organisations now claim to be DFIs, given their focus on development-oriented projects.

Considering such a varied set of institutions, and with core definitions varying and data often presented inconsistently, reliable aggregations and overview calculations are complex. However, in 2017, total assets of 500-plus banks and institutions – 93% of them national and subnational institutions operating in 147 countries and the rest multilateral – was estimated at around $23 trillion, and the annual investment of a subset of 30 bilateral and multilateral DFIs at around $87 billion (Runde and Milner 2019). Another analysis suggests DFIs annually invest $90 billion to support under-financed projects across the world (Carter, Van de Sijpe et al. 2019). Assets of EU Member State PDBs – including the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) – were estimated at $3.95 trillion in 2020. The International Finance Corporation (IFC), a member of the World Bank Group is the largest private sector focused DFI, having made $32.8 billion in investment commitments in 2021-2022 (IFC 2023). Figure 1 shows some major DFIs comparing them by portfolio value.

Figure 1. Selected DFIs: national ownership and portfolio value (2021, billion euros)

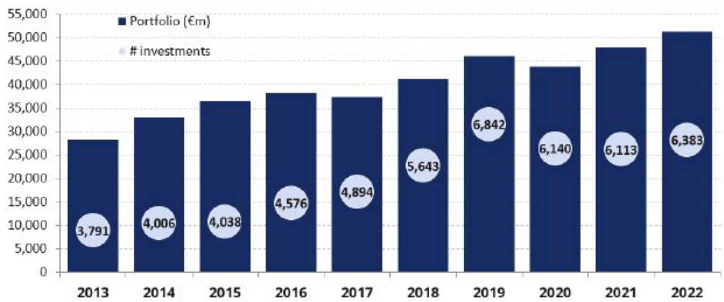


Data source: Devex 2022

Note: Currency conversions at 1 December 2022: GBP1 = €1.16; NOK1 = €0.098; USD1 = €0.95

The sector has grown significantly over recent decades. One analysis indicates that annual financial commitments from all DFIs grew from $10 to $70 billion between 2002 and 2014 (Kenny, Kalow et al. 2018). Another suggests that the bilateral DFI portfolio expanded from nearly $48 billion in 2012 to more than $84 billion in 2021, exceeding growth of official development assistance (ODA) or the global economy (Devex 2022). Yet another indicates that the combined portfolio of the 15 biggest European institutions doubled in a decade to $53bn at the end of 2021 (The Economist 2023).

Figure 2. EDFI portfolio evolution 2013-2022 (€m)



Data source: EDFI 2023

In addition, new DFIs continue to be created. In January 2018 Canada established FinDev, and in December 2019 the USA launched the International Development Finance Corporation (DFC). With a finance limit of $60 billion, DFC enjoys more than double its predecessor's Overseas Private Investment Corporation's (OPIC) $29 billion cap and has increased authority to make equity investments. Other large and diverse organisations have also recently joined the sector. In January 2020, J.P. Morgan announced the creation of its own 'DFI' within its corporate investment bank which assessed transactions with a total anticipated development impact value of $124 billion in 2021 (Euromoney 2022).

The DFI sector might therefore be considered to be thriving. In fact, as the scale of the challenge of lifting a billion or more people out of poverty becomes evident, many DFIs are facing what might be characterised as a 'crisis of confidence', uncertain of their ongoing role and relevance. Behind closed doors, some DFI staff admit that they are sometimes uncertain of the direction of their own organisations. Some complain that too many investment options with obvious positive development impacts are not pursued, given risk levels that are judged too high by their organisations' investment committees, and the focus that may be put on profitability.

With the emphasis of international development further moving from a focus on economic and infrastructure development to include social, environmental and political dimensions, and as a top-down, donor-recipient model moves to prioritise local ownership, partnership and stakeholder coordination, fundamental questions are emerging regarding the relevance of the DFI model today. With a wider range of state actors (e.g., China, India and Brazil as donors and investors in other developing countries) and non-state actors (e.g., non-governmental organisations, philanthropic foundations and private companies, including impact investors) engaged in financing development, and green growth, climate resilience and biodiversity conservation now central concerns, many feel that the world's DFIs need to change attitude, direction and emphasis.

2. Research scope and methodology

Against the changing landscape of international development, this paper aims to determine how DFIs should focus their skills, experience, efforts and attention for maximum impact in the future. Given limited resources and considering the high number of institutions and their varying mandates, the paper sets aside nationally and export orientated institutions to focus on DFIs that support sustainable development across borders by facilitating financial flows to the private sector in developing and emerging countries.

The scope of the paper includes bilateral European-based DFIs working internationally, such as British International Investment (BII), Belgian Investment Company for Developing Countries (BIO), German Investment Corporation (DEG), and Proparco (a subsidiary of the Agence Française de Développement (AFD) Group), and key multilateral DFIs, such as IFC, the private sector arm of World Bank Group, and the European Bank for Reconstruction and Development (EBRD). It extends to various regional multinational development banks such as the African Development Bank (AfDB) and the Asian Development Bank (ADB) in their private sector operations. Development banks that mostly focus on sovereign interactions (often in collaboration with DFI partners) were not specifically considered, nor were the large Chinese national institutions (e.g., China Development Bank (CDB) and Export-Import Bank of China (Exim)), other than as providing context or contrast.

Following a review of academic literature, public documents and news reports, the research employed a qualitative methodology based on non-attributable interviews with high level stakeholders and recognised domain experts from development finance and other development, environmental and social domains. In total, in April and May 2023, a total of 25 interviews were conducted. Twelve took place with senior representatives from AFD and four bilateral institutions – BIO, BII (formerly CDC), DEG and Proparco – and three multilateral institutions – EBRD, EIB and IFC – as well as the Association of European Development Finance Institutions (EDFI). In addition, 13 high-level representatives of private sector investment banks and funds, and civil society organisations (CSOs) were consulted.

Although it is common to accept that only quantitative data and modelling offer useful perspectives on DFI activities, purely quantitative approaches limit the scope of questioning and generate blind spots. Seeking to escape existing frameworks and explore new options, a primary objective of the research was to question the structure and effects of the discourse – the conversations, discussions, knowledge and communications that construct our experience of the world – rather than simply responding to it. Rather than accepting the structure of the prevailing discourse, this approach allowed its effects on strategic thinking to be considered, a perspective few studies adopt.

A qualitative approach also offered advantages in examining a diverse set of organisations operating in different contexts with varying mandates and objectives. In investigating the strengths and weaknesses of DFIs and how they could adapt to changing environments and new priorities, it further provided the opportunity to develop a nuanced understanding of the intricacies of operations and decision-making processes, and the complexities of operating contexts. Valuably, it facilitated the collection and analysis of multiple perspectives from diverse stakeholders, some of whom contributed candid and unorthodox viewpoints.

Noting that little evident analytical work addressing DFIs applies an organisational or business strategy lens, six frameworks were initially reviewed to shape the paper's conceptual approach to strategy making: SWOT, Porter's Five Forces, Resource-Based, Balanced Scorecard, Value Chain, Blue Ocean/Red Ocean, and Three Box Innovation. With its focus on planning for innovation and balancing the competing realities of past, present and future, Three Box Innovation was determined to offer a novel and potentially insightful approach.[1] This framework

[1] For more information see: https://hbswk.hbs.edu/item/a-three-box-solution-to-managing-innovation.

suggests that as the world keeps changing, “strategy is innovation” and in practical terms, delivering a successful future involves balancing the needs to: 1. Manage the Present (optimise what is already being done); 2. Selectively Forget the Past (let go of things that may be functioning now but have no real future or may prevent required evolutions); and 3. Create the Future (by testing enough innovations today so that tomorrow is well taken care of). This framework guided the formulation of the interview questions and the subsequent analysis of the structure and effects of the prevailing dominant discourse on DFIs.

1. Voices on the record

This section presents the views gathered during interviews with senior DFI representatives and private sector partners and stakeholders regarding the strengths and successes and the challenges and weaknesses of the DFI model, and their impact on the DFI track record. Nearly all interviewees were quick to point out that although a positive picture was easy to draw and not difficult to justify, room existed for improvement, and the DFI glass could be presented as half full or half empty. The paper does not attempt to make a judgement on this matter but capture the candid views and opinions of the professional community.

1.1. The positive picture

Many voices in the professional community suggest that with activity bigger today than ever, DFIs have in many ways succeeded. The transmogrification of the USA's OPIC into DFC in 2019, with increased funding and an enlarged remit, indicates that the model is still relevant, it is argued, as does the establishment of FinDev Canada in 2018. In its simplest terms, the positive picture suggests that DFIs have proven that business is possible in developing countries and thereby fulfilled a foundational objective. Foreign Direct Investment and local private sector funding have stepped up in many developing countries and in this sense DFIs might be seen to have both achieved and lost their original mission.

Along the way, DFIs have demonstrated their abilities to evolve and innovate. Blended finance approaches, which combine public and private sector resources to mobilise private sector capital, have been embraced, for example, along with financial instruments such as risk-sharing guarantees. In some cases, portfolios have been split into growth and catalyst segments with the latter allowing for greater risk-taking and potential impact, including through increased equity investments. Across the sector, organisational changes have been implemented often driven by measurement and reporting frameworks designed to assess social and environmental impacts.

In addition, DFIs have increased their support for small and medium-sized enterprises (SMEs) as engines of economic growth and job creation through technical assistance and capacity-building and have expanded their interests in partnering with local financial institutions or SME oriented investment funds with the aim of expanding access to finance for them. The concepts of microfinance and impact investing, which seek to achieve positive social and environmental outcomes alongside financial returns, have not been neglected, and engagement with specialist firms has increased. Many DFIs have also provided constant and rising support to local banks through concessional loans and technical assistance. Although they have often been criticised for doing so, on the grounds that development impacts are hard to track, strengthening the banking system is considered one core focus of the DFI mandate.

> ***In terms of what is working, I feel that in the larger scale of providing institutional capital where direct private investors would not be going, DFIs are doing a terrific job. In terms of results, that would translate to potentially de-risking or opening up opportunities for other investors like private equity funds, where other private investors can have a role. To my knowledge, it is useful in the context of unlocking capital for infrastructure investment.*** (Interview 26 April 2023)

Aiming to leverage resources, share expertise and promote synergy, strategic partnerships and collaborations among DFIs have become more common, it is reported, and interactions with other public and private sector organisations have increased. Co-operation between bilateral and multilateral DFIs has also been enhanced, with arrangements on co-financing and risk-sharing, knowledge-sharing and technical assistance, and other joint initiatives now more common. In particular, the experience and potential influence of multilateral DFIs in the policy space – nationally in target countries and internationally – has been recognised as valuable in creating enabling environments for investment and development impact. Common standards and harmonized approaches have been improved in an ongoing process.

The establishment of the Association of European Development Finance Institutions (EDFI) in 1992 by seven European DFIs is seen an important institutionalised step towards increased collaboration and co-ordination. Now representing fifteen members, its mission is to foster EDFI members' cooperation with EU institutions and other DFIs, improve their efficiency and effectiveness, provide them with common representation, develop and support joint policies, and secure financing opportunities. The organisation further expanded DFI influence and options in 2016 by establishing the EDFI Management Company (EDFI MC) to enable DFIs and private sector investors to invest more and in higher risk projects than they would otherwise be able to do. Similarly, the International Development Finance Club (IDFC), created in 2011, brings together 26 national and regional development banks from all over the world, a majority active in emerging markets. IDFC members represent the largest provider of public development and climate finance globally, with $4 trillion in combined assets and annual commitments above $600 billion, including $150 billion of climate finance.[2]

Reflecting a wider and growing emphasis on sustainability and responsible investment practices, DFIs have also been active in adapting to the green transition and working towards the United Nations Sustainable Development Goals (SDGs) and ESG and corporate social responsibility (CSR) standards. Increasingly climate action and environmental sustainability have been prioritised in DFI investments and operations with many DFIs introducing dedicated funds, bonds or investment

[2] Source: https://www.idfc.org/mission-vision/

vehicles, along with technical assistance, to support green initiatives involving renewable energy, energy-efficient infrastructure, and climate adaptation and mitigation initiatives, for example. ESG considerations have also been integrated into investment decision-making processes, technical support provided to banks and companies, and final impact assessments.

> ***I think that DFIs have continued to effectively execute on their basic mission. I define their basic mission as seeking to maximise development impact in their relevant geographies, while meeting basic financial constraints which normally involve preserving capital, preserving credit ratings and so on. I think that's the basic mandate.*** (Interview 28 April 2023)

Many respondents stress that over the years DFIs have gained a strong reputation and are highly respected especially within any specific geographical regions their activities focus on, and most especially in high-risk 'frontier' territories they may be familiar with. They play a unique role in providing more patient, more responsible and better supported capital, and can sometimes make deals happen by just committing, thereby reassuring and strengthening mobilisation of other investors' funds. DFIs are often prepared to take on more macro and political risks than other financiers, and private sector investors seek their involvement to raise the credibility of the deals they are organising. Table 1 shows key successes and strengths perceived in the professional community.

Table 1. Key DFI successes and strengths perceived in the professional community

THEME	NARRATIVE
Relevance	DFIs have supported Foreign Direct Investment, private sector funding and promoted business development in developing countries.
Innovation	DFIs have adopted new financial instruments, including blended finance approaches, that combine public and private sector resources, in order to 'leverage' additional funds from other actors.
Support for SMEs	DFIs have supported SMEs through technical assistance and capacity-building as well as financial support and even partnerships.
Strategic partnerships	Cooperation between DFIs, as well as other public and private sector organisations, has increased.
Sustainability	DFIs have adapted to the global push for sustainability, incorporating strong ESG considerations into their decision-making processes.
Catalyst	DFIs have raised the profile of sustainability issues in general and have catalysed investments related to areas such as climate change, financial inclusion and gender equality.
Reputation	DFIs are highly respected, especially in high-risk 'frontier' territories, and as patient investors.

1.2. The half empty glass

The DFIs and their partners know that they have limitations. More nuanced comments from DFI staff themselves and their partners suggest that, beneath the surface of expanding portfolios, a growing set of doubts and, for some, even a 'crisis of confidence' is emerging. Against the shifting landscape of international development imperatives, how can DFIs stay effective and relevant? For some interviewees, whose views are presented below, the glass is half empty, and new thinking and reinvigorated action is required to top it up.

Many voices in the professional community are quick to point out that the scale of financial needs in developing countries, particularly in areas such as infrastructure, education, healthcare and the environment, remains immense and continues to grow. Given their restricted capital base, risk appetite, and the constraints of their business models, DFIs are challenged to meet these extensive and extending needs. With the importance and impact of DFIs reduced by the scale of the funding requirements, their ability to stimulate significant change is intrinsically challenged, as is their wider influence. Insufficient size also affects the ability of DFIs to catalyse third-party private investment and help trigger the dynamics of private sector development in countries where it is most needed. If the scale of DFI involvement is small relative to the size of the investment, it may not provide sufficient confidence or risk mitigation to attract private investors.

> ***The biggest bottleneck that we see as private investors or developers is in deployment of capital and mobilising capital for transition, projects or development. The reason for the failures is that everybody talks about it, but there's no incentive within these DFIs to focus on this. They typically do not have the resources, competencies and skills to fully grasp what early development means and what it actually is. So, they tend to vacillate for too long.*** (Interview 5 May 2023)

Observers and direct stakeholders often suggest that, despite it being central to their mandates, DFIs are not sufficiently successful in mobilising private investment, especially in more challenging environments. The recent deterioration of macroeconomic conditions and the rise in rates on the OECD markets have significantly reduced the appetite of third-party private investments to invest in developing countries. In this context, the efforts made by DFIs to mobilise must be even greater, in a macroeconomic environment where their own risk appetite is more limited. Projects in developing countries, particularly those with significant development impact, may offer lower financial returns than investments in developed markets, and convincing private investors to accept lower returns for the sake of development impact can be challenging. 'Frontier' countries which are perceived as high-risk due to factors such as poverty levels, political instability, poor governance, economic volatility or foreign exchange risk, continue to struggle to attract new investments, especially from investors unfamiliar with the environment. Even the most innovative financial instruments or mechanisms are limited in their ability to address the wide array of unknowns and risks that private investors face. Many developmental projects also require long-term financing while private investors often prefer shorter-term and more liquid investments. This mismatch in investment horizons and the lack of liquidity perspective (for equity investments) can discourage private investment, even when DFIs are involved.

> ***I think the weakness is that we need to work more with the rest of the financial system. You hear a lot of mobilisation. This is really the term that everybody is using, how can we mobilise? And I think what we are saying is, how can DFIs be like the pilot for the rest of the financial system? In my opinion we are not there yet. The role that we are in, trying to mobilise other private financing, DFIs are not up to task. It's not just the fault of DFIs, it's also because sometimes funds say, oh yes, I want to finance the SDGs but then they want the DFI to take 100 percent of the risk.*** (Interview 11 May 2023)

DFIs are committed to high operating standards and transparent and accountable operations aligned with good practice in areas such as ESG, financial management and governance. Consequently, compliance with multiple standards and regulations adds complexity to DFI operations, slows processes and reduces partners' ability and willingness to engage. The need for due diligence, monitoring and reporting also increases transaction costs. Managing the risks associated with non-compliance, both in DFI operations and in financed projects, requires substantial capacity and expertise and limits DFIs' ability to finance riskier high-impact projects. In addition, many DFI partners, particularly smaller businesses in developing countries, lack the resources to implement the required procedures and systems and consequently find access to DFI investment difficult. Moreover, a DFI's minimum possible investment may often be above what a sound and rising SME requires.

Those DFIs regulated as banks and subject to international regulations can also find themselves constrained by capital adequacy, market liquidity, caps on financial exposure to a given country (e.g., Morocco and others for Proparco) and stress testing requirements, for example, which limit the amount of business possible, especially if operating in riskier environments or sectors. In this case, some suggest that larger multilateral DFIs could step in to relieve smaller bilateral DFIs of part of their country portfolio when they hit a country risk ratio/ceiling, allowing them to continue operating, but this sort of cooperation is not yet taking place. Although risk sharing (mainly through co-financing and sometimes through sub-participation) is quite common between DFIs, there is no such a thing yet as loan assignment.

> ***I think in operations DFIs should be less strict and be willing to take on more risky situations. And if or when the situation turns out bad, they should be more willing to be more engaged to rescue the situation. The problem today, and I've seen that at every level, is that people know they are risky business, but in their minds, they believe that they are not allowed to lose any money. To take risk you must accept mentally that you might lose money. This is something that needs to be at the heart of any reform.*** (Interview 22 May 2023)

Moreover, complying with regulations also requires substantial reporting, monitoring and internal risk management which again increases operating costs and reduces agility. In addition, regulations introduced under Basel III have procyclical effects, increasing risk weights during economic downturns and leading to a contraction of lending precisely when it is most needed for countercyclical purposes. Likewise, EU proposals for a comprehensive framework of regulations and standards (including, for example, the EU Sustainable Finance Taxonomy, the Sustainable Finance Disclosure Regulation, the EU Green Bond Standard and updates to the Non-Financial Reporting Directive) designed to promote sustainable investment, facilitate the transition to a low-carbon economy and combat, greenwashing is a positive development but may actually create strong disincentives to invest in developing countries.

Operating in multiple countries and jurisdictions, each with its own regulatory environment, also limits the ability of many DFIs to develop and implement uniform procedures and standards especially when faced with the varying expectations of different stakeholders, including governments, private sector partners and civil society.

Other critical voices, including from civil society, complain that DFI interest rates are too high, particularly considering the concessional funding and public support some receive, arguing that high rates limit the scope of DFI operations and make financing less accessible to the neediest projects. Most DFIs are however mandated to balance their developmental goals with financial sustainability. The risky contexts in which projects are carried out require interest rates to remunerate the risk taken which is not always compatible with the economic viability of the projects. This raises the question of the use of blended finance to ensure the viability of projects while ensuring that it does not create market distortions or constrain the development of the local financial system.

Conversely, if as part of their development mandate DFIs offer more affordable financing than would otherwise be available, they can be accused of undercutting the market and inhibiting other lenders and the development of an open market. Thus, in either case, the DFIs face criticism.

These dynamics can be cast as failures, but they can also be presented as part of normal processes whereby rates increase with risk and DFIs progressively retreat from economies where private sector financing is available and competitive.

> ***A lot of people who make the point about taking more risk, when I listen to what they have to say, it's fairly obvious that they've never run an investment portfolio to be honest. The deterrent to taking risk in a DFI is the need to or the idea that you should mobilise capital. There is a trade-off. The riskier the project the less likely you are to find commercial capital to go alongside. It's just a fact of life. The other big deterrent, obviously, is the need to be sustainable. But I think that any DFI model that suggests it could work without preserving capital, if preserving capital was not an absolute imperative, it would quickly fall apart. Boom!*** (Interview 28 April 2023)

The DFIs' limited ability to provide local currency funding is persistently cited as a challenge, especially as many potential borrowers do not generate hard currencies but revenues labelled in local currencies. When DFIs want to lend in local currencies, they take on foreign exchange risk as they themselves raise their core funds in hard currencies. If the local currency depreciates, the value of the repayments in the base currency will decrease, leading to losses. Likewise, in many developing countries financial markets are neither deep nor liquid enough to support large-scale local currency financing, and with investors willing to buy local currency debt often in short supply, the ability of DFIs to raise funds in local currencies is constrained.

Some useful developments have emerged in this area – currency swaps and hedging, local currency bond issuances, risk sharing and guarantees, for instance – and EDFI members are shareholders in the TCX Fund, a special purpose fund that offers currency hedging products for frontier and emerging markets.[3] Yet all these options come at a cost which must be carried by the DFI or passed onto clients. As things stand, no standard mainstream solutions are available that allow client businesses to borrow in their national currencies without DFIs taking on foreign exchange risk and borrowers paying for these increased risks.

Voices within the development finance community also advocate for stronger cooperation between DFIs and national public development banks (PDBs). National PDBs, which should be in a position to support local business endeavours with the greatest level of insight, complain that DFIs sometimes prefer to intervene in partner countries directly, on their own balance sheet, rather than intervening through local development banks – for instance by providing guarantees or other risk mitigation tools that would allow them to lend more.

[3] For more information see: https://www.tcxfund.com/.

Cooperation and coordination among DFIs have increased in recent years particularly in efforts to set standards, develop shared tools and services, and establish joint platforms and initiatives to foster collaboration and increase alignment, as well as to co-finance individual deals. Yet, important aspects of a collective voice and strategy are still missing. Established by different governments and organisations, each with individual and often specific mandates, priorities and operating procedures, and with size, scope, geographic focus, governance structures and risk appetites varying greatly, finding and formally articulating commonalities is challenging, even without considering the fact that DFIs may find themselves competing for investment opportunities. The level of coordination that has been secured at the European level through the creation of EDFI has not yet been reached at the international level. Currently there is no global association of private sector oriented DFIs linking the IFC, regional and bilateral DFIs, for instance.

This makes it challenging for DFIs to progress in terms of determining their future evolution together, as a community, at a strategic or systemic level, or even to develop a stronger collective voice for dialogue with local authorities, international development agencies, and shareholders. Many DFIs are subsidiaries or affiliates of larger agencies or organisations and, while they largely operate independently, they are still required to align their strategies and objectives with them and have not reached an independent strategic capacity or developed a collective voice to reorganise their relationships with their parent organisations or government shareholders.

Finally, a persisting background criticism of DFIs by CSOs should not be ignored, particularly regarding the financing of large-scale infrastructure and extractive industry projects in countries with low labour law or human rights safeguards, and potential or demonstrated gaps in ESG frameworks and their implementation. This is similar to the criticism heard against development agencies in general (e.g., World Bank) and their limited engagement and influence on national policies.

> ***One of the key strengths is that we know how to do what we do. And having done that for 40 years, 45 years or more for some of us, we have a very good understanding of our markets. But at the same time, we are often very reluctant to innovate and look at things from a different perspective. So, I guess innovation, being more agile, being more nimble in our financing is not necessarily where we excel. So that is certainly a room for improvement. There's definitely a lack of questioning or thinking more critically of what we do and how we could do things a little bit differently.***
> (Interview 9 May 2023)

The glass of the DFI community may therefore be presented as half empty, rather than half full. With their restricted capital, business model and risk appetite, they struggle to match the vast financial needs of the developing world and, although growing in number, size and portfolio, continuing with 'business as usual' arguably risks losing ground and relevance. Compliance with an ever-evolving set of standards and regulations adds complexity to DFI operations, slowing processes and increasing transaction costs, and this complexity is exacerbated for DFIs regulated as banks which can find business capacity limited and operating costs increased. The minimum investment and high interest rates charged by DFIs limits their scope and support to smaller or needy yet potentially impactful projects, and managing foreign exchange risks is troublesome. Finally, while there have been improvements in DFI cooperation and coordination, a collective voice and strategy is still lacking and DFIs remain beholden to their shareholders' individual perspectives and requirements. Table 2 shows key challenges and weaknesses perceived in the professional community.

Table 2. Key DFI challenges and weaknesses perceived in the professional community

THEME	NARRATIVE
Scale	Limited capital and risk appetite constrained by their business models affects DFIs' ability to stimulate significant change and catalyse third-party private investment.
Mobilisation	DFIs find it challenging to attract private investments in high-risk environments and in projects with lower and longer-term financial returns.
Standards compliance	DFIs have to adhere to high standards and multiple regulations, in particular regarding ESG and climate, which can slow processes, increase transaction costs, and deter partners.
Regulatory constraints	DFIs that are regulated as banks are subject to regulations which can constrain their operations and add to their costs.
High interest rates	The interest rates charged by DFIs are often perceived as high, limiting their reach to needy projects. Rates from DFIs are often close to market rates, whereas local players would expect them to be lower.
Local currency	DFIs face challenges in providing local currency funding limiting the scope of their investments, especially in countries facing high currency volatility and transferability and convertibility risk.
Cooperation with local development banks	Cooperation with national public development banks is sometimes considered weak, although it is far from non-existent
Collective voice	DFIs still lack a strong collective voice and strategy due to differing mandates, priorities and operating procedures. Their varied size, scope and geographic focus add to this challenge.

Whether the glass is positively half full, or more troublingly half empty, the bulk of the DFI professional community maintains that it has a balanced and realistic perception of the historical record and understands what is needed to improve in the future. In short, it knows where it has come from and where it is going.

This confidence is reinforced by the vigorous involvement of DFI professionals in a set of strategic and operational debates which reinforce the community's sense of commitment to its own transformation, testifying to its proactivity and determination. The next section analyses these debates, highlighting how they add value, but also how they monopolise the attention of the DFIs and their staff, obscuring important structural questions and impacts, and inhibiting DFI collective action in new directions.

2. Tensions, ambiguities and inhibiting debates

This section adopts a more analytical approach. Continuing to draw on interview material, and seeking to explore and understand the current concerns and ideas of the professional community, it finds that in a changing and increasingly demanding development landscape, a set of four interconnected debates has come to dominate thinking. Although these debates are pertinent and play a vital role in bringing critical issues to the surface, they also lock DFIs into discussions that are difficult – or even impossible – to resolve and restrict their ability and energy to explore the future and think collectively in new ways.

This paper argues that these debates tend to over-focus DFIs' attention on the ways and means to optimise their current operations, rather than opening pathways to explore the future and innovate further. In the language of the Three Box Innovation framework used as a conceptual framework for this paper, DFIs are focused on improving what they do (optimising the present), rather than forgetting the past (letting go of less relevant practices), or preparing for the future (innovating, testing, possibly failing and making adjustments).

Moreover, these four debates are founded in conceptual and practical ambiguities that are inherently entwined with the mandates and operations of most DFIs. The complexities and opposing views that ensue are difficult to escape and limit DFIs' ability to perceive other issues and so respond effectively to change.

Although these thorny debates, which relate to core DFI principles of additionality, risk, mobilisation and impact, are essential and inevitable, they are causing uncertainty and tension that inhibit DFIs' collective ability to generate, validate and deploy new ideas. While DFIs have succeeded to a large degree in helping grow businesses and markets in the developing world, their exploration of new approaches is constrained by the imperatives and manifold possibilities of these debates and the related ambiguities.

Following a brief outline of the dynamics driving rapid changes in the operating environment of DFIs, and a note on the complexities intrinsic to the DFI concept and role, the paper continues to explore and review these debates. Doubtlessly, DFIs are energetically engaged in responding to them but what remains unaddressed is how the associated complexities and ambiguities maintain the uncertainties, uneasiness and tensions that inhibit DFIs' ability to generate, validate and deploy new ideas, and give new direction to collective DFI action.

2.1. A changing environment and a complex mandate

While grant-based ODA remains the most significant component of international aid, over the past decades emphasis on other types of financing such as loans and investments has increased, along with focus on enhanced roles for the private sector and civil society. This would appear to play well to core DFI competencies and responsibilities. However, as the role of private investment and the transformative power and scale of the private sector in achieving the SDGs has attained such prominence (Runde and Milner 2019), the question emerges of whether DFIs can rise to what is doubtlessly a testing – even impossible – challenge. If DFIs are expected to mobilise vast sums of private capital – 'from billions to trillions' – to help close the SDG financing gap, some concern and even 'stage fright' might be expected. In this context, DFIs have come under increasing pressure to materially scale up investment and mobilisation, increase their risk appetite, and create and sustain new markets in the riskiest emerging economies while remaining profitable (Attridge and Novak 2022).

The recent rise of impact investing – investing to generate measurable social and environmental impact alongside a financial return – both validates the DFI model and, in the worst case and in the longer run, existentially threatens the institutions themselves. In the baldest sense, if specialist impact investors can demonstrate greater positive social and environmental impact along with viable financial returns, especially at scale, why should governments seeking maximum efficiency and committed to market competition not entrust them with taxpayers' funds? Increasingly, DFIs are supporting and partnering with impact funds, but the establishment of the private sector 'J.P. Morgan DFI' in January 2020, explicitly to mobilise private finance in support of the SDGs in emerging economies, brings this argument forward and highlights the contrast between hard-headed private investment banking and longer-established government-owned DFIs.

With total assets of $4 trillion, representing 35% of the global DFI portfolio (Xu, Ren et al. 2019), China's five PDBs, primarily the China Development Bank (CDB) and Export-Import Bank of China (Exim), have also radically expanded the idea of what constitutes a DFI. Often characterised as DFIs but with their own unique approach, China's 'policy' banks deploy a 'peculiar' means of development finance – funding projects in developing countries with relatively high interest rate loans – which represents the internationalisation of the finance model that drove China's own recent development (Chen 2020). As Chen suggests, Chinese interventions even in the private sector (not even as public-private partnerships) work closely with local States to enhance the creditworthiness of projects, helping them be financially viable. This 'state-supported, market-based' credit approach offers an alternative option for the developing world and may reshape development finance in ways that current DFIs have barely envisioned. The situation is further complicated by the fact that the Chinese DFIs are widely criticised internationally for weak human rights and sustainability performance.

In addition, across Africa and beyond, a cohort of well-managed local and regional banks are emerging more focused on local development needs, more willing to take on higher risks in financing development projects within their regions, and better focused on sustainable growth and positive development outcomes. As more highly educated and skilled individuals take on leadership roles in government, non-governmental organisations and the private sector, other changes include improved governance and accountability, enhanced decision-making and negotiating abilities, greater youth empowerment and inclusion, and increased generation of and reliance on homegrown solutions tailored to local needs. Beyond these positive developments, the world beyond the DFI community must consider the pressing imperatives of digitalisation, the climate emergency, and bringing the SDGs back on track.

Aside from these changes in the operating environment, the DFI mission and mandate present some intrinsic ambiguities and contradictions. DFIs are tasked with achieving developmental impact while also ensuring the financial sustainability of their investments, and finding the right balance between the two can be challenging. Investments that have a high developmental impact may not always be the most profitable, and pursuing profitability may lead to neglecting innovations, sectors or regions where impact would be higher but financial returns lower. However they attempt to resolve these issues, DFIs face tensions and potential criticism.

The DFIs owned by governments can also face tensions between their global development objectives and the foreign policy interests of their shareholders. While DFIs generally aim to operate based on development impact considerations, their strategies can be influenced by the political, economic or diplomatic priorities of their owners to ensure consistency with national development aid policy. Additionally, while many DFIs are ultimately publicly owned and have a public service mandate, their operations are largely oriented towards the private sector, and they use market-based approaches to achieve their goals. This can lead to tensions between the public sector 'civil service' mindset of the owners and the more entrepreneurial 'deal hunting' attitude required by investment banking. If the former dominates, too much energy may be expended in ensuring coordination with public sector policies, for instance, and if the latter comes too much to the fore, commercial considerations might be prioritised over development objectives.

For the most part, DFIs are well experienced in managing these long-standing tensions. Nevertheless, as the fundamentals of international development cooperation transform, rocked most recently by COVID-19, increasing violent conflict and rising geopolitical tensions, and as pressures increase on DFIs to respond, adapt and deliver, the ambiguities and tensions inherent in a set of fundamental principles – additionality, risk, mobilisation and impact – divert and distract them, inhibiting innovation and forward thinking.

2.2. The imperatives of additionality

Additionality is a fundamental principle for DFIs. Replacing the logic of subsidiarity, this refers to the unique contribution that DFIs bring to a project or investment, justifying interventions and ensuring that DFIs do not displace or substitute private sector activities, but catalyse and complement them, and deliver further impact through their investments. Essentially, DFIs should add value that is not currently present in the market. Aside from development impact, additionality takes two main forms: financial additionality and non-financial (or value) additionality (OECD 2018). The former refers to DFIs providing services additional to the financial market where the private sector is unwilling or unable to do so. This could be due to factors such as high perceived risk, long payback periods, or large capital requirements. The latter involves DFIs offering other types of support, such as technical assistance, capacity-building, consulting and business services, policy advocacy, or setting higher standards in areas such as environmental impact, social inclusion and corporate governance that can positively influence businesses and investors.

However, it is rarely clear what evidence is needed to prove additionality (Carter, Van de Sijpe et al. 2019) and interview respondents were imprecise on the matter. One said: "We measure the impact of the project. Whether it has a green component, an inclusion component or gender component. So, we look at the additionality as sort of the impact of the project."[4] Another said: "So, it tends to be the case that if you're building a road, for example, because it's developmental a DFI would claim, oh, it's additional. No, it's not. It's developmental. It's not additional, the market can handle it."[5] The respondent continued: "When a DFI is involved, it should be clear about the positive externality that's going to be achieved. When you're using official money, I think there has to be some sense of additionality. I think that the DFIs and the multilaterals for that matter tend towards being vague or too extensive, whether you want to put a negative or positive spin on it, in terms of what is the additionality."

> ***It's possible to fund on a sustainable basis a project in the South without any grant etc. That was basically the idea and in 2015 there was this triggering event [the adoption of the SDGs] and now basically we are at the stage where the question is not so much as to whether it's possible to invest in the South and have a decent return, but what actually is the additionality of DFIs? And we are challenged in this area.*** (Interview 2 May 2023)

4 Interview 11 May 2023

5 Interview 2 May 2023

One relatively clear aspect of financial additionality is DFIs investing where private investors will not due to risk concerns, or 'de-risking' private investors by providing a guarantee or some other instrument designed to make the investment more attractive. However, even this approach creates tensions in the requirement for many DFIs to be financially sustainable and successfully balance risk and return. One respondent said: "It's okay to fund a project which needs a bit of grant in order to achieve additional impact. But at the end of the day, the DFI economic model needs a project which is somehow self-sustainable from a financial standpoint. And the expectation from other decision makers, policy makers, etc. is that we should go a bit beyond in terms of risk, even if those projects might not be financially sustainable. So, that's one example of a situation where there is tension."[6]

Blended finance – using public or philanthropic capital often provided on concessional terms to buffer risks and attract private investment – rests critically on the ability to maximise additionality, both in terms of the financial resources mobilised and the developmental impact created, but this too hinges on the risk appetite of the DFI involved.[7] As one respondent explained: "In life, it means accepting risk and not hiding behind the private sector. The full concept of blended finance is that we're trying to make risk more palatable for everyone. If the public sector actors are more risk-averse than the private sector ones, then that's not going to work. That culture change really needs to happen. DFIs need to be able to tell themselves, 'Why am I additional on this particular transaction?' They should not assume that they exist by their definition. That doesn't last long."[8]

Another criticism exists that DFIs might be operating, even without such an intention, as an organised club of rather cautious organisations, presenting a show of 'competition' among themselves that might resemble oligopolistic behaviour. This analysis suggests that DFIs tend to jump onto and share among themselves the rather rare good opportunities that would have been financed without their intervention. One respondent was explicit: "It is this principle of additionality which is supposed to lead the intervention of DFIs in emerging countries but sometimes it is challenged because the DFI's board is asking for some profitability. And we see some DFIs switching from this additionality to acting as a kind of strong competitor in front of the commercial banks, and this can damage the relationship with the commercial banks."[9]

6 Interview 2 May 2023

7 The OECD defines blended finance as 'the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries. It attracts commercial capital towards projects that contribute to sustainable development, while providing financial returns to investors. This innovative approach helps enlarge the total amount of resources available to developing countries, complementing their own investments and ODA inflows to fill their SDG financing gap, and support the implementation of the Paris Agreement.' (Source: https://www.oecd.org/dac/financing-sustainable-development/blended-finance-principles/)

8 Interview 5 May 2023

9 Interview 5 May 2023

Others suggest that DFIs are failing in their mission to maintain their additionality as they often engage with the same client repeatedly, even if setting up long-term partnerships with some clients is also a powerful way to help those clients succeed in their transition path. One respondent said: “Once you’ve worked with a client a few times, what’s your additionality?”[10] In the same tone, another respondent suggested that the role of DFIs is being surpassed: “One objective is finding and accepting deals that are currently being rejected because of a risk concern. When it comes to the provision of capital to intermediaries, such as local country banks, we could have them work directly, not with bilateral DFIs, but with some of the big philanthropic investors, mission investors, social finance providers.”[11]

Increasingly, the additional value of DFI engagement is being seen in non-financial terms. One respondent said: “I think we need to be more creative about how to divorce the financing coming to companies from the additional technical support that’s needed because it shouldn’t always be a condition of the financing. Sometimes it should be something that’s being done anyway and then financing can help them grow and scale and meet the things that the DFIs require.”[12] Re-iterating this point, another respondent said: “At the end of the day, a DFI should be in partnership with businesses, as a stable investor, not running away, bringing constant value to companies, which in turn requires consultancy and business services. For instance, we can provide legal support to family businesses on how to integrate new expertise on their board without loosing family control.”[13]

> ***When using official money, there should be a sense of additionality, and the focus should be on project preparation and promoting good policies and projects rather than simply financing. DFIs should focus on the small and the poor, projects with clear additionality, and uncertainties rather than risks. Furthermore, they should prioritise talent and expertise in project preparation, design, and non-financial aspects that separate technical work from financing activities.***
> (Interview 2 May 2023)

Another respondent suggested that DFIs have a more valuable role to play in delivering additionality at the national policy level: “So what I’m suggesting is that DFIs in the public sector should be using their muscle as government-owned entities to promote good policies and good projects in these countries more than financing.”[14]

[10] Interview 16 May 2023
[11] Interview 26 April 2023
[12] Interview 3 May 2023
[13] Interview 12 May 2023
[14] Interview 2 May 2023

This brings the local experience and broader knowledge and capabilities of DFIs to the fore. For DFIs to operate at this sort of business consulting or policy advisory level, a skill set is required that goes beyond finance and investment, as well as a significant presence on the ground. Assessing additional impact, which is often long-term and complex, not least because there can never be a certain counterfactual scenario in which the DFI would have not intervened or even been present. This concern also calls for a significant continuing presence. Aside from 'proving' that an investment would not have occurred without DFI involvement, clear non-financial additionality can be hard to quantify, especially if it involves meeting and promoting high ESG standards.

The complexities and debates around additionality and how to deliver and measure it are so intense, one respondent went to extreme lengths to illustrate the value of the DFI model: "You know, I think that one proof of additionality is that compared to private sector finance, we [as DFIs] are quite painful to work with. By this I mean that in terms of transaction costs, in terms of what we are asking, etc. it takes time to work with us because we ask things on the KPIs, the climate aspect, on many things. And so, on that front, it gives us some indication that if a counterparty wants to work with us, it's because we are providing financing which the local market cannot provide."[15]

One escape from the debates around additionality could be to accept that it is an inherently vague concept. Within the boundaries of good sense, and empirical justification, the richness of the concept is better embraced than fought against. A less reductive approach would open up new perspectives on development objectives and how to attain them. While financial additionality might usefully be subject to a more demanding set of criteria and required from particular types of operations (even possibly to the extent of accepting that one or more specific transactions or investments might provide no additionality), if looser criteria were accepted for non-financial additionality, so that it need not be so quantitatively and evidentially 'proved', and if longer timescales were accepted for softer non-financial additionality impacts to emerge (e.g., professional skills development), more valuable and innovative forms of additionality could result.

However, as things stand, the ambiguities, debates and tensions over additionality do little to help DFIs explore and move into fresh territory. With the concept of additionality so disputed, the DFIs' commercial imagination and energy for innovation is significantly consumed. A similar process occurs with the thorny issue of risk, which is discussed next.

15 Interview 2 May 2023

2.3. Optimising risk management

DFIs experience fundamental tensions regarding risk. The most basic concerns how to measure the financial risks taken in investments. Then, even with that conundrum cleared, another emerges in the shape of tensions associated with the level of risk appropriate for a DFI. Doubtlessly, DFIs can de-risk projects and open up opportunities for other investors by accepting the possibility of losses and going deeper into investable opportunities, but with risk taking multiple forms for DFIs, including significant reputational risks involving often politically sensitive shareholders, further complexities, ambiguities and tensions emerge that consume energy and attention, and inhibit exploration and creative innovation.

> ***Equity gets to this question of risk. If you have a greater appetite for risk, you can get more development impact, and I think there is some evidence to suggest that. Equity is the riskiest part of the capital structure. So, you can draw some conclusions about a DFI's appetite for risk just by looking at a couple of things: one, their equity weighting; two, their weighting in fragile states, really difficult countries, as opposed to middle-income countries. I think the perception is that some DFIs are quite constrained from a risk perspective.*** (Interview 28 April 2023)

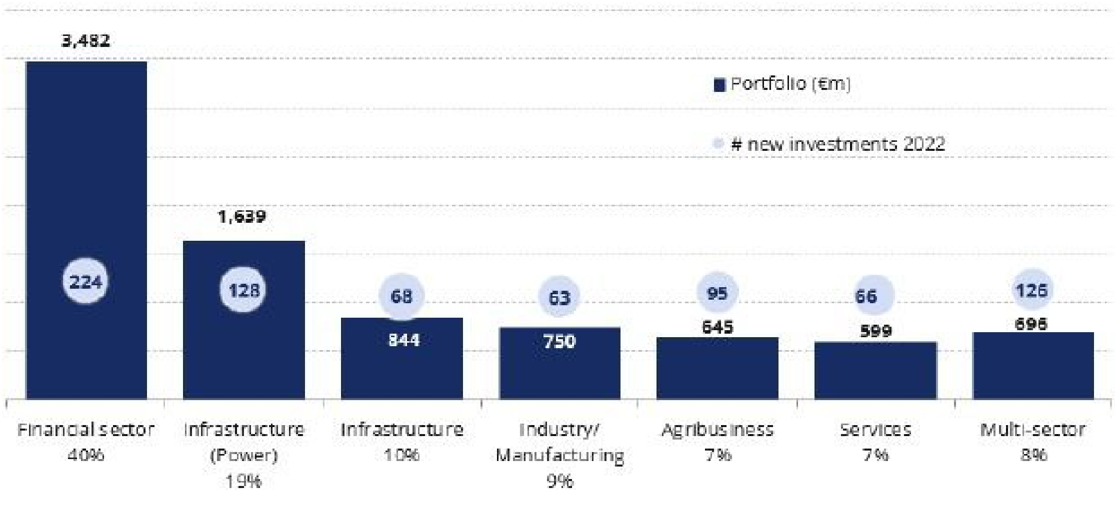
DFIs face a range of risks general to the financial industry – credit risk, market risk, liquidity risk and operational risk, for example – and more specifically related to their development oriented mandate. Charged with operating in places that often experience poor governance and unstable politics, country risk is particularly relevant, as is currency and exchange rate risk given the international scope of DFI operations. Bound by and publicly promoting ESG and other standards, reputational risk is also ever-present as even the most careful and informed investments may result in negative impacts.

Likewise, managing legal and regulatory risk is complex as DFIs need to comply with laws and regulations both in their home countries and in the countries where they operate. Similar pressures apply to other international institutional investors, but DFIs – charged with supporting higher-risk investments and early-stage projects that are less attractive to private capital – find themselves more subject to the complexities, ambiguities and debates that accompany risk, and its close relation uncertainty.

> ***The key for me in an emerging country is not to take risks or not to take risks, but it is to be able to assess the risk correctly. Even if the country is risky, you can take a risk by assessing it correctly. Or you can take a risk by managing it with all the banks, with DFIs, with guarantors, so in those countries which are risky by nature, you have DFIs taking good risk, and sometimes additional risk to the commercial banks.***
> (Interview 5 May 2023)

One thing, however, is certain. Multiple calls exist, from both DFI insiders and their commercial partners, for DFIs to take on more risk, to adopt a higher risk appetite and accept the possibility of losses. One respondent, echoing the sentiments of many, said: "DFIs are increasingly selective about where they invest, often choosing markets and companies that offer lower risk, thus protecting their capital. But this creates expectations and restrictions that can inhibit progress and risk-taking needed for substantial developmental impact."[16] A DFI client said: "They [the DFIs] told us that it was possible for them to invest in sectors they are comfortable with, especially the banking sector, a sector with less risk. But when it comes to a sector perceived as high-risk such as agriculture and forestry, we understood it was not possible."[17]

Figure 3. Final beneficiary of new projects in 2022



Data source: EDFI 2023

At the heart of this issue is the need for DFIs to balance not just risk and return but also to consider impact. One respondent explained: "You talk to investors, banking people and so on, and they say there's a lot of risk, so I will ask for a superior return. And that's where there is a problem because we accept that there is the risk, there is a potential of huge impact, but we cannot do a higher

16 Interview 3 May 2023
17 Interview 27 April 2023

return, especially when we work with the poorest of the poorest. So that's where the question is for me, and it is unsolved today."[18] Higher risk for a DFI should result in higher development impact and higher return for the client business involved, but in many environments where DFIs operate, this equation does not operate.

> ***I think one of the areas that, I suppose, one would question is 'Have we done enough, in terms of risk-taking?' When you look at the overall returns of the DFI community, you'd have to say that actually, they're not making large amounts of money. You would think that there is a trade-off, but in our markets, higher risk doesn't necessarily translate into higher expected return, as it would do in more developed markets. So, if you take more risk it means you end up compromising your overall sustainability. I think that's the trade-off we're making. So, risk is one issue.***
> (Interview 28 April 2023)

Nevertheless, much of the academic literature suggests that more risk could be easily taken by major DFIs. A 2018 analysis of IFC's portfolio suggested that it was avoiding risky investments and not focusing on the places where it could make the most difference (Kenny and Ramachandran 2018). Another more recent broader study, which includes several European bilateral DFIs, argues that – to varying degrees – all institutions could potentially increase their risk appetite and their levels of high-risk investment without adversely affecting the business model or requiring new funding or increased donor concessional finance (Attridge and Novak 2022).

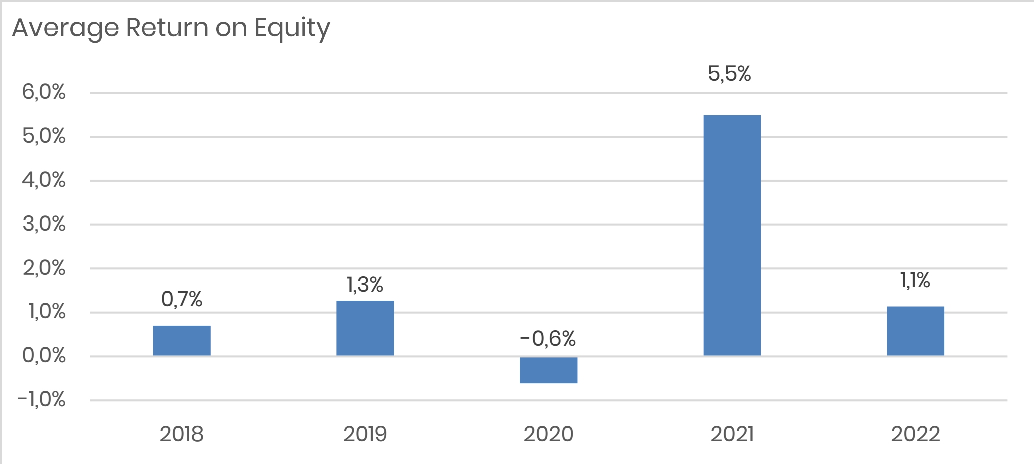
In response, DFI insiders observe that with levels of non-performing loans relatively high, and profits relatively low, from a financial standpoint at least, DFIs are taking sufficient risk. In fact, DFI net profits vary substantially from year to year and often are negative. One respondent said: "When you look at the financial model, we are sustainable in the way that we respect all the financial ratios, we preserve our capital etc., but we cannot say that we are generating a lot of profit. So, from that angle, it's difficult to say that we don't take enough risk globally."[19]

A recent study by Jacouton and Marodon (2023) supports this contention. As shown in Figure 2 below, an analysis of the financial outcomes of 22 major DFIs from 2018 to 2022 reveals an average return on equity (ROE) of 1.5%. Austria's OeEb topped the list with 11%, while the multilateral Islamic Corporation for the Development of the Private Sector (ICD) and Finland's Finnfund trailed with -9% and -3% respectively.

[18] Interview 27 April 2023

[19] Interview 2 May 2023

Figure 4. Average return on equity per year of 22 leading DFIs (Jacouton and Marodon 2023)



> ***What I keep saying to my shareholders and other stakeholders is that the financial performance will stay very volatile because we have a very narrow economic model. I know this is the same for other bilateral DFIs. The space is too narrow, so when we have one or two bad results in one country it generates a bad financial performance.*** (Interview 20 April 2023)

Most DFIs do not appear to have a business model that allows them to take on more risk, unless they decide to adjust their tariffs or reduce their costs, which is not straightforward. However, some notable exceptions exist. Spain's COFIDES, Austria's OeEb and the Luxembourg-based European Investment Fund regularly post higher returns. Essentially, DFI ROE is highly volatile, linked to macroeconomic conditions. The repercussions of the COVID-19 pandemic caused a significant downturn, for example, with 13 out of the 21 DFIs posting negative net incomes in 2020. However, a strong financial performance was observed in the subsequent year, with an average ROE of 9%. DFI performance may also fluctuate depending on the overall financial strength if the institution, or the combination of instruments (e.g., debt, insurance, equity, guarantees) and the risks they entail. The correlation coefficient between total assets and ROE stands at 0.08, suggesting no substantial connection between a DFI's total assets and its financial output. Likewise, no notable correlation exists between the equity to assets ratio and ROE.

> ***There's a price for every risk from the market. So, you don't need to de-risk everything. In fact, sometimes you like the risk because it's got an attractive premium on it. What you do want to de-risk are the risks that are unknowable. Call it the difference between uncertainty and risk. Uncertainty is endemic in the emerging markets and developing countries. Risks can be known. If they can be isolated, they can be priced. Rather than so-called de-risk, what you want to do is get rid of as much uncertainty as possible.*** (Interview 2 May 2023)

The tensions associated with the need to find the right balance between financial sustainability and developmental impact troubles many DFIs. One respondent explained: "The problem today, and I've seen that at every level, is that DFI people know that they are in risky business, but in their minds, they believe that they are not allowed to lose any money. To take risk you must accept mentally that you might lose money. We really have to switch the operating system. We have to make sure that people understand that they need to go fast, be effective and they need to take risk."[20]

In comparison, commercial banks, focused on a more straightforward risk-return trade-off where profitability is paramount and higher levels of risk are accompanied by the potential for higher returns, are untroubled by this dynamic. By their nature, DFIs are required to deliver development impact, complicating the risk-return equation and confusing the fundamentals of investment banking. Further complexities arrive when the concept of additionality is included in that a DFI investment may be made at higher risk in order to attract other private investors.

The attitudes of government shareholders and the fact that DFIs are accountable for taxpayers' money adds another layer of complexity. The most delicate of balancing acts is required in order for DFIs to make enough – but not too much – profit to be sustainable but also to match their risk profile to shareholder expectations and the related imperatives of domestic politics. One respondent explained the drawbacks of the relationship: "So we came up with what I still believe was a wonderful project, but then there were questions in parliament and my chairperson knocked at my door saying please stop the project – I'm not going to go to parliament again to defend what you are doing."[21]

The DFIs, then, are faced with not only balancing their risk as financial institutions but also the risks and political concerns of their shareholders. By all accounts, public sector representatives are overly focused on the downsides of investment risks rather than seeing them as opportunities. Public authorities rarely want their DFI to become a financial burden on the state budget and generally consider that their DFI should 'do good at little or no cost'. This is arguably a misunderstanding of the primary mission of a DFI, which is to unlock private sector development in partner countries, and this may involve costs that the public shareholders find difficult to accept. This issue partly emerges from the original nearly 50-year-old mandate of DFIs which was to demonstrate that profits can be made by financing the private sector in emerging and developing countries. With this attribute proven, at least partially, DFIs should move to the next step with the support of their public shareholders.

[20] Interview 22 May 2023

[21] Interview 28 April 2023

However, calls abound for a clearer long-term mandate. One respondent said: "So, I think one of the things that I would say is necessary is that shareholder governments need to start looking at this as a long-term investment, not as just something where they want to see their money back in a few years' time, because that's not always going to happen. But, if you can look at this as a long-term investment, then I think you can start getting the risk appetite right."[22]

> ***All the DFIs have been created as special institutions to take risks that no other is willing to take. This is the development mandate. But more and more DFIs are being regulated like commercial banks and that puts us under severe pressure because commercial banks are being regulated in a way to take less risk.***
> (Interview 28 April 2023)

Setting aside the fact that some DFIs are subject to banking regulations and technically limited in the financial risk they can take on, two main drivers for this confusion are evident. The first relates to how DFIs can measure financial risk, and the second concerns how the multiple risks DFI face should be identified, prioritised and balanced. Regarding measuring financial risk, few metrics other than non-performing loans (which can suggest either successful risk-taking or poor risk management) and overall profitability (which is subject to an even wider range of factors) are available as indicators, and related discussions quickly move to the partial solution of assessing the nature of the DFI's clients as a possible proxy, or the internal risk rating of current live projects. However, proponents of all approaches also accept their limitations.

Table 3 shows various proxy measurements of risk taken by DFIs. It indicates how difficult risk is to assess. Many approaches are open to different interpretations and generate additional complexity and debate.

Table 3. Some proxy measurements of risks taken by bilateral DFIs

DFI	Rate of non-performing loan (2022)	Net profitability (2022)	Risk rating of project portfolio (A to E...) normalised on a 1 to 5 scale	Proportion of activity in lower-income countries (%)
BII				
BIO				
COFIDES				
DEG				
DFC				
FMO				
IFU				
Norfund				
OeEB				
Proparco				

22 Interview 26 April 2023

Yet another dimension emerges in calls for DFIs to address the multiple and interrelated political, regulatory and policy risks that the private sector cannot calibrate, with the aim of reducing wider political uncertainties rather than reducing the risk on any specific individual project. As one respondent said: "The money is important, but maybe the key point is about getting some political protection because when you talk about risk, we're only private players and we might not have the leverage, the power to put pressure on government. But DFIs, as arms potentially representing a financing government, have got other means to give that potential protection."[23] This capacity, which is highly valued by other private investors on risky projects, expands the potential role and complexity of DFI engagement in risk management even further to include responsibility for influencing a country's overall macroeconomic stability.

With the good news including the facts that commercial banks and impact funds are increasingly financing projects traditionally handled by DFIs, and that many countries are developing more robust financial systems capable of financing projects previously deemed too risky, DFIs are increasingly being asked to operate in riskier areas that fall outside their comfort zone. This creates a sense of vulnerability as well as a set of questions that go to the heart of the DFI mandate.

> ***The reality is they're DFIs; they're development finance institutions. They are meant to take risk; they are designed to take risk, but they hate taking risk. So, we find ourselves sitting in between the DFIs who don't want to take risks and the companies who are risky and need capital. We're often like dragging them saying, 'Please make a bet on this this kind of company, this industry, or put your money to work here because they desperately need your capital'. Often the answer is: 'It's too risky, we can't do it, we can't do it without a very fat layer of guarantees and philanthropic capital to take the risk'. So, we have to build that in order to attract them and then we have to put the senior capital on top so that they can say that they've mobilised commercial capital.*** (Interview 3 May 2023)

In response, many DFIs make it clear that they actually have two mandates. One is to operate in emerging countries, where they can be profitable and provide additionality including in relation to impacts and standards, and mobilising private capital. The other is to operate in poor or dysfunctional 'frontier' environments where risks will be higher, profitability lower than expected in such environments (since higher risks should in theory come with higher profits), and the ability to mobilise other investors reduced. This, in turn, opens up a debate on the extent to which this 'dual mandate' vision should be embraced, or whether it constitutes a deviation.

[23] Interview 27 April 2023

Etymologically a conflation of danger, possible gain and exploration, the concept of risk causes complexity and confusion in many domains where it is central (e.g., public health, environmental safety). Nevertheless, DFIs have little option but to confront it in the context of their work in investment management, financial markets and insurance. One possible way to clarify the consequent debates would be to make a clearer distinction between mathematical work on probability, which defines risk as the probability of harm (i.e., financial loss, reputational damage), and less technocratic approaches which place more emphasis on possible gain and exploration. An ever-increasing number of technologies and instruments are emerging to address the former, including blockchain to enhance transparency and reduce fraud, for example, social impact bonds to incentivise risk-sharing with private investors while ensuring developmental impact, and retroactive development bonds that offer higher returns if projects exceed their developmental goals but reduce returns if they underperform. A probabilistic rules-based approach to financial risk is not challenging to design, implement and refine for a specific project or an entire organisation.

More stochastic risks, however, especially societal risks, do not bear so well to rigorously quantitative approaches. In this case, broad-based participation involving DFI staff, external experts, shareholders, and partner entrepreneurs and local communities, for example, could draw on multiple perspectives to gather collective intelligence to forecast and assess potential risks, and indeed related benefits. Transparent open-source risk models could even be developed to encourage peer review, improve risk analysis and ensure buy-in from all parties, including DFI shareholders.

> ***Believe it or not, sometimes when you take a risk, the risk happens, it materialises. The big issue is that people are saying, in principle, 'I'm fine that we are taking risk.' Then when the risk materialises, 'Oh my God, why did we do that?' and then it's frozen for six months. So, people are schizophrenic.*** (Interview 22 May 2023)

Implementing such an approach would probably exceed current DFI capacities and competences but it would move thinking and discussions forward. As things stand, the debates, doubts and uncertainties that surround risk – although unavoidable and not without value – further inhibit DFIs' appetite for exploration and their ability to consider the future and innovate. In the here-and-now reality of the hectic present, the complexities of risk are demanding enough. The same stands true for the complexities associated with mobilisation, which is discussed next.

2.4. Mandates for mobilisation

The concept and practicalities of mobilisation – DFIs catalysing or mobilising sources of finance beyond their own direct investments to support a project or investment – is also a source of tension and debate, consuming creative energy and limiting appetite for exploration. The stakes have become even higher given the anticipation that DFIs will harness substantial private sector investment to support the SDGs and Paris Agreement climate targets.

One root of the tension lies in the imprecision of the term. One respondent was explicit: "There is a kind of misunderstanding when we talk about mobilisation of private capital, this famous billions to trillions equation. I think that we need to be very clear on what we mean by mobilisation. In many forums, round tables, whatever, where we talk about mobilisation, each one has their own definition of mobilisation. So, I think that's one thing where we need to be clear. What are we talking about?"[24]

Mobilisation may be said to be 'direct', when funds are invested alongside the DFI's own commitment and under the same investment terms (e.g., through co-financing arrangements or syndicated loans). It may also be 'indirect' when funds are raised as a result of a DFI's involvement and invested under different terms or at different times (e.g., as a result of guarantees or insurance mechanisms). As the concept tries to capture the 'extra investment that would not have taken place without the involvement of the DFI', any calculations or empirical demonstrations become challenging, especially in the absence of any counterfactual scenario. Similarly, when 'direct mobilisation' is claimed, for instance in the context of co-financing, Various partners may claim they have 'mobilised' one another leading to double counting.

> ***There is a realisation that the role of ODA and DFIs is becoming smaller and smaller relative to other financial options. The idea that other private money must be mobilised is getting more traction. There is perhaps some sort of ideological agenda behind that, the idea that we have to leverage on public funds that go to developing countries. Questions on leverage are really strong. Is the money all going for sustainability? In the world of ODA and DFIs there is a realisation that other sources of funding are more and more available.*** (Interview 14 April 2023)

[24] Interview 2 May 2023

A fundamental complexity relates to the difficulty of measuring the impact of mobilisation efforts. Although two common accounting standards exist for mobilisation – one from OECD and one from the World Bank/ IFC – it is significant that no standard measure exists to measure and report on mobilisation, direct or indirect. The literature emphasises the difficulties of this sort of accounting, and the lack of universally accepted definitions (e.g., Benn, Sangaré et al. 2017). This situation provides little support to DFIs struggling with the imperatives of mobilisation.

Doubtlessly, DFIs have a vital role to play in attracting private capital to supplement their own investments but involving private sector investors presents a number of challenges. Private investors generally seek higher returns to compensate for higher risks, and many development projects may not provide the financial returns that private investors expect. As one respondent put it: "There is a trade-off. The riskier the project, the less likely you are to find commercial capital to go alongside. It's just a fact of life."[25] Development projects also often have long gestation periods before they start generating returns and limited exit options, such as selling to other investors or through public markets, make it harder for investors to realise returns and may discourage them.

DFIs also report a scarcity of investment-ready projects. In the most challenging markets, with the least developed economies, viable investment opportunities may be in short supply without even considering the requirement to conduct the feasibility studies, risk assessments and ESG impact assessments necessary to present and structure the project for investors. One respondent explained: "We all know that in the DFI world the issue is not the lack of funding, it's the lack of bankable projects. So, if those projects are not bankable for us, there's no hope that they will be bankable for private capital."[26]

In addition, many developing countries lack a diverse range of financial intermediaries, such as banks, investment funds and pension funds, which can be mobilised to channel funds towards investments. This makes it difficult for DFIs to identify local partners for their mobilisation efforts. Capital markets may also be underdeveloped, with limited liquidity, a small number of listed companies, and limited opportunities for diversification, again restricting options for DFIs.

In response to these challenges, DFIs have developed a range of approaches towards mobilisation.

[25] Interview 28 April 2023

[26] Interview 2 May 2023

Guarantees are reported as reliable mechanisms. One respondent said: “There’s lots of different types of guarantees, and having the right guarantee mechanisms in place can really help to bring in private sector finance.”[27] ‘De-risking’ has consequently become an important concern of DFIs. One understanding of this term is as a guarantee from a government or government-like entity that allows DFIs to take on more risk. Another is that it refers to the process whereby DFIs themselves de-risk other private investors by taking a higher part of risk. Many respondents applauded this approach. One said: “This is quite powerful I think to attract new investors. The idea is that the perception of risk could change because those financial companies are not used to that kind of risk. So, if we start like this, they can become more used to that risk, they can experiment with that risk and maybe it will contribute to change perceptions.”[28]

This approach, however, cannot provide a blank cheque to private investors. A respondent observed: “Sometimes funds say, ‘oh yes, I want to finance the SDGs’ but then the way they want to finance the SDGs is for the DFI to take 100 percent of the risk. If you really want to mobilise the private sector, everybody has to do their part. So, it cannot just be like 100 percent de-risking of the financial system by DFIs. We need to do more, we need to try to find the right way to be able to mobilise at scale, and right now we’re not there yet. We have a lot of pilots, we have a lot of initiatives, everybody’s speaking about it, everybody’s trying to do it, but we are not there yet.”[29]

> ***To me blended finance should really be about getting things done that wouldn’t otherwise get done and certainly mobilising investors that wouldn’t otherwise be there. But a lot of the time it just seems to be providing a little bit of subsidy to people who really don’t need it. I’m definitely a supporter of blended finance, but I’m not in the camp that this is the whole solution to all the challenges we have in development and climate finance at the moment. It’s harder than that.*** (Interview 28 April 2023)

Whatever the approach or combination of approaches adopted, another fundamental complexity is linked to the undesirable biases that they can contain. A respondent explained: “The thing about blended finance is that too much of its success is driven by mobilisation leverage ratios. So, if I put in a dollar of concessionary finance, I gauge my success by how many dollars come alongside me. Like if I bring twenty dollars alongside me it is better than ten. But if that’s the success metric you use, inevitably it pushes you towards those transactions that are closest to commercial. You see that happening. If you push to being close to commercial, you end up doing a lot of transactions where actually the blend, the concessionality, is not really necessary.”[30]

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[27] Interview 26 April 2023

[28] Interview 20 April 2023

[29] Interview 11 May 2023

[30] Interview 28 April 2023

Again, a tension emerges as to the mandate and the means. Nevertheless, it is generally accepted that DFIs can indeed be catalytic in mobilising third-party investment. For instance, a DFI commitment to first closing can instigate momentum for later rounds of financing. Likewise, a DFI's willingness to be an early funder also often helps draw in private sector investors, who are reassured by the DFI's presence and commitment.

The more intangible non-financial aspects of mobilisation such as advocacy towards both the private sector and public authorities are less discussed. As one respondent suggested: "In a big sense, there is a problem of perception by the private sector. I think for pension funds and life insurance companies investing overseas, it is very good business in the very long run. The work needed to get them there is very comprehensive and very long-term, and it needs to be carried out by DFIs as part of their support packages."[31] Doubtlessly, DFIs could play a larger advocacy role in terms of promoting private investment in developing countries, but such a move only makes the concept of mobilisation broader and more open to dispute and debate. Similarly, on the public authority side, promoting macro-environments that encourage alignment between private investment and development goals is also a potentially valuable approach. A respondent suggested: "It's about making sure that the conditions are right for private sector finance. It's not just about guarantees, it's about making sure the policy environment is right, the regulatory environment is right, the legal system is right, all of those things that private sector investors need to have confidence in."[32] For DFIs, this indicates a need to move the discussion beyond the private sector and work with public sector development banks and other public authorities to target the bottlenecks in unlocking private investments. Being at the junction of both private and public sectors represents a significant shift for DFIs both in terms of mandate and business model.

Beyond that, some respondents are more critical, pointing particularly to DFI staff and organisational incentives. One said: "I think one necessity is to clarify DFIs' mandate because some of them are not really sure what their mandate is. With regards to mobilising the private sector, which is my focus, they really should have key performance indicators for their bonuses, for their board report for the year. In terms of how much they've actually mobilised, they don't have these indicators today. Most of them have indicators about how much they deploy, but they don't necessarily have the right incentives and measurements in terms of what they're achieving."[33] However, others point out that this is less and less the case and that mobilisation is increasingly

[31] Interview 28 April 2023
[32] Interview 26 April 2023
[33] Interview 5 May 2023

an explicit objective for many DFIs, even if they are not committed to individual performance monitoring.

> ***I don't think we've been as effective in mobilising particularly commercial capital, as we would hope to be. I also think that's a very complex subject, since we work in very difficult markets. Because we're ODA-funded, under the ODA rules we're required to be additional. And there's a significant trade off between additionality and mobilisation.*** (Interview 28 April 2023)

Another respondent pointed to deeper issues, including a lack of trust and connections between private and public sectors in many countries that hinder the engagement of the private sector and the concept of mobilisation generally: "I'm fine with having a clear public sector and a clear private sector and a clear willingness to work together. Where it starts to be difficult is when the public sector says, 'I have my vision and I don't trust the private sector because these guys are just interested in my money, or whatever.' Or when the private sector says 'The public sectors are bureaucrats. They don't understand anything. I don't want to work with them.' That's what we see today. There is disconnect and distrust between both parties and it goes both ways."[34]

The debates over mobilisation are therefore central to the relationship between public and private money in financing development, and the practical and cultural divides between the two. However, yet again, DFIs find themselves enmeshed in a set of unavoidable and vital but stubborn questions.

One conceptually simple, but no doubt politically and operationally complex solution, to the issue of measuring mobilisation would be for the DFI community, including shareholders and investment partners, to agree on a set of common definitions and standards. Here, the OECD has significantly prepared the ground in its development of an international standard for measuring the volume of private finance mobilised towards the SDGs.[35] This has been developed in partnership with multilateral and bilateral DFIs with the aim of ensuring data collection using instrument-specific methodologies. While efforts to capture the separate mobilisation impact of technical assistance activities are ongoing, determined, collective and continuing support and participation by DFIs in agreeing a set of common definitions and standards would diminish the frequency and intensity of debate, enhance transparency, and open up space for new thinking.

[34] Interview 22 May 2023

[35] For more information see: https://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/mobilisation.htm.

2.5. The intricacies of impact

DFIs differentiate themselves as investors by having objectives that go beyond financial returns, prioritising long-term impact and addressing issues such as climate change, decent jobs and diversity. This throws DFIs squarely into one of the most complex and contested topics of international development: how to measure impact. This creates further ambiguity, uncertainties and tensions which again limit DFIs' ability to explore and innovate for the future. Even if the intricacies of empirically assessing additionality and mobilisation are set aside, debates regarding how DFIs can reliably measure the development performance of their strategies and activities distract them from creatively and effectively responding to change and preparing for the future.

> ***Overall, taking on more risk requires a balance between managing risk and achieving development impact. It's important for DFIs to recognise the potential benefits of taking on more risk in order to achieve greater impact and work towards implementing strategies that allow for more risk while still maintaining responsible management.***
> (Interview 26 April 2023)

Measuring impact and quantifying the resulting benefits is recognised as challenging in international development (Epstein and Buhovac 2014). Determining the success of climate change adaptation and mitigation efforts is considered even more so, especially considering the timescales involved (Morecroft, Duffield et al. 2019). In many developing countries, reliable and accurate data are lacking and collecting it can be logistically challenging and expensive. Proving causality or directly attributing outcomes to specific interventions is often conceptually and practically impossible, especially if the objective is long-term change, where the full impact may not be evident for decades. In addition, some aspects of development (e.g., well-being or happiness) are inherently difficult to quantify, and even when more tangible measures like income levels or employment rates are used, differences often exist in how data are collected and interpreted. Projects can also have negative or unintended spill-over effects that escape assessment.

The DFIs and their investment partners are alert to these challenges and many judge that progress is being made. One respondent said: "The financial part is easy to measure and understand. Beyond that, I think we, as a group, have gotten better at measuring the development impact. We've moved from just having a strong focus on 'Don't do any harm' and strong ESG standards to really try to focus on intentional impact. And we have various different methodologies that we've developed for that. So, I think we've done well on those areas."[36] Another said: "My institution, like many others, tracks direct jobs created or maintained by our investments, but we are also part of a joint initiative, which is called the Joint Impact Model. This is a mechanism

[36] Interview 28 April 2023

based on research and the use of proxies to define the indirect development impact of development finance investments. The indications there are really impressive. We've been extremely successful, especially in this area."[37]

The importance of having a clear focus on impact objectives and reliable monitoring processes is not in dispute and it is recognised to have multiple benefits. One respondent said: "We felt that we would be engaging more investors into our deals if we could give them clear criteria, and then a framework by which they could accept whether or not those criteria had been met. So, criteria, transparency, the monitoring framework are key."[38] The same respondent pointed to other operational benefits of reliable impact monitoring: "We thought that because we're using the same methodologies as existing development institutions, or even better than theirs, that this would make us a better, faster and cheaper partner to work with. We have now got a far greater range of new investors into our deals because of these development criteria, because investors care about having this framework."

However, the fact is that a bewildering range of impact assessment tools and methodologies is available. Setting aside wider initiatives such as the World Bank's Development Impact Evaluation (DIME) group, and IFC's Development Outcome Tracking System (DOTS) indicator framework, along with its widely used Anticipated Impact Measurement and Monitoring (AIMM) system, notable recent additions include Inter-American Development Bank's Development Effectiveness, Learning, Tracking and Assessment (DELTA) tool, KfW and DEG's Development Effectiveness Rating (DERA), AFD and Proparco's sustainable development rating, and DFC's Impact Quotient (IQ) tool. To this might be added frameworks such as IRIS+, B Analytics, Principles for Responsible Investment (PRI), Harmonized Indicators for Private Sector Operations (HIPSO), Operating Principles for Impact Management (OPIM), and a recent private sector tool called Simpl® (Sustainability Impact Measurement Platform) designed to measure investment performance against the SDGs.

> ***The diversity of standards means that it is too chaotic, and in the end it creates a lot of transaction costs. It creates confusion, the risk of greenwashing and so on. When you find a project and you say it will generate Y, will give access to power to X number of people, and will create Z number of jobs, it's not easy to define.*** (Interview 2 May 2023)

This complexity makes it hard to compare results across projects or across organisations. The diversity of DFIs and their impact frameworks creates challenges and hinders comparability and credibility of impact metrics (Attridge and Engen 2019). While DFI investment may be shown to create jobs, deliver power, and increase access to finance, for instance, little is known about who gets the jobs, the quality and type of employment, and who has access to the power or the funding (Attridge and Gouett 2021). One respondent summed up the situation: "In terms of impact

[37] Interview 28 April 2023

[38] Interview 2 May 2023

measurement, the tools are so different from one institution to another that it really doesn't help. It's true on the climate side, but it's also true in many other aspects. When DFIs talk about job creation, when they talk about access to other benefits, everything is related to and depends on impact measurement."[39]

Although progress has been made in DFIs sharing standards, especially regarding ESG, the desire for shared impact metrics has practical consequences for investment partners. Collecting data is costly and time consuming. One respondent said: "The more we are talking of impact, the more we rely on the client, and the client can only provide all this data if the client has all the systems in place to secure that the data is available and subject to independent evaluation and scrutiny. So, we are coming with a lot of additional transaction costs."[40] The same observation is reported more graphically by a private DFI partner: "Well, we certainly get our data from our companies, not from anyone else, and at the end of each fundraising, we try to take all of the information requests and try to standardise them into one. If we didn't, then we would be only recording. There will be no doing, no ESG work. This is because we have 11 DFI partners. If you have 11 different sets of information required, it obviously cannot work."[41]

Inflexible impact assessments also potentially limit possibilities for DFI engagement with private partners. One respondent said: "In a way, when you say this is a project which is green or this is a project which contributes to the SDGs, it's always difficult to find the right partners because if you put criteria which are too strict, then you will have difficulty to convince people because they won't have a big enough part of their asset qualifying for that. And then if it is too wide, you will basically go down the route of greenwashing."[42] Another respondent pointed to the nuances inherent in the mandate of DFIs: "I believe DFIs should make sure that what they require in terms of impact is relevant for the geographies that are concerned. And that can be a challenge because some DFIs can sometimes be too demanding because their references are based on what is required from western countries which cannot fit with emerging countries."[43]

Nevertheless, the benefits of DFIs having detailed standards for impact are generally accepted. One respondent from a DFI partner said: "If it wasn't for the DFIs, I don't think we would be as sophisticated on ESG. We now have gone one step further and we've made real progress. The whole impact circle of intentionality, having a management system, due diligence sourcing, measurement reporting and so on, but that's based on a lot of information over the years on ESG, so we build on that."[44]

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39 Interview 2 May 2023
40 Interview 28 April 2023
41 Interview 17 May 2023
42 Interview 2 May 2023
43 Interview 5 May 2023
44 Interview 17 May 2023

While metrics are accepted as important, tensions emerge regarding harmonisation. One respondent said: “So I think there is a need for harmonisation, which is very important – not only for us as DFIs so that we can better work together and not only for our clients so that we are all clear on what we are asking from them in terms of impact – but also to mobilise private capital.

Then we all have the same thermometer to measure impact.”[45] Another said: “On the face of it, if clients are dealing with more DFIs, then we would like to see that they are not confronted with different kinds of reporting requirements, disbursement requirements, etc., etc. No, a standard set is required.”[46]

The fact is, that while convergence around standards is essential to producing transparent, consistent and comparable data on impact, it may not be useful to converge towards a single, limiting measurement framework (OECD 2021). One respondent suggested a practical solution: “Ideally DFIs would try to simplify the criteria put on the capital. So, yes, you might have impact targets related to education, health, nutrition, food, waste or climate change. You can try to impact everything, or you can try to impact one problem. I would focus your impact on the one problem you’re trying to solve with this project or fund rather than saying everything possible has to happen in the instrument and everything possible has to happen on impact.”[47]

> ***Another reason is a lack of standardisation. There are very few techniques of blended finance – bringing together different pools of capital that have different risk, return and impact objectives into the same vehicle – that you can say are standardised. You can find multiple examples. Everything seems to be highly bespoke, which means it takes a lot of time, it’s expensive and difficult to replicate.*** (Interview 28 April 2023)

Indisputable impact metrics have long been the holy grail of development work and the principles for obtaining them are well established. However, operating in such a variety of contexts on such a wide range of projects, and often through third parties (i.e., with one or more investment partners) who may have different metrics, priorities, criteria and timescales, it is not surprising that DFIs are challenged by impact as representing an ultimate truth, especially if it is to be reported annually, and the intended impacts extend over decades. One powerful argument suggests that the different contexts and geographies that DFIs operate in, as well as their different stakeholders and shareholders, demand flexibility.

45 Interview 2 May 2023
46 Interview 28 April 2023
47 Interview 3 May 2023

> ***The context is changing in that there are some countries which two decades ago needed investments in basic economic infrastructure. By this I mean financial services, healthcare, education, manufacturing, etc. But those countries don't need it anymore, not because their healthcare, education, manufacturing infrastructure is built, but because there is private capital available to service that demand. What is required now from a DFI is more concessional capital focused on relevant problems that private markets are not yet targeting like climate, gender and diversity, etc. Alternatively, we shift the focus to regions where the basic private and economic infrastructure is not yet in place. These are usually countries which are facing headwinds of various kinds ranging from governance issues to other problems. Longer term, patient, higher risk capital should play a role either in tougher regions or in tougher segments of the economy where private capital or impact capital doesn't yet go.*** (Interview 9 May 2023)

Nevertheless, harmonisation – commonly agreed impact measurement standards and frameworks – offers one conceptually straightforward solution to the demanding complexities of impact. Doubtlessly, as the ever-increasing plethora of impact assessment tools demonstrate, intense challenges would emerge determining the details of a common approach, but collective and determined efforts by the DFI community, or a significant sub-set of it prepared to agree to and adopt harmonised standards and frameworks, could set a powerful example for others to follow, especially if developed in partnership with other development actors such as international organisations, NGOs and the private sector. Likewise, a simplification of objectives and targets would reduce debate. In this, Canada's FinDev, focused on women's economic empowerment, climate action and local market development, provides an interesting example at the institutional level, and at the project level, simplified targets, or even agreement to accept robust proxy metrics would assist in opening space for new and more creative innovation.

2.6. The bottom line

The energy and intelligence that DFIs bring to bear on the thorny and in some cases intractable debates associated with additionality, risk, mobilisation and impact serve as positive testament to the rigour with which the professional community – and other commentators – interrogate their approaches and actions. Ultimately, these four debates, which frame the dominant discourse around DFIs' identity, purpose and priorities, play an essential part in structuring the thinking and action of DFIs. They stand as benchmarks for interpreting and guiding DFIs, serving as key incentives to improve on various fronts, rather than to identify single methods of action or formulae to converge on.

However valuable they may be, the dominance of these four debates must be questioned. It is tempting to regard them as DFIs' ultimate objectives, which risks giving them disproportionate attention and energy. Likewise, it would be a mistake to set them up as the sole pillars of potential transformation. On the one hand, the complexities and ambiguities associated with them maintain uncertainties, uneasiness and tensions that can inhibit DFIs' ability to focus on and deploy new ideas. On the other, these 'regulatory' ideas, which have become part of the essence and common sense of DFIs, do not in themselves encourage DFIs to radically challenge, renew or update their logical frameworks of intervention, the development theories on which they are based, and ultimately the formulation of the collective action DFIs should lead.

This paper argues that other formulations that go beyond these four founding and continuing principles, are necessary – and even urgent. The focus on debates around additionality, risk, mobilisation and impact over-condition and over-capture DFIs' collective thinking about themselves and the world. They consume and distract DFIs and limit the possibilities of new thinking and innovation for the future.

The following final section sets these four dominant debates aside and outlines possible new directions of travel and ways of framing the approaches and actions of DFIs as a community.

3. A strategic compass

The four debates above focus on how DFIs should operate, whatever their endeavour – emphasising the need to mobilise investment, maximise impact, manage risk and so on. They do not provide more substantive guidance on what they are supposed to be pursuing. With the aim of guiding the DFI community forward on its 'what' and 'why' rather than 'how' and elevating the DFI contribution within both the real economy and the wider financial system in target countries, this paper now moves to offer a 'strategic compass' to direct action in the next decade at both the individual institution and the collective professional community level.

First, it is evident that DFIs can no longer focus on deal hunting. This has become especially true given heightened concerns over climate change, ESG standards, SDG targets, development impact tracking, mobilising private investors, and more. Second, it is clear that most DFIs must have a twin mandate – one to operate in emerging countries, where they can be profitable, improve standards, mobilise private capital and so on; the other to operate in extremely poor and challenging 'frontier' countries where risks are higher, profitability lower, and the ability to mobilise other investors is greatly reduced.

When criticised about their record in the poorest countries, DFIs such as IFC rightly note that a significant proportion of the world's poor live in middle-income countries and face huge socio-economic and geographical inequalities.[48] Many development projects in these countries, especially those with sub-investment grade status, may not be realised without the additional support of specialised institutions. Moreover, today's urgent climate and biodiversity challenges are largely unfolding in middle-income countries such as Brazil and China. Continued or even expanded action in these countries is therefore required, with vigorous encouragement for the private sector to transition faster towards more comprehensive social and environmental considerations. This should apply not only in the potentially defensive mode of meeting ESG standards but also in the more proactive mode of contributing to the SDGs. Within the broader structure of the international financial system, specialised institutions like DFIs also have a vital role to play in educating and incentivising private investors to prioritise the well-being of the planet and its people. This applies not just to standards, but also to the geographical location of investments.

However, even accepting that DFIs have a clear and important role to play in middle-income countries, they should aim to do more in the world's most difficult environments. Staying true to their mandate and seeking more profound structural impact necessitates greater attention,

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[48] For more information, see the IFC comment at: https://www.cgdev.org/blog/international-finance-corporation-mission-facilitating-risky-investments-so-why-it-taking.

strategic thinking, creativity and financial resources than DFIs and their shareholders currently allocate. In this, little significant progress can be made by the DFIs without renewed and strengthened support from their political shareholders, who alone can clarify mandates and strengthen means of action.

To this end, this paper identifies four cardinal directions to guide the future of DFIs. These points require significant focus, thoughtful consideration, innovation and increased financial commitment compared to that which DFIs and their shareholders currently provide.

The proposed compass recognises that DFIs must operate within two distinctly different environments: low-income and fragile countries on the one hand, and middle-income and emerging countries on the other. Balancing these two spheres of responsibility is essential, ensuring that one does not overshadow the other. By leveraging and following the indications of the compass in both contexts, DFIs can exploit the four entry points, re-orientate their efforts, and steer toward a new development focus. While it is tempting to perceive DFI responsibilities as radically different in low-income and middle-income contexts, this paper contends that they are similar, and the compass can unify their actions.

The following four cardinal points should be viewed as the 'four waves of the future', representing recommendations necessary for the deepening or even redesign and re-orientation of DFI work. Embracing these directions is crucial for DFIs to remain relevant, development-focused, and to respond to the rapid growth of global private finance effectively.

3.1. SDG Transition Support

The pursuit of the SDGs, including unlocking the potential of the private sector, demands a paradigm shift in how global economic actors operate. Companies, banks and investment funds wield critical influence over economies and societies, enabling them to drive progress towards sustainable development. However, achieving significant impact requires them to transcend traditional boundaries and embrace sustainability as both a core value and a practice. To this end, DFIs should spearhead a programme of 'SDG Transition Support,' providing strategic guidance and resources to help economic actors in partner countries chart a trajectory towards sustainability and maximise their contributions to the SDGs.

The journey towards sustainable impact is challenging. Many companies face operational constraints, limited access to sustainable finance, and resistance to change from stakeholders accustomed to conventional practices. Additionally, banks grapple with balancing financial profitability and sustainable lending, while investment funds struggle to identify viable projects aligned with the SDGs, often amid a dearth of investable opportunities in difficult countries.

Moreover, orientating business strategies towards the SDGs requires navigating an intricate web of targets and indicators, posing a formidable challenge for economic actors to design coherent initiatives.

> ***I am a bit concerned that in managing the process of going out of middle-income countries with better business environments and moving to lower income countries with far less favourable business environments, we might fail. The risk-taking capability very much depends on the readiness of shareholders to accept higher reputation risk and also their willingness to provide us with some guarantee.*** (Interview 28 April 2023)

DFIs, too, encounter hurdles in providing effective SDG Transition Support. They must balance the urgent need for transformation with financial sustainability concerns and operational constraints that hinder innovation and risk-taking. While some DFIs have initiated efforts to support sustainability, a more coordinated and innovative approach is essential to address systemic barriers.

Many DFIs have taken notable steps in supporting sustainability among economic actors. They offer financial incentives, concessional financing, technical assistance and business services to spur sustainable practices. Many DFIs also invest in impact funds, channeling funds to SDG-linked projects and businesses. Additionally, DFI-instigated capacity-building programmes and knowledge-sharing platforms foster awareness and understanding of sustainable practices.

However, the impact of these efforts is limited by several factors. Current support often lacks a holistic, value-chain approach that can drive sector-wide transformation. Many economic actors struggle to measure and communicate their SDG impacts effectively, leading to fragmented initiatives and difficulties in attracting investors aligned with their values. Moreover, the financial industry's focus on short-term returns and rigid risk-assessment criteria may discourage investments in sustainable projects with longer-term payoffs.

> ***I think one big challenge that we are very much focused on is the least developed countries, the so-called fragile states, even though I hate the term. We are also focused on going down to the market, to rural areas and all that type of stuff. The problem there is that the costs of doing so are extremely high, the risks are extremely high, and the returns, on average, are relatively low. So, we are involved in discussions with our shareholders, like many other DFIs, where we say: 'Well if you want us to go down this route, which we would like to do because we think it's our mission, you are going to have to accept high costs, high risks and low return.'*** (Interview 28 April 2023)

To strengthen the support provided by DFIs for the transition to the SDGs, the following avenues could be explored further.

First, DFIs should work with economic actors to develop a **holistic vision** that aligns their entire value chain and operations with specific SDGs. This approach involves conducting robust impact assessments to measure and track SDG contributions accurately. By establishing clear sustainability targets and outcome-based measurements, economic actors can make better informed decisions and prioritise impactful initiatives.

Second, DFIs should invest more in comprehensive technical assistance, **capacity-building programmes** and relevant business services to help empower economic actors navigate complex sustainability challenges successfully. These programmes may focus on developing expertise in sustainable business practices, integrating SDG considerations, and driving cultural shifts towards sustainability.

Third, DFIs can further explore **innovative financing mechanisms**, such as impact-linked financing or blended finance, to incentivise economic actors to achieve specific SDG outcomes. By offering financial rewards for achieving predefined sustainability targets, DFIs can encourage economic actors to go beyond compliance and embrace ambitious sustainability practices.

Fourth, DFIs should help foster **collaborative partnerships** between companies, banks and investment funds and other stakeholders, such as private sector networks, CSOs and even, in some instances, public authorities in the framework of innovative public-private partnerships. By leveraging collective expertise and resources, DFIs can facilitate multi-stakeholder initiatives that address systemic challenges and create impact.

Fifth, to identify areas for improvement, DFIs should invest in **data-driven decision-making** processes within their economic partners to help them assess progress as well as the effectiveness of DFI support. By leveraging data analytics and impact measurement tools, DFIs could better track and evaluate the SDG transition progress of partner organisations and refine their interventions.

Sixth, DFIs could support current initiatives by banks or funds towards **sustainability Impact bonds** that help align financial incentives with SDG achievements. These bonds could offer variable interest rates tied to an issuer's performance in meeting SDG targets. In Africa, there are few such initiatives, but DFIs are often supporting them. For instance, Proparco is leading the first sustainability-linked loan of Ecobank, a pan-African bank.

Finally, there is a need to **reassess portfolio priorities**. While the inclination of DFIs to bring on board new 'green' or 'best practice' clients is notable, it is essential not to neglect existing portfolio clients, particularly those that are lagging behind in sustainable practices such as reducing greenhouse gas emissions. DFIs should prioritise the development of robust mechanisms and incentives to drive these clients towards desired sustainable benchmarks. This not only fosters loyalty, but also illustrates commitment to holistic sustainable growth. Progressive improvements with these clients can lead to significant collective progress towards the SDGs, inducing a ripple effect that encourage other entities in similar positions to adopt sustainable practices.

SDG Transition Support is a critical endeavor for DFIs to accelerate progress towards achieving the SDGs. By guiding economic actors in their transformation, fostering collaboration, and adopting innovative approaches, DFIs can support economic actors to become champions of sustainable development.

3.2. Supporting pioneers in the real economy and the financial system

DFIs operating in low-income countries face a lack of investment opportunities. These countries are short of formal private companies suitable for investment and scaling up. In addition, investment banks capable of structuring deals to deliver transformative infrastructure projects are scarce, as are investment funds – local or international – including private pension funds operating with ESG or SDG perspectives, as well as well-functioning stock markets able to allocate capital. Consequently, when a promising deal arises, DFIs compete among themselves.

> ***We need to think of other ways to finance this industry and that includes the use of blended finance. That's a key buzzword but no one has really pierced the model yet. How do we make it? Under what conditions? How do we use soft resources of concessional finance to encourage development of an industry, and to make sure that industry looks as much at developmental impacts as financial returns? And how we combine both is where the difficulty lies. I've seen a few structures and in that respect I think foundations and philanthropists are leading the way. Not the DFIs.*** (Interview 9 May 2023)

Addressing the issue of deal scarcity is of utmost importance, and any steps taken to alleviate this challenge would significantly contribute to the relevance of DFIs, particularly in low-income countries. Ideally, DFIs should collectively establish a system or mechanism that consistently helps generate bankable deals. While DFIs cannot be the sole creators of this 'deal machine', they can play a stronger and more direct role in stimulating deals and fostering partnerships with stakeholders to facilitate deal origination. On that basis, the future of DFIs lies in transitioning from a passive position of waiting for deals or companies to approach them to a proactive stance of actively seeking and promoting companies that have the potential to enter or create new markets. In addition, DFIs should provide support to intermediaries such as stock markets, investment funds and banks that play a pivotal role in the emergence of deals. This line of work may be referred to as supporting 'pioneers' in both the real economy and the local financial sector, enabling it to increase its support.

To strengthen the support provided by DFIs to these pioneers, three main avenues should be explored.

First, promoting the emergence of stronger stock markets is vital. Stock markets serve as crucial channels for directing capital towards productive investments, enabling companies to access funds for expansion and infrastructure development. However, in many low-income countries, barriers such as regulatory constraints and limited financial infrastructure hinder the establishment of robust stock markets. DFIs can play a transformative role by offering technical expertise and financial support and advocating for regulatory reforms. Through targeted technical assistance, DFIs can help local institutions build the necessary capacity and knowledge to operate and regulate stock markets effectively. Additionally, providing DFI investments may help kickstart the functioning of these markets, encouraging more companies to participate. Prioritising exits through stock markets when possible and helping increase the secondary markets would also be critical in strengthening local financial market infrastructures. By engaging with regulatory authorities, DFIs can also identify and address obstacles hindering stock market growth. Proposing innovative regulatory frameworks that strike a balance between oversight and flexibility can help instil investor confidence and attract businesses to list on the stock exchange.

Second, investment banks are also critical actors that deserve encouragement whenever they step in as pioneers.[49] They support the private sector by facilitating capital flows, offering financial expertise, and driving corporate transactions in developing countries. Yet in most low-income countries, investment banks are rare or non-existent. Factors influencing their presence and operations include the size of the local financial market, regulatory frameworks, a less sophisticated financial infrastructure, and challenges in attracting foreign investment given the overall investment climate. Multinational investment banks with a global presence, however, often have operations or affiliations in developing countries. DFIs could play a significant role in promoting the emergence and strengthening of investment banks in partner countries. They could provide more technical assistance, financial support, and advocate for regulatory reforms to create a conducive environment for investment banking. They could also foster partnerships and facilitate knowledge sharing among peer institutions and help establish incubation frameworks and programmes for such banks, as well as collaborate with universities for appropriate skills development and encourage technology adoption in investment banking operations. DFIs could also conduct market research, establish peer-to-peer learning platforms, and facilitate networking to facilitate investment banking. In addition, they could develop risk mitigation instruments and provide sector-specific support to nascent organisations involved in impact investment banking and green finance initiatives. By embracing these approaches, DFIs can help drive the growth of investment banks.

> ***I think DFIs should focus on those projects which we believe are sustainable and for those where it's too risky, perhaps it's more the work for some national public development bank or international public development bank to take that kind of risk because otherwise it would put that risk on the economic model of the DFI. So, you know, the question is where you put the cursor. It's not easy.*** (Interview 2 May 2023)

Third, DFIs should orient their support more systematically towards pioneer companies, defined as the first firms to "produce a new product, introduce a new process, or enter a new market" (Collier, Gregory et al. 2019). These pioneer firms can operate in any sector of economic activity, and be of any size, age or origin. Pioneering comes with positive externalities and macroeconomic benefits. By adding a new activity, a pioneer firm helps broaden the economy, grow and diversify markets, and open possibilities for other firms.

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49 Investment banks assist governments and corporations in raising capital by advising on the issuance of securities such as stocks and bonds. They provide advisory services for mergers and acquisitions, helping businesses identify suitable opportunities, conduct due diligence, and negotiate favourable terms. They also offer financial advisory services, assisting clients with strategic planning, restructuring and risk management and contribute to market efficiency by conducting analysis, producing insights that aid investors and businesses in making informed decisions. In addition, they engage in trading activities, providing liquidity and facilitating smooth transactions in the secondary market.

However, as previously noted, low-income countries experience a dramatic lack of formal firms. Many markets simply do not exist as high entry costs and disincentives challenge a company operating in a fragile economy to behave as a pioneer. In such countries, the 'first-mover advantage' usually transpires to be a set of disadvantages with heavy costs and risks. First entrants face deep market uncertainties, free-riding behaviour on the part of competitors through imitation and use of free market signals, chaotic shifts in demand, supply, regulations, and more. In other words, pioneering firms face heightened costs that generate benefits that do not accrue to the firms. Given those heavy costs on pioneers, new markets will not be created purely by conventional market forces.

As Collier suggests, DFIs have a crucial role in supporting the growth of pioneer companies. First, DFIs can develop subsidy mechanisms to offset initial entry costs and address the externality problem. Second, DFIs can offer technical assistance and capacity-building to support market creation activities, including skills development and assisting government regulators and banks to better serve the market. Third, DFIs must be willing to embrace the uncertainty of pioneering investments and invest in pioneer firms, even with incomplete information about the risk profile. Blended finance mechanisms, which combine commercial-term financing with subsidies tied to specific costs, benefits or risks, can help provide this support.

In this line of activity, however, DFIs cannot rely on pioneer firms to approach them. DFIs need to take a more proactive approach in seeking these firms out as they often operate as small, informal businesses that deliberately stay inconspicuous to avoid government attention. It is important for DFIs to lead and invite such companies into a stronger investment dynamic. Collier suggests that DFIs should actively search for firms willing to be pioneers and provide them with appropriate subsidy support. This would involve a proactive phase of searching, potentially through an open call for proposals and targeted invitations to suitable firms. To do this, DFIs need to shift from a passive evaluation approach to actively generating opportunities and fostering engagement with potential firms.

Finally, DFIs should actively support and collaborate with pioneering investment funds that prioritise the integration of ESG criteria into their strategies along with alignment with SDG targets. While ESG criteria and the SDGs share a common focus on sustainability, they differ in scope and specificity. ESG criteria are mainly used by investors and financial institutions to assess the sustainable development risks of companies and investment opportunities. The SDGs, on the other hand, represent a broader framework that goes beyond the financial industry and encompasses global development priorities. The link between ESG criteria and the SDGs is not well established in the financial industry, even in impact funds. The result is a lack of alignment between investment strategies and the broader sustainable development agenda.

3.3. Ecosystem support

Another important direction that DFIs need to rethink at both the collective and individual level is their contribution to building local ecosystems able to support private sector development. The traditional focus of DFIs on selecting and supporting discrete projects, companies, banks or funds is not sufficient to meet their development mandate. DFIs need to leverage their direct knowledge and the expertise of the private sector to contribute to ecosystem building, including through close negotiations and partnership with public authorities. DFIs are closer to the private sector than traditional development agencies which are more public sector orientated. DFIs arrive with relationships with private stakeholders, insights about their challenges and possibilities, and credibility on how best to support them that cannot be matched by other donor instruments. Not using that capital to help strengthen the ecosystem as a whole, including through advocacy and support towards public authorities, is a missed opportunity.

Strengthening local ecosystems to support private sector development has four main aspects.

A first important aspect is to engage with local authorities on improving public policies, regulations, taxation systems and other dimensions that affect the business environment. In doing so, DFIs need to build their collective thinking and voice, and make themselves heard. The need for better business environments is a priority in most target countries, particularly the most fragile ones. DFIs should help inspire and support reforms, and liaise with regulators, private sector representatives, policymakers and others to help them build their visions, roadmaps and implementation capacities. In that spirit, over the past decade, IFC has increased its work on 'upstream' activities to promote business friendly environments. More of this could be done better by the DFI community, including bilateral organisations, to deliver new breakthroughs. Collaboration with multilateral DFIs is essential, as well as an increased ability to provide technical assistance. In this, DFIs could provide expertise and financial resources to support policy discussions, implementation capacities and reform monitoring. They could facilitate knowledge exchange and best practice sharing among stakeholders, both local and international, and engage with the private sector to understand its needs and priorities, as well as bringing a focus on addressing specific regulatory challenges. The DFIs could also contribute to ensuring a more inclusive business environment, promoting diversity, equity and inclusion, encouraging access to opportunities for under-represented groups, and fostering partnerships with organisations that focus on social inclusion and empowerment.

> ***But it's not just about guarantees, it's about making sure the policy environment is right, the regulatory environment is right, the legal system is right, all of those things that private sector investors need to have confidence in. And that's where the DFIs can really be helpful in the policy debate with the governments of these countries, to try and make sure that the conditions are right. It's not just about the financing, it's also about the policy environment and the guarantee mechanisms that are in place.***
> (Interview 26 April 2023)

Second, beyond policy work, it is vital to strengthen concrete public policy instruments and organisations that can effectively support the private sector at the local level. Among these, public development banks (PDBs) emerge as pivotal stakeholders in the ecosystem, requiring increased international attention and support. The existing connection between DFIs and PDBs is insufficient and lacks depth. To date, these two worlds have had limited dialogue and cooperation, although such partnerships can enhance the transfer of knowledge and expertise to partner countries. Bilateral and multilateral DFIs should consider expanding similar collaborations to support the development of robust PDBs.

Doubtlessly, strengthening PDBs will be recognised as a critical mission for DFIs in the future. To achieve this, it will be necessary to reconsider the collaboration between DFIs and their 'parent' development agencies, particularly with a focus on enhancing DFIs' ability to provide technical assistance. Once this issue is addressed, the entire DFI community should coordinate efforts to support the growth of local PDBs. This may include providing financial support, sharing best practices, fostering knowledge and technology exchange programmes, along with co-investment initiatives to maximise impact and drive entrepreneurship. Comprehensive technical assistance programmes to enhance PDBs' operational effectiveness may be part of activities, along with joint explorations of sustainable finance solutions, research and development collaborations, and support for innovative digital platforms. In addition, co-establishment of accredited impact investment funds, entrepreneurship ecosystem mapping, and various targeted interventions should be considered.

Third, DFIs should collaborate more closely to facilitate the establishment of robust and diverse support organisations for SMEs and entrepreneurs. This will involve actively participating in supporting accelerators, incubators, associations promoting the interests of entrepreneurs, and other organisations, whether originating from the private sector or civil society to influence national regulations and make them more business friendly. By leveraging their networks and resources, as well as capacity-building programmes, DFIs can help these organisations enhance their ability to provide more comprehensive assistance to entrepreneurs. DFIs can also facilitate knowledge sharing and best practices among these organisations, fostering a collaborative ecosystem where they can learn from each other's experiences. Furthermore, DFIs can play a catalytic role in encouraging partnerships between support organisations and local educational institutions, research centres and industry associations. Such collaborations may lead to the development of tailored programmes, specialised training, and access to industry networks, empowering entrepreneurs with the skills and connections necessary for success. By actively supporting and nurturing entrepreneur support organisations, DFIs can contribute to the creation of a vibrant entrepreneurial ecosystem that drives innovation, job creation and economic resilience in target countries. However, it is essential to avoid spreading support too thin. Instead, attention should focus on ensuring the emergence of a few state-of-the-art support organisations in each country. A single powerful incubator, such as MEST in Ghana or Flat6Labs in Egypt, has the potential to deliver substantial economic value, surpassing the impact of numerous underdeveloped incubators that struggle to provide comprehensive long-term support.[50] In any case, providing direct support to help companies develop teams, strategies, products and solutions is at the heart of the DFI mandate, as is helping private stakeholders – both investors and entrepreneurs – to identify sound market solutions to local challenges.

> ***DFIs should be more willing to work with others. Most of the institutions are suffering from two things. One is doing more of the same and second is not being inventive. You have to accept that if things have not worked that well over the past 50 years, maybe we need to change what we do a little bit. And we need to accept that others might bring us great ideas. That for me is the main building block around what needs to be done.*** (Interview 22 May 2023)

Fourth, in an increasingly volatile, uncertain, complex, and ambiguous world, DFIs will need to work harder to reduce entropy within local ecosystems. They will have to deliver collective macroeconomic impact during times of crises, assuming a clear countercyclical role. This emphasises the importance of partnerships, coordination, sector prioritisation, agility and collaboration to respond to and mitigate macroeconomic disturbances effectively. The COVID-19 crisis highlighted the ability of multilateral DFIs to fulfil this role through increased activity. However, it is imperative for all DFIs to actively contribute to this function consistently.

To strengthen their countercyclical impact, DFIs can adopt several approaches and strategies. They can enhance coordination and knowledge sharing among themselves to facilitate the development of cohesive and effective response mechanisms. They can also enhance their agility and flexibility by developing contingency plans, resilience funds, or specialised investment vehicles that provide targeted support to vulnerable sectors during economic downturns. In addition, they can foster stronger partnerships with governments, international organisations and private sector entities to leverage collective resources and expertise during crises. Institutions like the World Bank or the International Monetary Fund could provide DFIs with access to automated additional resources, ensuring a timely and robust response. In this context, DFIs can do more to strengthen the resilience of local ecosystems by prioritising entrepreneurship and innovation, as

[50] For more information see: https://meltwater.org/ and https://www.flat6labs.com/.

well as investing in critical sectors (such as healthcare, digital infrastructure, renewable energy and sustainable agriculture) to foster resilience and countercyclical growth.

When DFIs take on a countercyclical role, they grapple with the challenges of investing in ventures that might be riskier and lack immediate returns, especially during economic downturns that deter private investors. To address this, DFIs can employ strategies such as further diversifying their investment portfolios. They can tap into blended finance instruments, and utilise risk mitigation tools, from guarantees to insurance. Collaborative ventures with other DFIs or multilateral banks can also distribute the risk, pooling expertise and resources.

3.4. Supporting digital transformation

The digital transformation in developing countries, which is transforming all economic sectors and is essential to future prosperity and competitiveness, is not yet adequately addressed by most DFIs and is therefore the fourth cardinal direction of the proposed compass. This transformation faces daunting challenges. These include the lack of robust digital infrastructure, reliable connectivity, digital skills and digital services, as well as funding for digital innovations. All of this exacerbates the digital divide. Insufficient investment combined with political uncertainties and inconsistent policies creates a challenging environment for private sector involvement. A pressing need exists for coordinated efforts and investments from governments, DFIs and private investors. Furthermore, it is essential to view the digital transition as a 'twin transition' explicitly linked with the green transition. While the green transition aims to address environmental challenges and promote sustainability, the digital transition focuses on leveraging technologies to drive economic growth, social inclusion and improved public services, as well as supporting the green transition itself.

To date, most DFIs have not prioritised digital transformation, with digitalisation often missing as a cross-cutting goal or sector in their strategies. This situation stems from a combination of factors. First, arguably a lack of support for or understanding of digital transformation exists among the 'political masters' and shareholders of DFIs. This results in a lack of clear mandate for DFIs to work on digitalisation. While some DFIs, such as BII and FMO, invest significantly in digitalisation through venture capital, the DFIs as a group have not yet dedicated the required resources and attention.

Digitalisation is a cross-sector issue that requires the mastery of a variety of instruments, such as equity capital in the venture capital space, project finance or business finance for digital infrastructure, and so on. It also requires expertise and understanding of technology, infrastructure, and its impact on various sectors. DFIs need to invest in building staff capacity in this domain. On the national counterpart side, there are also constraints that further impede progress in digital transformation. Lack of formal project requests from local stakeholders and limited organisational capacity to lead digital projects are significant factors. In addition, key digital stakeholders often do not approach DFIs, resulting in a limited project pipeline. While needs for digital projects exist within countries, the lack of dialogue and collaboration between DFIs and relevant stakeholders hinders progress. Public actors also have a crucial role in correcting market failures, particularly in rural and remote areas. In this regard, DFIs need to explore ways to engage the private sector and leverage public-private partnerships to address these market failures and extend digital services to under-served areas.

Several recommendations can be made to enhance the role of DFIs in the digital domain. One would be to contribute to establishing a global alliance for digital investments (GADI), as currently proposed in some policy circles at the European Union (EU) level. This involves creating a collaborative platform involving governments, DFIs and private investors to address barriers hindering digital investments in low and middle-income countries. This alliance would focus on infrastructure, connectivity and related services, driving digital transformation through public-private partnerships. Within the EU context, several ideas are emerging that have the potential to inspire the broader DFI community. The first is a Digital Leap Fund. This suggests that the EU could establish a co-funded, revolving fund, managed by a dedicated team of investment professionals, which would enable European DFIs to hold greater equity in digital projects. This initiative may inspire private investor confidence and attract substantial investments in digital infrastructure, connectivity and services. The second idea is that of a Political Insurance Shield. Through this tool, the EU could offer first-loss guarantees for political risks. Such a facility would protect investors' interests in high-risk digital infrastructure and connectivity projects. By providing a safer investment environment, this guarantee, extended via DFIs or the EIB, could encourage private sector investment in digital transformation. Of course, the issue of political insurance is broader than just the digital sector, but this could be a case where such an approach could be tested. The third idea is a mechanism that could help 'Ignite Bankable Investments'. Such a mechanism would support the bankability of innovative digital investments through advisory services, technical assistance and partnerships between EU-based and locally-based initiatives and investors. This targeted conduit would help facilitate access to financial resources for project promoters, strengthening the pipeline of viable digital initiatives and investments. By following some of these approaches, the international community could help DFIs play a more significant role in supporting digital transformation.

3.5. The Compass – Enabling conditions and requirements

Pursuing the recommendations outlined in this paper requires long-term commitment from DFIs, governments, shareholders and stakeholders. It is essential to recognise that meaningful impact and transformation take time and sustained effort. It is also essential to recognise that most DFIs are very largely beholden to their government shareholders, and if these shareholders are not prepared to instigate and drive change, they need to be persuaded of the necessity – and benefits – of supporting it.

The bottom line is that in today's rapidly changing world, it is imperative that DFIs innovate and adapt. It is no longer sufficient for them to rely solely on their core business models. Fintech, for example, offers significant opportunities for DFIs to rethink some of their own operations, as do impact investing networks, technology-enabled risk management, open innovation platforms, impact bond innovations, and more. Delay or complacency, leading to diminished influence and relevance over time, are not options. Innovation must be embraced now to ensure that DFIs remain relevant to the future.

While 'innovation' has become a buzzword in many sectors, DFIs need to move beyond the superficial allure of the term and ensure tangible, actionable change. True innovation necessitates robust budgeting, structural adjustments, and a comprehensive organisational overhaul. Traditional methods need to be re-thought, established norms challenged, and the unknown embraced. Embracing innovation is not just about adopting new technologies or methodologies but involves a fundamental transformation in strategy and operations. If approached with commitment, a focus on innovation would amount to a revolutionary shift in the functioning and impact of DFIs, ensuring that they remain not only relevant but also pioneers in a world that never stops changing.

However, DFIs face formidable challenges and constraints when it comes to innovation. The intricate web of regulatory constraints and financial sustainability concerns limit their flexibility and agility. This can discourage risk-taking and experimentation, stifling the potential for breakthrough innovations. Moreover, the fear of failure and its associated repercussions further discourage DFIs from venturing into uncharted territory. Nevertheless, a number of ideas can help strengthen the innovation capacity of DFIs.

First, DFIs can establish separate or joint innovation hubs that serve as dedicated spaces for the formulation of ideas and concepts and testing and piloting new approaches. These hubs would operate independently from the core activities of DFIs, providing a safe environment for experimentation, iteration, and the opportunity to learn from failures. By creating this specialised infrastructure, DFIs would foster a culture of innovation and provide the necessary support for unconventional ideas to flourish.

Second, advocacy for regulatory flexibility is essential. DFIs can actively engage in dialogue with regulatory authorities to find a balance between prudential oversight and the flexibility that nurtures innovation. This could involve proposing the implementation of a regulatory 'sandbox' approach, which would grant DFIs a controlled environment to test innovative financial products and services. By alleviating the burden of stringent regulations during the experimentation phase, DFIs might explore new avenues without compromising financial stability or investor protection. Unfortunately, it is certain that this sandbox approach would be difficult to implement for DFIs, which are highly regulated.

A third crucial aspect is innovation funding. DFIs should allocate dedicated streams of funding from within their budgets specifically targeted at innovation. This would ensure that more adequate resources are available to support pioneering projects, research and development initiatives, and capacity-building efforts aimed at fostering a culture of innovation within DFIs. By providing a financial foundation for innovative endeavours, DFIs could unleash the full potential of their teams and foster a spirit of creativity and exploration.

Fourth, DFIs should develop alternative performance metrics that go beyond traditional financial and impact indicators. These metrics should capture the value and impact of innovation in pursuing development outcomes. By incorporating these metrics, DFIs can incentivise and reward innovative approaches while maintaining accountability and transparency. This shift in evaluation criteria will encourage DFIs to push the boundaries and embrace unconventional solutions.

Finally, fostering learning and knowledge sharing is crucial. DFIs should actively seek collaboration and partnerships with private sector entities, academia and research institutions to tap into their expertise, knowledge and resources. By forming alliances, DFIs may access external innovation ecosystems, leverage cutting-edge research, and benefit from cross-sectoral collaboration. Platforms for peer-to-peer exchanges, capacity-building initiatives, and sharing best practices may cultivate a culture of continuous learning and inspire new ideas within the DFI community.

In addition to enabling greater innovation, to successfully be guided by the compass, at least eight other enabling conditions are required:

Clear mandates and political support: DFIs require clear mandates and strong political support from their respective governments and shareholders to prioritise their actions in line with strategic directions. This support should encompass the recognition of new directions for DFIs to pursue and the allocation of adequate resources to enable operations.

Stronger ecosystem and government collaborations: DFIs will need to collaborate with an increasing number of stakeholders, including governments, private sector networks and CSOs, to unlock new policies. This may require a cultural change within DFIs, as well as new resources or a collective organisation of advocacy work among DFIs.

Greater regulatory flexibility: DFIs need an enabling regulatory environment that strikes a balance between prudential oversight and flexibility for innovation. Governments and regulatory authorities should engage in dialogue with DFIs to identify and address regulatory constraints that hinder their ability to experiment, take risks and adapt to evolving circumstances.

Staff capacity-building: DFIs must invest in building the capacity of their staff to understand and navigate the complexities of the focus areas, including SDG support, ecosystem support, supporting pioneers, digital transformation, and innovation. This includes developing expertise in relevant sectors, technology, policy, and impact measurement. DFIs should collaborate with educational institutions, industry experts and specialised training providers to enhance the skills and knowledge of their teams.

Capacity-building for economic partners: DFIs should enhance their capacity to offer technical assistance and comprehensive capacity-building support to a wider range of partners and stakeholders, including investment funds, governments, pioneer companies, PDBs, investment banks, regulators and policymakers. To support SDG Transition, DFIs must further invest in empowering economic actors through capacity-building programmes that extend beyond traditional training. These efforts should focus on developing expertise in sustainable business practices, integrating SDG considerations into strategies, and fostering cultural shifts towards sustainability.

Adaptive risk management: DFIs should cultivate a culture that embraces calculated risk-taking, experimentation, and adaptive management. This requires creating an environment where failure is seen as an opportunity for learning and improvement, with mechanisms in place to identify, analyse and mitigate risks effectively.

Collaboration in pivotal moments: Recognising that DFIs alone cannot single-handedly foster the development of the private sector, it is crucial for them to collaboratively seize pivotal moments in countries where visionary leaders and transformative shifts are emerging. By joining forces and coordinating their actions, DFIs can harness these opportunities and help empower transformative change.

Working and expanding as a community: The challenges that DFIs face cannot be addressed individually by each DFI. The international community needs to orientate them collectively towards renewed and mutually agreed goals, encourage them to collaborate, and possibly develop new instruments (e.g., substantial guarantee funds such as the EFSD+ in the context of the EU) that guide and support them as a group towards greater impact for the 2030 Agenda.

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Acronyms and initialisms

AFD	Agence Française de Développement
CSO	Civil society organisation
DFC	U.S. International Development Finance Corporation
DFI	Development finance institution
EBRD	European Bank for Reconstruction and Development
EDFI	Association of European Development Finance Institutions
EIB	European Investment Bank
ESG	Environmental, social and governance
EU	European Union
IFC	International Finance Corporation
ODA	Official development assistance
PDB	Public development bank
SDGs	Sustainable Development Goals

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