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# Development Finance Institutions Come of Age

Policy Engagement,  
Impact, and New  
Directions

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Daniel F. Runde

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PRINCIPAL AUTHORS

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A Report of the  
CSIS PROJECT ON PROSPERITY AND DEVELOPMENT  
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Center for Strategic & International Studies  
1616 Rhode Island Avenue, NW  
Washington, DC 20036  
202-887-0200 | [www.csis.org](http://www.csis.org)

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# Executive Summary

Development Finance Institutions (DFIs) are government-backed institutions that invest in private-sector projects in low- and middle-income countries. DFIs are structured as either multilateral or bilateral organizations that seek to invest in commercially sustainable projects often in concert with private investors.

These are not new institutions; the United Kingdom created its DFI, CDC, in 1948 and the Overseas Private Investment Corporation (OPIC) was spun out of the U.S. Agency for International Development (USAID) in 1971. Since then, the number of DFIs—bilateral DFIs in particular—has grown, as several countries have sought ways to facilitate private-sector investment in developing and emerging market economies. How bilateral DFIs are governed varies; some are fully state-owned institutions and some are partially owned by private shareholders. Their sector and regional focus, and the instruments they have to catalyze investment, also vary widely.

There is an increasing interest in DFIs from both donors and developing countries. Policymakers face an increasingly complex set of challenges, including the newly adopted Sustainable Development Goals (SDGs), Paris climate financing commitments, and ongoing crises in fragile and conflict-afflicted states. All of these call for a move from “billions to trillions,” meaning that financial resources mobilized to support development need to be in the trillions of dollars and not billions. Yet traditional, official resources are limited and likely will not increase dramatically in the coming years. Policymakers wish to support DFIs and to deploy them to help solve these global challenges. This is especially true as DFIs are seen as having the ability to catalyze investment above and beyond their own resources. Since 2002, total annual commitments by all DFIs have grown from \$10 billion to around \$70 billion in 2014—an increase of 600 percent, spurred in part by new capital replenishment from their owners and retained profits. Official development assistance (ODA) grew by just 50 percent during the same period: from \$88.6 billion in 2002 to \$137.2 billion in 2014.

At the same time, there is a broader acceptance by the international development community of the centrality of the private sector to achieving long-term, sustainable economic growth. Extreme poverty will not be eradicated by 2030 without jobs, economic growth, and increased local tax revenue—all development outcomes produced by DFI investments. DFIs have a clear theory of change: through the provision of financing to private-sector entities and responsible investment practices, they can produce direct contributions (jobs, economic growth, and increased taxes) that have wider development impacts. This impact, though, is not always well understood by the broader development community. More can also be done to fill out knowledge gaps about the development impact of DFI activity at the macro level.

The challenge for DFIs will be to build on their core competencies of supporting private-sector finance even as they are asked to occupy a larger role and take on new tasks. As traditional donor countries have run up against resource constraints, policymakers pay

increasing attention to DFIs and their investment operations. DFIs are powerful, but precise development tools, and ones that are not well understood by some policymakers. As resources have expanded, so too has the potential to deliver long-term and sustainable development impact. The downside of this growth is that the DFIs could become the default instrument of choice for any and every development-related foreign policy quandary, even when their capabilities and strengths may not be suited to the task. If DFIs are deployed for the wrong purposes it would limit their impact, and even potentially threaten their long-term financial sustainability. DFIs cannot tackle existing development challenges on their own, but through their targeted investments they can play a specific role in solving these issues.

While DFIs have always had an economic development mandate, they have previously DFIs tended to focus by and large on the financial/investment side of the business. Today they have become firmly focused on achieving the bold development goals. Policymakers also seek to deploy DFIs toward a broader range of foreign, economic, and national security policy objectives. This creates an opening for DFIs to engage more fully in helping to design, or even taking the lead on designing, private-sector development policy. DFIs and aid agencies must have a direct dialogue on private-sector development. But for this to be successful, policymakers must have a better understanding of the basic DFI model, what DFIs can and cannot do, the development impacts that DFIs have, and the objectives that DFIs can help them to achieve.

Aid agencies and other foreign policy decisionmakers increasingly look to DFIs to help solve or provide support in regions, sectors, or issues that are not traditional priorities, but in which DFIs may have a specific contribution. This might include: fragile and conflict-afflicted states or the ongoing global refugee crisis. It would also include expanding DFI investments in areas that are traditional priorities such as sub-Saharan Africa, energy and environment, and infrastructure. In the latter, shareholders would want to see DFIs bolster their support for low- and lower-middle-income countries and shift their portfolios away from upper-middle-income countries. Neither of these shifts will require that DFIs fundamentally change their business model, but rather draw upon their unique skills, competencies, and knowledge to deliver development impact. This requires a more forceful (proactive) and targeted approach to developing projects in specific areas.

Complicating the policy role of DFIs is the growing support offered by traditional aid agencies for private-sector development purposes. Traditional bilateral donors have long supported the type of efforts aimed at improving the enabling environment for private-sector-led economic growth, but now many seek a broader role. This broader role includes offering their own instruments, but more often through third-party fund managers, similar to those that have long been at the core of DFIs, including loan guarantees, equity, investments, and other financing tools. These “blended” instruments are still at relatively modest levels, but they are growing. Critically important is that aid agencies rely upon grant funding in these cases, with high levels of subsidy, which may risk distorting markets and crowding out DFIs and private investors.

DFI leaders must, to a much greater extent than before, navigate the policy process to ensure their institutions are clearly understood and properly utilized. In this regard, there is an



opportunity for DFIs and policymakers to work together to effect change within the development system. DFIs need to evolve and expand their capabilities to respond to emerging policy goals, but policymakers also need to understand how and where DFIs should be deployed. On the DFI side, this will likely require a higher risk tolerance, greater willingness to accept (in some cases) lower returns, more resources (both finances staff), and an improved ability to disseminate lessons learned and to measure impact.



# 01

## Introduction

This report is the result of a research project that has looked at the role of Development Finance Institutions (DFIs) in the new global development policy landscape over the course of 2016. The project has been a joint undertaking of the Center for Strategic and International Studies (CSIS) in Washington, D.C., and the Overseas Development Institute (ODI) in London.

This report builds on what was originally a series of four essays<sup>1</sup> that were the result of consultations and research undertaken by CSIS and ODI. This work included a series of working group meetings that drew together DFI representatives—past and present—private-sector actors, development policymakers, and other stakeholders.

There have been significant shifts in the global development policy landscape, and these shifts have important implications for the role of DFIs. The development finance architecture is shifting as DFI investment and domestic resource mobilization have grown while traditional aid has stagnated. At the same time, the policy landscape is changing to put more emphasis on private investment, jobs, and growth.

This report argues both that policymakers and DFI shareholders need to better understand the unique role of DFIs in the wider aid architecture; and that DFIs themselves need to address development challenges more forcefully in order to remain effective players and improve their contribution to development goals in the future.

The report explores these issues, while also looking at where DFIs fit within the evolving development finance architecture, the potential roles they could play in shaping private-sector development policy, the significant development impact they have, and finally future directions.

Chapter 2 describes highlights of the shifting aid architecture and the role of DFIs within it. It highlights the changes in the global development policy landscape as more emphasis is put on private investment, jobs, and growth. It also shows how the development finance architecture has shifted dramatically over the past decade.

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<sup>1</sup> The essays include two written by Daniel F. Runde and Conor M. Savoy of CSIS: “DFIs and the Changing Development Finance Architecture” and “DFIs and International Development Policy”; one written by Dirk-Willem te Velde, Paddy Carter, and Alberto Lemma of ODI: “The Contribution of Development Finance Institutions to Global Development”; and a report coauthored by the authors from the two institutions: “The Future Direction of DFIs.”

Chapter 3 presents the DFI model in more detail. It presents the key features and variations of DFIs and discusses how their business model and unique competencies affect what they can do and cannot do effectively.

Chapter 4 looks at the development impact of DFIs. It describes how DFIs track their development impact and discusses the research on the DFIs' contribution to global development goals, including an overview of important knowledge gaps.

Chapter 5 lays out the current policy debate on private-sector development and DFIs in more detail. It highlights how we can expect DFIs to be playing an even more significant role in development finance. But it also discusses how important it will be for DFIs to engage actively in the policy dialogue to ensure that the role set out for them is one they can fulfill with success.

Chapter 6 sets out recommendations relating to how DFIs can shape their role within the new development finance architecture in an active and constructive way while protecting the successful elements of their business model and core competencies.

## The International Development Policy Context

After the Millennium Development Goals (MDGs) were adopted in 2000, extreme poverty was cut in half by 2010—five years ahead of schedule. Yet broader progress was uneven, and this led directly to the international community adopting a new set of goals in 2015. At the core of the new Sustainable Development Goals (SDGs) is a pledge to end extreme poverty by 2030; if the international community is serious about this, then economic growth and job creation must be at the forefront. The need for jobs in the formal sector is immense, with unemployment high, especially among youth populations. Jobs and economic growth will come largely from the private sector, which is responsible for 9 out of 10 jobs created in the developing world.<sup>2</sup> In the 2013 *World Development Report*, the World Bank noted that the private sector accounted for 90 percent of jobs created in Brazil and 95 percent in the Philippines between 1995 and 2005.<sup>3</sup> What does this mean in practical terms? Future development progress will require sustained economic growth, job creation, and greater tax revenue for domestic governments, all things the private sector provides when it is properly supported in a friendly investment and business climate. Aid alone will not be sufficient: the SDGs' financing estimates range into the trillions, a level that traditional official development assistance (ODA) will never reach: a mix of aid, domestic government resources, and private-sector capital will be needed to achieve results.

Looking more directly at how to finance the new SDGs is illustrative, because the role of the private sector—in particular investment—has emerged most clearly in the conversation around how to finance development. Since 2002, the United Nations has hosted a “Financing for Development” conference three times: Monterrey in 2002, Doha in 2008, and Addis Ababa in 2015. In Monterrey the focus was by and large on generating new ODA commitments by traditional donors and urging them to meet the 0.7 percent of gross national income (GNI) target and about making aid more effective. The consensus document from Monterrey notes that “a substantial increase in ODA and other resources will be required if developing countries are to achieve the internationally agreed development goals and objectives.”<sup>4</sup> Foreign direct investment and other private flows are discussed, but at the time the focus was on *increasing* the amount available through an improved investment climate.

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<sup>2</sup> The World Bank, *World Development Report 2013: Jobs* (Washington, DC: The World Bank Group, 2013), 7.

<sup>3</sup> Ibid.

<sup>4</sup> United Nations, “Monterrey Consensus on Financing for Development,” 2003, <http://www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf>.

The July 2015 Financing for Development conference in Addis Ababa was a watershed for a number of reasons. First, the outcome document placed the domestic resources of developing countries squarely at the center of development finance. This reflects the tremendous growth of taxes and government revenue in developing countries since 2002. Second, the document acknowledges the central role that private-sector investment plays; over the past 15 years, foreign direct investment (FDI) in developing and emerging markets has surged. This has fundamentally altered financial flows from developed countries; what was once dominated by public spending (e.g., ODA) is now overwhelmingly private. Across all low- and middle-income countries combined, FDI is now five times all ODA. Finally, Addis fundamentally reconceives of the role of ODA, seeing it as a “catalyst” to mobilize additional public and private resources, specifically highlighting support for improved tax collection and private finance through blended, pooled, or risk mitigation tools.

There are many countries where ODA remains the most important source of financing, but the number is declining and Addis acknowledged the reality that ODA is no longer the powerful tool it once was. Especially in least-developed countries (LDCs) and fragile and conflict-afflicted states (FCS) that struggle to attract sufficient investment, either international or local, to support private-sector development ODA will remain important. Beyond FDI, access to finance is an impediment to the benefits that the private sector can deliver through economic growth, job creation, and higher tax revenues for the state. Local capital markets are shallow in many developing countries with high interest rates for local borrowers, limited appetite to lend to small and medium-sized enterprises (SMEs), and underdeveloped stock exchanges.

## Changing Development Finance Architecture

The field of development finance has changed dramatically over the past 15 years as the amount available, types of resources and institutions, and the number of countries involved has grown. Resource flows were once dominated by ODA provided by bilateral donors or the multilateral development banks, which were in turn largely run by rich countries. Since 2000, official flows from donors have become a minority share in the overall makeup of development finance, while remaining an important component for many lower-income countries and fragile countries. This switch has been driven by the growth in private financial flows, such as foreign direct investment (FDI), remittances, and philanthropy to developing countries. FDI, for example, increased from \$78 billion in 2000 to \$402 billion in 2014. At the same time, new donor countries have emerged, some of which are former recipients of aid and others that continue to receive it. These new donors—China, Brazil, and others—do not rely on traditional ODA and have largely focused on providing financing for infrastructure projects. This section will briefly introduce and highlight trends in ODA, DFIs, private flows, and domestic resources.

**Official Development Assistance.** ODA, as defined by the Organization for Economic Cooperation and Development (OECD)-Development Assistance Committee (DAC), is provided by official agencies and is “concessional in character” with a grant element of at least 25 percent. For much of the postwar period, financial flows to developing countries were dominated by ODA from OECD-DAC countries; that is no longer the case as private-

sector flows, remittances, and new donors have entered the picture. In 2014, OECD-DAC countries provided \$137.2 billion in net ODA, which is an increase from the \$80.4 billion in 2000. The level has remained relatively constant since 2005.<sup>5</sup>

The other main source of ODA is the multilateral development banks (MDBs). The MDBs—the World Bank and the four regional development banks—remain a large pool of development capital. These entities are specifically designed to achieve development outcomes through the use of a blend of loans, guarantees, grants, and technical assistance. In particular, they remain a large source of public-sector finance for low- and middle-income countries. The World Bank alone provided over \$60 billion in 2014, broken down into: International Bank for Reconstruction and Development (IBRD), \$22.2 billion; and International Development Association (IDA), \$18.6 billion. The regional development banks provided the following funds in 2014: African Development Bank, \$7.1 billion; Asian Development Bank, \$13.5 billion; European Bank for Reconstruction and Development, \$8.9 billion; and Inter-American Development Bank, \$13.5 billion.

**Development Finance Institutions.** DFIs mobilize various amounts of investment for private-sector projects, but the story of the past 15 years has been the high amount of growth they have experienced. Since 2001, the amount of financing committed by these institutions each year has exploded: growing from approximately \$10 billion in 2000 to just under \$70 billion in 2014 according to estimates by CSIS, which corresponds to a nominal growth rate of more than 10 percent per annum.<sup>6</sup> This growth has been driven by reinvestment of profits and other sources of new capital on DFI balance sheets. Beyond the direct commitment amount, DFIs also mobilize (or leverage) additional capital for the projects they invest in from private-sector sources. In 2015, the European DFIs made new commitments of \$6.8 billion for a total portfolio of \$37 billion. OPIC made new commitments of over \$4 billion with a total portfolio of \$19 billion. On the multilateral side, the International Finance Corporation (IFC) provided \$18 billion in commitments in 2015 for a

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<sup>5</sup> Organization for Economic Cooperation and Development (OECD), “Statistics on resource flows to development countries: table 29,” December 2015, <http://www.oecd.org/dac/stats/statisticsonresourceflowstodevelopingcountries.htm>.

<sup>6</sup> The DFI financing number for 2002 is from International Finance Corporation, *International Finance Institutions and Development through the Private Sector* (Washington, DC: IFC, 2011), 36. The number for 2014 is based upon CSIS’s own estimates of DFI private-sector financing based on a review of the annual reports of the following DFIs: Asian Development Bank, African Development Bank, Biotechnology Innovation Organization (BIO), Black Sea Trade & Development Bank, Development Bank of Latin America (CAF), CDC, Cofides, German Investment Corporation (DEG), European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), Finnfund, Netherlands Development Finance Company (FMO), Islamic Development Bank (ICD), Inter-American Development Bank (IDB), Inter-American Investment Corporation (IIC), International Finance Corporation (IFC), IFU, Japan Bank for International Cooperation (JBIC), Multilateral Investment Fund (MIF), Multilateral Investment Guarantee Agency (MIGA), NIB, Norfund, Development Bank of Austria (OeEB), OPEC Fund for International Development (OFID), Overseas Private Investment Corporation (OPIC), Proparco, Belgian Corporation for International Development (SBI-BMI), SIMEST, Sofid, Sedfund, Swiss Investment Fund for Emerging Markets (SIFEM). See Chapter 5 for a fuller discussion of CSIS’s methodology and additional details on DFI financing growth. Daniel F. Runde and Helen Moser, “DFI Finance Increase to One Half of ODA: OPIC Needs Greater Authority,” July 13, 2015, <https://www.csis.org/analysis/dfi-finance-increases-one-half-oda>.

total portfolio in excess of \$84 billion.<sup>7</sup> Table 1 shows a comparative breakdown of OPIC and European DFI new commitments, total commitments, and profit or loss for 2015.

**Table 1: OPIC and European DFI Financial Statistics<sup>8</sup> (millions of USD)**

DFI	Country	Commitments, 2015	Total Portfolio Commitments, 2015
OPIC	USA	4,390	19,930.0
BIO	Belgium	131.3	697.3
CDC	UK	1,084.6	6,723.9
COFIDES	Spain	354.4	969.7
DEG	Germany	1,204.6	8,061.3
FINNFUND	Finland	93.9	674.9
FMO	Netherlands	1,793.4	10,376.2
IFU	Denmark	100.8	641.2
Norfund	Norway	281.9	1,763.4
OeEB	Austria	262.7	1,090.8
PROPARCO	France	1,089.2	6,303.5
SBI	Belgium	9.1	24.7
Sifem	Switzerland	82.7	622.2
SIMEST	Italy	242.3	2,350.8
SOFID	Portugal	2.3	12.3
SWEDFUND	Sweden	46.4	421.5
<b>EDFI Total</b>		<b>6,779.6</b>	<b>39,433.7</b>

**Private Flows.** The biggest shift that has occurred is the massive growth in private finance to developing and emerging market economies. Foreign direct investment from OECD-DAC countries increased from \$78 billion in 2000 to \$402 billion in 2014. In 2012, for the first time, developing and emerging markets attracted more FDI than developed countries. Though much of this is concentrated in specific countries (by one measure, 10 countries attract approximately 70 percent of all FDI), all regions and all developing countries have seen some kind of increase. For example, in 2014 sub-Saharan Africa attracted nearly as much FDI (\$42 billion<sup>9</sup>) as ODA (\$43.95 billion<sup>10</sup>). Yet, the least-developed countries (LDCs)

<sup>7</sup> International Finance Corporation, *Annual Report 2015*, 23, [http://www.ifc.org/wps/wcm/connect/73e2d10049c65e8a81ada3e54d141794/AR2015\\_Financial\\_Highlights.pdf?MOD=AJPERES](http://www.ifc.org/wps/wcm/connect/73e2d10049c65e8a81ada3e54d141794/AR2015_Financial_Highlights.pdf?MOD=AJPERES).

<sup>8</sup> Overseas Private Investment Corporation, *Annual Report 2015*, <https://www.opic.gov/sites/default/files/files/2015annualreport.pdf>; European Development Finance Institutions, *Annual Report 2015* (Brussels, BE: EDFI 2016), 25.

<sup>9</sup> UN Conference on Trade and Development, *World Investment Report 2015*, [http://unctad.org/en/PublicationsLibrary/wir2015\\_en.pdf](http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf).

<sup>10</sup> OECD, "Statistics on resource flows to development countries: table 29," December 2015, <http://www.oecd.org/dac/stats/statisticsonresourceflowstodevelopingcountries.htm>.



and fragile and conflict-afflicted states (FCS) continue to struggle to attract investment (unless they are resource rich) to generate the private-sector growth needed for job creation.

**Emerging Economies.** Emerging economies themselves are increasingly providing development finance, specifically the so-called BRICS (Brazil, Russia, India, China, and South Africa) and oil-producing states in the Middle East. The Export-Import Bank of China and the China Development Bank (CDB) had outstanding overseas loans of \$684 billion as of 2014. In addition, China launched two new multilateral development banks: the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB) or BRICS development bank. Together, this total far exceeds the estimated \$700 billion in assets held by the six major multilateral development banks.<sup>11</sup> While China is by far the largest emerging donor, institutions in other countries have also increased their development financing. The Brazilian Development Bank (BNDES) has also emerged as a significant development financier with total assets of nearly \$280 billion in 2015, including significant support for Brazilian exports and the internationalization of Brazilian companies.<sup>12</sup> Much of this financial support has been directed toward infrastructure projects across the developing world.

**Domestic Resources.** While external aid, loans, and investment finance continue to play a major role, developing countries' own resources are also a significant factor. Domestic resource mobilization—a government's ability to raise taxes and other revenues—is an emerging area of focus for international development policymakers. The figures here are truly staggering: developing countries (excluding China) collected just over \$4 trillion in taxes and revenues in 2014. On a regional level, in sub-Saharan Africa taxes collected rose from \$100 billion per year in 2000 to \$461 billion in 2014.<sup>13</sup> This growth is partially the result of the commodities boom, but it is also reflective of wealthier populations and improved tax-collection practices. Government revenue remains uneven across the developing world with lower-income countries collecting far less than middle-income countries and wealthy countries.

Taken together these development finance trends indicate a development finance architecture that is no longer dependent on ODA as the primary source of development finance. As FDI, private lending, and domestic resource mobilization continue to grow, donor countries are seeking to leverage the instruments and capabilities provided by DFIs to maximize their development impact.

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<sup>11</sup> World Bank, Asian Development Bank, Inter-American Development Bank, European Investment Bank, European Bank for Reconstruction and Development, and African Development Bank.

<sup>12</sup> International Development Finance Club, "Brazilian Development Bank (BNDES)," <https://www.idfc.org/Members/bndes.aspx>.

<sup>13</sup> African Development Bank, OECD, and UN Development Program, *African Economic Outlook 2014* (Paris: OECD, 2014), 65, [http://www.africaneconomicoutlook.org/fileadmin/uploads/aeo/2014/PDF/E-Book\\_African\\_Economic\\_Outlook\\_2014.pdf](http://www.africaneconomicoutlook.org/fileadmin/uploads/aeo/2014/PDF/E-Book_African_Economic_Outlook_2014.pdf).

# 03

## The DFI Model and Track Record

There is significant diversity to the DFIs in terms of their governance, instruments, and regions and sectors of focus. Bilateral DFIs include OPIC and the 15 European DFIs that are members of the Association of European DFIs. Other bilateral DFIs include the Japan Bank for International Cooperation (JBIC), and multilateral DFIs such as the World Bank's IFC, and the private-sector arms of the regional development banks. The unique characteristics and differences of DFIs' engagement are shaped by the policy dialogue between DFIs and their governments of ownership that determine the why (policy and strategy), the how (instruments), and the what (regions and sectors).

### DFI Features

**Governance/Ownership.** DFIs operate under two types of ownership structures: either fully government owned (e.g., OPIC) or partially owned by the government and private shareholders (e.g., Dutch FMO). These ownership structures influence how the entities are regulated; FMO, for instance, is treated by its government like a bank and must meet certain capital requirements. DFIs operate with a variety of risk appetites that are often a direct result of their ownership structure. For OPIC, ownership by the U.S. government imposes political constraints; some members of Congress object to a government entity providing support for private investment. This is less of a concern for the European DFIs. Multilateral DFIs are responsible to multiple country shareholders, which can at times add an additional layer of complexity.

**Instruments.** DFIs use a range of investment tools including equity or quasi-equity investments, loans, loan guarantees, and risk insurance. Most DFIs offer a mix of these products, though some focus almost exclusively on equity investments and some are prevented from making equity investments (i.e., OPIC) by their governing rules. European DFIs provide approximately 50 percent of their commitments through either equity or quasi-equity. In addition to the financial instruments, many DFIs can deploy some technical assistance (TA) to help prepare and mature an investment opportunity to make it bankable in advance of the final investment decision.

**Regions and Sectors of Focus.** Each DFI focuses on regions and sectors of importance specific to the particular organization. Some are highly specialized, such as CDC's focus on sub-Saharan Africa and South Asia, which was the result of a 2010 strategic review that sought to align its resources with the government's policy priorities. The largest DFIs operate across most regions and sectors. Though there are regional and sectoral differences, there are some general trends worth highlighting. For example, Africa has grown in importance for OPIC and the European DFIs with both now investing just over 30 percent of their financing

in sub-Saharan Africa. In addition, priority sectors such as infrastructure (which requires far more private investment) and financial services have received significant DFI resources. This is particularly true of renewable energy projects, and previously telecommunications. Relatively few DFIs have provided financing for, for example, agribusiness, though some, such as FMO are strong in this sector.

Given their mandate to mobilize private investment, DFIs are at the center of the emerging consensus around the role of the private sector in meeting development objectives. Table 2 summarizes key features (instruments, regions invested in, sectors of focus, etc.) that contribute to their comparative advantages that need to be part of this discussion.

## The DFI Model

Until recently, in spite of their mandates, DFIs have been relatively disconnected from the broader international development policy agenda. DFIs have focused on providing finance in emerging and developing markets, but they have by and large not been recognized as achieving important “development outcomes.” In the last 15 years, however, this changed for a number of reasons: First, there is a policy consensus, outlined above, that the private sector has a role to play in achieving development outcomes and DFIs play a central role in facilitating this involvement. Second, there is a growing body of evidence of what works to create jobs and sustainable economic growth. Third, there is a growing track record of what constitutes successful DFI ventures through additionality, sustainability, and catalytic effect.

At its most basic level, a DFI serves to shift or share the balance of risk and return in developing and emerging markets away from the private sector alone. How do you measure success in such a situation? There are direct and indirect development benefits that occur, because of DFI-supported investments. Direct benefits are typically defined as number of jobs created or supported, local tax revenue generated by a firm or project, and access to infrastructure or goods and services. European DFIs, for example, estimate that the businesses they support directly created more than 4 million jobs, generated \$11 billion in local tax revenue, and helped to generate 74,000 GWH of electricity (as one measure of access to infrastructure) in 2015.<sup>14</sup>

In addition to these types of development outcomes that a DFI investment can contribute to, DFIs use additional criteria to define success. This generally includes three basic criteria: additionality, catalytic effect, and project sustainability.<sup>15</sup> Project sustainability is a relatively straightforward concept: Is the investment by a DFI commercially sustainable from a financial standpoint in the long term? The degree to which private investors participate in projects alongside DFIs or enter markets in follow-on investments is an important indicator of the longer-term development effects. Additionality, however, is a term of art used by

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<sup>14</sup> European Development Finance Institutions, *Flagship Report 2016: Investing to Create Jobs, Boost Growth, and Fight Poverty*, July 2016, 15, <http://www.edfi.be/news/news/38-edfi-flagship-report-2016.html>.

<sup>15</sup> Association of European Development Finance Institutions, *EDFI Flagship Report 2016*, 21–24, <http://www.edfi.be/news/news/38-edfi-flagship-report-2016.html>.

Table 2: Key Features of OPIC and European DFIs<sup>16</sup>

DFI	Sector	Region	Instrument	Staff Size	Ownership Structure	Tied to National Interests
OPIC	I, F, A, SME	G	L, G, I	230	Owned by U.S. government	U.S. interest required
BIO	F, SME, I	A, A-P, LA, MENA	E, Q-E, L	44	Owned by Belgian government	Untied
CDC	F, I, S	A, SA	E, Q-E, L, G	158	Owned by UK government	Untied
COFIDES	I, A, M, SME, S	G, LA	E, Q-E, L	72	Owned by Spanish government (54%), Spanish banks (45%), and CAF (1%)	Spanish interest required
DEG	A, F, I, M, SME	G	E, Q-E, L	491	Owned by KfW, the German development bank	United
FINNFUND	F, I, A	G	E, Q-E, L	54	Owned by Finnish government (93%), Finnvera, and Confederation of Finnish Industries	Finnish interest required
FMO	F, I, A	G	E, Q-E, L, G	372	Owned by Dutch government (51%) and commercial banks, trade unions, and others (49%)	Untied
IFU	I, F, A	G	E, Q-E, L, G	56	Owned by Danish government	Danish interest required
Norfund	I, F, A	A, LA, A-P	E, Q-E, L, G	45	Owned by Norwegian government	Untied
OeEB	F, I, A	G	E, Q-E, L, G	40	Owned by Oesterreichische Kontrollbank AG, the Austrian export credit agency	Untied
PROPARCO	F, I, A, S	G	E, Q-E, L	168	Majority owned by AFD (64%), the French development agency	Untied
SBI	S, A, I	A-P, LA, LA, A	E, Q-E, L	6	Owned by Belgian government (63%) and private financial institutions	Belgian interest required
Sifem	F	G	E, Q-E, L	17	Owned by Swiss government	Untied
SIMEST	S, I, A	G	E-, Q-E, L	163	Owned by CDP, the Italian national promotional bank	Italian interest required
SOFID	I, S, A	A, LA, MENA	L, G	12	Owned by Portuguese government (60%) and four Portuguese banks	Portuguese interest required
SWEDFUND	F, I, A	G	E, Q-E, L, G	33	Owned by Swedish government	Untied

Key:

Sectors: I=infrastructure; F=financial services; A=agribusiness; M=manufacturing; SME=small and medium-sized enterprises; S=services

Regions: G=global; A=Africa; A-P=Asia-Pacific; EE=Eastern Europe; LA=Latin America; MENA=Middle East and North Africa; SA=South Asia

Instruments: L=loans; G=loan guarantees; I=insurance; E=equity; Q-E=quasi-equity

<sup>16</sup> Overseas Private Investment Corporation, *Annual Report 2015*,

<https://www.opic.gov/sites/default/files/files/2015annualreport.pdf>; European Development Finance Institutions, *Annual Report 2015*, September 2015, <http://www.edfi.be/news/news/35-edfi-annual-report-2014.html>.

development financiers (not just DFIs) to refer to a unique benefit created by their involvement in an investment. At the most basic level, additionality implies that projects would not obtain the required financing in the private capital markets without DFI involvement.<sup>17</sup> However, in practice, additionality can be hard to firmly demonstrate and measure. DFI investment decisions also involve difficult tradeoffs between additionality and catalytic effect and project sustainability.

Though DFIs have a strong track record and can point to tangible numbers to demonstrate their development impact, there are criticisms of the projects they support. This is particularly true of projects that some critics view as having little or no development benefit. A 2013 article, titled “Can You Fight Poverty with a Five Star Hotel?,” is emblematic of the type of criticism leveled at DFI investments.<sup>18</sup> The article details an IFC investment in a hotel in Accra, Ghana, that was cofinanced with a Saudi investment company. At its core the article questions whether the outcome produced (e.g., employment in a hotel) is a legitimate development outcome (and whether the Saudi investment company needed an IFC loan to build the hotel). One can debate whether creating jobs in a hotel in Ghana is a development impact (those who support the DFI model would say that yes, job creation leading to higher incomes has a clear impact on development), but regardless it does capture the tension between the financial and developmental prerogatives within DFIs. These cannot necessarily be resolved, but rather managed.

## The DFI Track Record

DFIs, unlike aid agencies and other development actors, provide bottom-up demand-based services not unlike private-sector financial firms. In order to do a deal, a DFI requires a potential client to approach them with a potential investment or financing request. Ultimately they cannot create an investment opportunity where one does not exist. This is in marked contrast to aid agencies, which tend to operate through supply-side interventions: top-down projects or programs designed to achieve desired development objectives or outcomes. This is where policymakers struggle the most to understand the role and value of DFIs to development policy. In discussing the role of DFIs, it is essential to understand their fundamental characteristics, competencies, and capabilities:

- DFIs are **demand-driven** in that each investment stems from a request made by private-sector sponsors that offers the prospect of positive **financial returns**.
- From the universe of potential projects, few make it to the *clearance in principle (CIP)* stage owing to **stringent investment criteria required to safeguard financial sustainability, transparency, and observance of human rights** in projects (e.g., in some DFIs this is one project per person per year).

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<sup>17</sup> Daniel F. Runde, “Development Finance Institutions Come of Age,” *Forbes.com*, October 17, 2014, <http://www.forbes.com/sites/danielrunde/2014/10/17/development-finance-institutions-come-of-age-dfi/#757cdb5b6e52>.

<sup>18</sup> Cheryl Strauss Einhorn, “Can You Fight Poverty with a Five-Star Hotel?,” *Pro Publica*, January 2, 2013, <https://www.propublica.org/article/can-you-fight-poverty-with-a-five-star-hotel>.

- It can take a **long time (sometimes several years) to develop large-scale projects** to the point of final approval. Complex projects often need considerable advice and expertise from DFIs and other technical assistance.
- **DFIs offer a wide variety of individual qualities** (in terms of speed, scale, instrument, sector, country, and experience) and a diverse choice of products and services to their clients, but they also often coinvest in projects, especially in larger projects to spread risks or reduce the administrative burden for the project sponsor.
- A quarter of portfolio is turned over each year for some DFIs, so **changes in investment priorities are phased in gradually** as it takes time to build up required competencies and approve new investments.
- Final investment decisions by DFIs are made by apolitical bodies (investment committees or boards of directors) rather than by the shareholders (aid agencies or other policy making bodies).

The task of DFIs is to combine considerations of development impact and financial sustainability. This is done by combining the competencies of investment professionals with the skills to assess a project's contribution to development outcomes. This is achieved through a long-term perspective and by building a specialist understanding of the risks in frontier markets and sectors and how these can be mitigated. Pioneering investments in frontier markets can be seen as experiments that demonstrate commercial viability, yet the risks involved will often be too great for private investors. DFIs are not only better able to bear risk, but also willing to invest more in project preparation and monitoring, thereby actually reducing underlying risks. There are also potential risk perception issues; DFIs have long experience of investing in frontier markets and may be more familiar with local market conditions than most private investors.

In response to market demand, DFIs can and will create new products to support private investors. For example, OPIC was largely responsible for creating the political risk insurance market in the United States in response to requests for insurance products that would protect against expropriation and local currency fluctuations. DFIs are also in large part responsible for seeding the emerging market private equity industry. But they do not have a track record of providing financing where no financing opportunity exists.

Yet the DFIs' demand-side approach has clear development implications, especially when looking at where DFIs provide financing from a regional and sectoral perspective. The European DFIs, for example, invested approximately 30 percent of total financing provided in 2015 to projects in the financial services sector (this includes investment funds) and 29

## Views Expressed on DFI Competencies

The CSIS-ODI-led consultations highlighted what DFIs consider their key competencies:

DFIs argue that they are good at supporting private-sector enterprises, managing risk and selecting profitable business propositions that create jobs and tax payments.

DFIs suggested it is difficult for them to apply criteria that restrict their investment universe, such as (1) targeted impacts; (2) social and behavioral change; (3) reaching marginalized people and tiny geographies; (4) tied investments. They also indicate that it is impossible for them to (5) create investments where there are none; and (6) address humanitarian issue where there is no prospect of a financial return.

DFIs feel they are not always well understood by policymakers in the following areas: (1) the time frame required for investments is years not months and often the hard part starts only when the investment has been approved; (2) DFIs cannot throw large amounts of money quickly at specific areas without following their investment process; (3) risk is at the core of their operations, and not just financial risk; and (4) often the bottleneck to good project outcomes is not simply capital, but also people with the right skills.

DFIs feel that there is a large difference in mentality between aid agencies and DFIs that needs to be addressed: aid is macro, strategic, and creative, while DFIs are pragmatic and mostly work at project level.

Shareholders indicate that they are eager to see DFIs scale up investment in areas that can contribute to global development goals; and that they may like DFIs to take on more risks to promote development outcomes in frontier markets and projects that are more transformational.

NGOs express a desire to push DFIs to operate more like aid agencies and less like institutional investors in the private sector by having political accountability in investment decisions (e.g., implementation of “country ownership” principles), permitting public scrutiny of investment decisions, and pushing for more restrictive practices with regards to, for example, corporate responsibility and taxation.

Source: CSIS-ODI consultations, 2016.

percent in infrastructure projects.<sup>19</sup> Since 2000, OPIC has provided nearly two-thirds of all its financing toward projects in the same sectors.<sup>20</sup> From a regional perspective, both the European DFIs and OPIC have shifted the focus of their financing toward areas where the need is most great, such as sub-Saharan Africa (both OPIC and the European DFIs provide approximately 30 percent of their new commitments to Africa). To be sure, some individual DFIs have retained a focus on some specific regions for largely historical or expertise reasons (e.g., the Spanish DFI, COFIDES, remains largely focused on Central and South America).

It is important to be clear on what DFIs can do and cannot do; DFIs are a powerful, but precise development tool. If policymakers are seeking to effect a particular social change (e.g., increase in women in the workforce) in a particular region, country, or sector, DFIs are probably not the best agency to carry out this work. They could do two things to support such objectives: first, DFIs could create funds or other investment vehicles that are targeted to provide financing for specific types of companies. In this case, a DFI could create a fund that seeks to invest only in women-led businesses. Second, a DFI could rely upon screens (and most do) that seek to eliminate investments or clients that are harmful from an environmental, social, or governance perspective. To be sure, both approaches could reduce

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<sup>19</sup> Association of European Development Finance Institutions, *Annual Report 2015*, September 2015, <http://www.edfi.be/publications/edfi.html>.

<sup>20</sup> Benjamin Leo and Todd Moss, “Inside the Portfolio of the Overseas Private Investment Corporation,” Center for Global Development Policy Paper 81, April 2016, 7, <http://www.cgdev.org/sites/default/files/CGD-Policy-Paper-81-Leo-Moss-Inside-the-OPIC-Portfolio.pdf>.

the pipeline of potential projects. In cases where the pipeline was drastically reduced, DFIs could find that there are no qualified investments to support, and that they are subsequently unable to contribute to the hoped-for development policy outcome.

On the policy side, requests for DFIs to direct their investments in ways that help achieve specific national security or foreign policy objectives are increasing; this trend is likely to continue for the foreseeable future, given budget pressures and the economic development angle of many foreign policy concerns. For example, in the U.S. context, OPIC has used its instruments to provide financing in the Republic of Georgia in 2008 following the Russian invasion, Arab Spring countries in 2011, and in Afghanistan since the U.S. invasion in 2001. The Georgia case is a good example of how a DFI could be deployed to help achieve indirect foreign or national security policy objectives. One direct economic consequence of the Russian invasion was an almost total freeze on domestic lending, in particular the commercial and residential mortgage market suffered severe effects. As part of the broader U.S. response to Russia's invasion (approximately \$1 billion in total U.S. assistance), OPIC agreed to provide \$176 million to support the local mortgage market.<sup>21</sup>

More recently, the United Kingdom's CDC worked with Standard Chartered to create a lending line for SMEs in Sierra Leone following the Ebola outbreak. Three West African countries—Sierra Leone, Liberia, and Guinea—suffered a crippling outbreak of Ebola in 2014–2015 resulting in many deaths. Given the extreme measures implemented to control the outbreak of the disease, local economies slowed to a halt. As the outbreak of Ebola came under control, donors and the local governments shifted their attention to economic recovery. In Sierra Leone growth was cut from 11.3 percent to just 4 percent, which placed pressure on local banks' capital bases. CDC and Standard Chartered agreed to a \$50 million facility that would allow the bank to increase loans and overdrafts to local businesses.<sup>22</sup>

DFIs have also provided significant financial support for the development of renewable power generation in developing and emerging market economies. Some of this support has been a reaction to the broader policy push to mitigate climate change, but it is also a reflection of an organic recognition by DFIs of the commercial opportunities that exist in renewable energy. This is one area where there is clear alignment between the DFI model and the broader policy zeitgeist.

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<sup>21</sup> U.S. Department of State, "Georgia: \$1 billion Assistance Commitment," December 10, 2008, <http://2001-2009.state.gov/r/pa/prs/ps/2008/dec/113077.htm>.

<sup>22</sup> CDC Group, "CDC and Standard Chartered Bank commit to support increase lending to businesses in Sierra Leone," February 6, 2015, <http://www.cdcgroup.com/Media/News/CDC-and-Standard-Chartered-Bank-commit-to-support-increased-lending-to-businesses-in-Sierra-Leone/>.



# 04

## DFI Development Impact

There are several motivations for why DFIs gather information and generate knowledge about their operations and impact. First, this helps to inform donor policy and future allocation of aid spending. Second, DFIs themselves benefit: measuring the impact of DFI-supported operations improves accountability to stakeholders, including taxpayers who would like to know what is going on. Monitoring impact during project execution can also provide important information for effective implementation by DFIs. And finally, evaluating development impact can inform future investment decisions.<sup>23</sup> For example, when the availability of finance is the constraint on project closure (rather than the number of profitable projects that satisfy project investment codes), DFIs could select projects that are more likely to be innovative and transformative, rather than selecting those projects that do not change the economic structure in the country. Having said that, the availability of good projects also seems to be a constraint in practice.

DFIs already collect a large amount of information on their operations and their investee companies, which helps to understand the contribution of DFIs to development. However, evidence on the impact on the rest of the economy and wider development objectives is emerging more slowly and could be used more strategically. This is part of a more general challenge in development economics of understanding attribution and additionality, which is a very hard topic to tackle.<sup>24</sup>

### Current DFI Reporting

DFIs use a number of tools to measure their contribution to development, focusing mainly on their direct contribution (e.g., jobs, taxes). While these tools tend to vary by DFI, which makes detailed comparable demonstrations of development impact a challenge, there is a broad level of comparability. Although DFIs have used different measures and definitions of what defines impact, there have been concerted efforts to harmonize definitions (including

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<sup>23</sup> Dirk Willem te Velde, "DFIs should work together to measure job impacts," World Bank, November 12, 2015, <http://blogs.worldbank.org/jobs/dfis-should-work-together-measure-job-impacts>.

<sup>24</sup> Paddy Carter, *Why subsidize the private sector? What donors are trying to achieve and what success looks like?*, Overseas Development Institute, November 2015, <https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9948.pdf>; S. Spratt and L. Ryan-Collins, "Development Finance Institutions and Infrastructures: Findings from a Systematic Review of Evidence for Development Additionality," Institute of Development Studies, August 2012, <http://www.ids.ac.uk/files/dmfile/2012IDS-PIDGReview2.pdf>; Dirk Willem te Velde, *The Role of Development Finance Institutions in Tackling Global Challenges*, Overseas Development Institute, August 2011, <https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/7310.pdf>.

by the IFI Working Group on harmonized indicators for private-sector operations<sup>25</sup>), if not actual impact evaluation methodologies.

At the broadest level, we can distinguish among the following development outcomes where DFIs report direct impacts:

- *Employment generation*: Employment creation is often reported as the “direct” number of jobs created (or supported) in DFI-supported business and sometimes as “indirect” jobs calculated through input-output tables. Direct employment impacts are relatively easy to monitor, assuming willingness by DFI clients to divulge such information and capacity to baseline, monitor and report any changes in employment levels. Most DFI annual reports report on direct jobs supported, and the evidence base on this is of reasonable quality.
- *Government/tax revenues*: Reported tax revenue relate to government revenues generated by DFI-supported projects in-country. An increase in taxes paid by DFI clients helps improve government revenues, which could in turn unblock growth-enhancing public investments (e.g., infrastructure, health care, education). Revenues tend to be reported as direct contributions (by DFI clients/projects).
- *Investment outcomes*: As part of the project appraisal processes, DFIs report financial rates of return of an investment. DFIs also examine the direct contribution impacts on other enterprises supported by their financial activities.
- *Environmental and social outcomes*: Information varies significantly between DFIs. Some DFIs report on CO2 emissions avoided through saving energy. Some also report on the quality of jobs.
- *Catalyzing and mobilization*: Mobilization is usually measured as the amount of coinvestment by other parties (often divided into other DFIs and private-sector finance). This is relatively straightforward to report, although there could be issues of commercial secrecy related to coinvestors. Mobilization is often reported in annual reports in the form of leverage ratios (e.g., the ratio of DFI investment to total investment), although we should realize that a statistical leverage ratio does not automatically assume cause and effect. DFIs can also catalyze investment through demonstration effects. In a systematic literature survey, Spratt and Ryan-Collins find that the existing evidence on DFIs’ demonstration effects is still limited, given the too recent introduction of DFI impact evaluation systems as well as the difficulty of proving causality.<sup>26</sup>

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<sup>25</sup> International Finance Corporation, “Memorandum Regarding IFIs Harmonized Development Results Indicators for Private Sector Investment Opportunities,” October 12, 2013, <http://www.ifc.org/wps/wcm/connect/d7d1128041773cdb9af3bb9e78015671/Harmonization+MOU.pdf?MOD=AJPERES>.

<sup>26</sup> Spratt and Ryan-Collins, “Development Finance Institutions and Infrastructures.”

**Table 3: Contribution to Development Outcomes Reported by European DFIs<sup>27</sup>**

	Contribution by European DFIs in 2015
Jobs supported	More than 4 million (direct and indirect, in companies and institutions)
Taxes paid	€11 billion
Electricity supply	74,000 GWh

Table 3 provides an example of the development contribution reported by European DFIs. The importance of DFIs in supporting jobs and tax revenues is clear and an important piece of information for DFI shareholders. We can be reasonably satisfied with such data on the direct contribution of DFIs.

## The Indirect Effects of DFIs and Contribution to Global Development Goals

DFIs report development outcomes at project level, but these outcomes are normally not reported in the context of global goals such as the SDGs. Understanding how DFIs contribute to global development goals hinges critically on the ability to assess and communicate the indirect effects of DFIs. Some evidence on the indirect impacts has emerged, but further, more detailed analysis would be beneficial.

There are many examples of the importance of indirect impacts for reaching global goals. For example, the ability of DFIs to contribute to climate change goals depends on their ability to catalyze investment in energy efficiency and green technologies, not just on whether an individual project has an acceptable good financial return or saves on energy use. Likewise, their impact on poverty does not depend so much on how many jobs are created directly in beneficiary companies, but also on how many jobs are consequently created indirectly in suppliers and the wider economy. If DFIs had better evidence of their indirect impacts, they would be able to have more strategic engagement on the global development goals, and this more compelling case would make it easier for their shareholders to allocate more resources through DFIs.

The emerging evidence on the indirect effects is structured around: indirect employment effects; labor productivity and economic growth; investment; and poverty and environmental effects. This section discusses the availability and quality of evidence relating to indirect impacts.

**Indirect employment effects.** The employment impact of DFIs follows a number of channels:

- *Direct Impacts:* Jobs created in companies or projects directly supported by DFI investments.

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<sup>27</sup> Association of European Development Finance Institutions, *EDFI Flagship Report 2016*, 15.

- *Indirect Impacts*: Jobs created through forward and backward supply-chain linkages as a result of a DFI-supported project or company.
- *Induced Jobs*: Jobs created through demand multipliers and other consumption effects of direct and indirect jobs created by DFIs.
- *Second-order, Growth Effects*: Jobs created through growth effects (some of these relate to productivity spillover effects when third companies operate more efficiently, expand economic activities, and create more jobs in the process).

Examining the effects beyond direct impacts requires either making assumptions on impacts or using deep-dive case studies of impacts. Different DFIs have used different in-depth studies (e.g., PIDG, CDC, DEG, and FMO have commissioned different types of ex-post impact studies) as well as studies relating to effects on employment, for example, in the energy sector and on skills gaps. The evidence base on indirect effects could be significantly strengthened, although resource constraints tend to limit the amount of in-depth studies.

The evidence so far suggests that the indirect job effects are important. A review of the development impacts of DFIs found that the average ratio of indirect-to-direct jobs supported by DFIs, between 2012 and 2013, was approximately 1.7 indirect jobs for every direct job created.<sup>28</sup> Similar evidence showed that in 2015 European DFIs supported 2 million direct jobs, 1.3 million indirect jobs, and a further 2 million jobs through fund investments.<sup>29</sup>

There are few estimates of indirect job effects at project level. One study examines the impacts on employment of the Bugoye hydropower project in Uganda. They find second-order growth effects (as well as induced jobs) are more significant than direct and indirect effects. The direct job effects were around 1,000 while the second-order growth effects were estimated to be around 10 times of between 8,000 and 10,000.<sup>30</sup>

Analyzing the impact of DFI investments on employment is complicated because the creation or expansion of enterprises may also result in some job destruction in competing firms. This makes estimates of the macroeconomic impact an important complement to estimates based on trying to count jobs at project level across firms. Macroeconomic evidence (using a production function approach for 2007) suggested that DFI investments (the multilateral and main regional and bilateral DFIs) supported a total of 2.6 million jobs (directly and indirectly) in over 70 countries.<sup>31</sup> Since then DFI investments have increased significantly. But this estimation technique has its own challenges as it requires assumptions about the additionality of DFIs.

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<sup>28</sup> Isabella Massa and Dirk Willem te Velde, "The Macroeconomic effects of Development Finance Institutions in Sub-Saharan Africa," May 2016, unpublished report prepared by ODI for Norfund.

<sup>29</sup> Association of European Development Finance Institutions, *EDFI Flagship Report 2016*.

<sup>30</sup> Andrew Scott, Emily Darko, et al., "Job Creation Impact Study: Bugoye Hydropower Plant, Uganda," Overseas Development Institute, June 2013, <https://www.odi.org/publications/7529-job-creation-impact-study-bugoye-hydropower-plant-uganda>.

<sup>31</sup> Marie-Agnes Jouanjean and Dirk Willem te Velde, "The role of Development Finance Institutions in promoting jobs and structural transformation: a quantitative assessment," Overseas Development Institute, March 2013, <https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/8323.pdf>.

**Table 4: The Expected Employment Impact of DFIs by Sector<sup>32</sup>**

Sector	Direct Jobs Impact	Indirect Jobs Impact	Induced / Second-order Job Impact
Manufacturing	<i>Very important</i>	<i>Potentially important</i>	<i>Less important</i>
Tourism	<i>Medium important</i>	<i>Very important</i>	<i>Less important</i>
Infrastructure (e.g., energy, roads)	<i>Less important</i>	<i>Temporary</i>	<i>Very important</i>
Agriculture	<i>Very important</i>	<i>Less important</i>	<i>Less important</i>

Taking the evidence together, employment impacts are likely to differ by sector (see Table 4). There are differences between, for example, manufacturing, where direct impacts are important (e.g., garments), and infrastructure investments (e.g., in the hydropower example above), which have stronger induced / second-order impacts.

**Labor productivity.** DFIs can also raise (labor) productivity. Identified impact channels include investments in new enterprises that help create new jobs as well as directly carry out (and demonstrate the feasibility of) investments in innovative and technology intensive activities, and investments in sectors that promote positive productivity changes and structural transformation.

Although still limited, initial evidence on the labor productivity impact of DFIs, carried out on a panel of 62 countries in a period between 6 and 11 years, shows that DFI investments have a significant impact on labor productivity with ranges between a 3.5 percent and 7.5 percent increase over the period 2001–2009 depending on the DFI.<sup>33</sup>

**Economic growth.** Although not a strongly developed strand of research, a number of studies have examined the wider macroeconomic impacts of DFIs. One assesses the economic impacts of multilateral DFIs on GDP per capita growth for a number of selected countries covering the 1986-to-2009 period and found that there was a strong positive correlation between investments and growth, where an increase of 10 percent in investment volumes by multilateral DFIs increases incomes by 1.5 percent. Disaggregated results by sector show that impacts are greatest from investments in infrastructure and industry.<sup>34</sup>

Impacts also depend on the income level of recipient countries where lower-income countries benefit more from investments in infrastructure and agribusiness and higher-income countries benefit more from investments in industry. A study by ODI examined the macroeconomic impact of DFIs in sub-Saharan Africa. It found that, if the DFI/gross domestic product ratio increases by 1 percent (or by some €10 billion, which is a challenge given that this is approximately the current European DFI portfolio in sub-Saharan Africa), per

<sup>32</sup> Ibid.

<sup>33</sup> Ibid.

<sup>34</sup> Isabella Massa, "Impact of multilateral development finance institutions on economic growth," Overseas Development Institute, August 2011, <https://www.odi.org/publications/5980-impact-multilateral-development-finance-institutions-economic-growth>.

capita incomes increase by on average 0.24 percent and labor productivity by 0.27 percent.<sup>35</sup> Given the importance of growth for achieving development goals, DFIs contribute significantly to the achievement of development goals in the region.

**Investment.** In a 2011 report, ODI found that there are 26 developing countries where the IFC, EIB, and the United Kingdom's CDC together make up between 2 percent and 12 percent of total fixed capital formation. Using standard regression analyses, and based on data for EIB, EBRD, IFC, and CDC from 1985 onwards (depending on data availability), he finds DFIs have indeed raised investment (GFCF) in recipient countries compared with the constructed counterfactual. A 1 percent increase in DFI as a percentage of gross domestic product (GDP) would lead to a 0.8 percent change in the investment ratio. Hence, for 26 countries, these major DFIs have kept investment to GDP ratios more than 1.5 percent higher than would otherwise have been the case.<sup>36</sup>

Evidence suggests that DFI investments can also be counter-cyclical sources of investment and can potentially act as buffers in periods of crisis. A study by Dalberg shows that DFI investments supported financial institutions in Africa, maintaining stable (and increased) flows while private-sector investments retreated.<sup>37</sup> An example includes the partnership among FMO, Norfund, and Rabobank to invest in local financial institutions at a time when, for example, Barclays announced it would leave African banking.<sup>38</sup> Others also found that DFI investments tended to complement rather than replicate patterns of private investment, being concentrated in countries with lower levels of foreign direct investment.<sup>39</sup>

**Poverty and environmental impacts.** It is the combination of the above indirect impacts that affects poverty more than the direct poverty impacts. There is little direct evidence on the impacts of DFI investments on poverty reduction. Research by Spratt and Ryan-Collins on investments in infrastructure show little is known on the impact on poverty reduction.<sup>40</sup> Others have argued that DFIs do not explicitly measure their poverty impacts. A review of projects carried out by IFC between 2000 and 2010 found that in only 13 percent of projects the mandate included an explicit poverty focus.<sup>41</sup> But it is debatable whether this is—or should be—the role of DFIs.

In terms of sustainability and environmental impacts, direct impacts were initially mostly anecdotal, typically based on a case-study approach. However, more recently DFIs have introduced reporting relating to clean energy capacity and CO2 mitigated. The evidence available points to increases in renewable energy production. There is also more evidence

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<sup>35</sup> Massa and te Velde, "The Macroeconomic effects of Development Finance Institutions in Sub-Saharan Africa."

<sup>36</sup> Te Velde, *The Role of Development Finance Institutions in Tackling Global Challenges*.

<sup>37</sup> Dalberg Global Development Advisors, *The Growing Role of Development Finance Institutions in International Development Policy*, July 2010, <http://www.bio-invest.be/en/component/downloads/downloads/38.html>.

<sup>38</sup> Rabobank, "Rabobank, Norfund, and FMO join forces and invest in financial institutions to support growth in Africa," August 4, 2016, <https://www.rabobank.com/en/press/search/2016/20160804-rabobank-norfund-and-fmo-join-forces-and-invest-in-financial-institutions-to-support-growth-in-africa.html>.

<sup>39</sup> Te Velde, *The Role of Development Finance Institutions in Tackling Global Challenges*.

<sup>40</sup> Spratt and Ryan-Collins, "Development Finance Institutions and Infrastructures."

<sup>41</sup> International Finance Corporation, *IFC Jobs Study: Assessing Contributions to Job Creation and Poverty Reduction* (Washington, DC: IFC, 2013).

that DFI investments have helped increase the availability of climate finance in developing countries, helping to facilitate the transition toward low carbon growth.<sup>42</sup>

## Gaps in Knowledge on Development Impact

There is much to admire in the way DFIs already cover the direct outcomes of their investments. They do this better than most aid agencies, for example. Improvements can be made (e.g., by adopting the same metrics), but it is not a major source of contention among stakeholders. Instead, as the previous section indicated, the indirect effects matter a lot for understanding the contribution of DFIs to global development goals. Progressing on these areas requires more studies that examine the indirect effects of DFIs. However, these effects are not easy to measure and there are challenges to navigate. DFIs can be expected to deal with some but not all of these challenges as they extend well beyond the realm of DFIs. We discuss the challenges and possible solutions here.

- The type of DFI investment shapes the type of development impacts that is usually highlighted. Investments in infrastructure will generate data on infrastructure availability (i.e., additional energy generated), but not data on productivity, which need to be estimated; investments in small and medium-sized enterprise funds will provide data on the number of SMEs supported. As investments target private-sector engagement through operations that lead to financial returns, development impacts (i.e., poverty reduction) beyond this sphere cannot feasibly be captured without making assumptions and engage in estimations.
- Whereas direct impacts such as job creation can be used to support a DFI's theory of change, it is more challenging to establish causality for indirect impacts from DFI investments even though there is some plausible causal chain. This is a general problem. All development actors that aim to make something happen that would not have happened otherwise find producing evidence of doing so challenging. The fundamental problem lies in knowing what would have happened without intervention, which cannot be observed. The desire for robust evidence of causal impacts has led to the "randomization revolution" in development economics, where a random allocation to treatment and control groups makes it possible to estimate what would have happened without intervention. But running a randomized control trial for DFI investments is challenging. In the absence of experimental research design, or where certain statistical techniques designed to establish causality are not feasible, in observational data there is an intractable problem of separating correlation from causation. There is therefore a question as to what type of efforts should be going into designing impact assessments that will provide sufficient information, on the understanding that we will never be able to obtain perfect knowledge.
- A further constraint relates to data protection regulation and use of commercially sensitive information. There are limits to how much commercially confidential information can be divulged. This leads to potentially missing metrics that could

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<sup>42</sup> Massa and te Velde, "The Macroeconomic effects of Development Finance Institutions in Sub-Saharan Africa."

provide the DFI development impact discussions with more depth (e.g., finance flows and profits coming in and out of target countries). Stringent data requirements for impact evaluation will require collaboration from DFI clients, who may have challenges to complying. DFIs need to keep pushing the boundaries on this given the reasonable demands from taxpayers, who provide the funding for DFIs.

- Finally, attention and capacity to undertake development impact studies within DFIs is limited, especially in smaller bilateral DFIs. They will not be able to undertake detailed impact assessments of each individual investment.

It is important to undertake more impact studies of indirect effects and tackle the issue of additionality, but this needs to be done in a targeted way underpinned by a practical strategy. For example, DFIs can work together for a number of sector studies and individual DFIs can undertake a number of illustrative studies each year.



# 05

## DFIs and Policy Engagement

As DFIs have grown in the scale of their investment activity, policymakers are increasingly interested in how these entities can be deployed to achieve *both* development outcomes and other foreign, economic, and security policy objectives. DFIs, traditionally, focus on the commercial sustainability of individual investment transactions and do not engage in broader policy discussions. This can contribute to a misunderstanding by policymakers (often representatives of “shareholders” of the DFIs) of what DFIs can and cannot do with their private-sector instruments. Policymakers often focus on the amount of funding available and where to direct it to meet relatively broad objectives, rather than on the feasibility of addressing these problems with DFI instruments. This is understandable as many of these policymakers are used to designing top-down development projects that seek to solve discrete problems.

These challenges in terms of basic understanding of what DFIs can and cannot do, and where and how they can make the biggest impact from a development, policy, and financial sense, are fundamental to DFIs successfully engaging in the policy process. The operational challenges that DFIs face on a daily basis, such as finding investable opportunities, safeguarding against corruption, the length of time it can take to fully realize an investment, can be used to test what sorts of policy demands DFIs are suitable for addressing.

DFI leadership is clear that there are instances where deploying their resources will not help solve the problem, but ensuring that this is part of the broader discussion around development remains challenging. The nuances of DFIs and their operations remain relatively unknown to many of the policymakers who have crafted the new sustainable development agenda. For example, relatively few DFIs sent (or were requested to send by their respective governments) senior representatives to attend the Addis conference. This creates a situation where DFIs may be asked to implement policy priorities that are outside of their capabilities. Ensuring that DFIs are deployed in ways that best leverage their resources and capabilities will require that policymakers develop a better understanding of the DFI model. But given their experience and expertise, DFIs should play a stronger role in designing private-sector development policy.

### The Policy Debate

A central theme of this paper revolves around the question of how DFIs should engage in the policymaking process. But in the context of DFIs, what does policy mean? In this context policy is related to the broad contours of *private-sector development* or the levers that policymakers have to support a vibrant local private sector that creates jobs and contributes to sustainable growth. There are questions about how DFI instruments can best make

strategic contributions to development goals and other policy priorities. DFIs' knowledge and experience could also help inform policymaking beyond their own investment operations. On both fronts, there is scope for many of the DFIs to participate more actively in the policy dialogues.

Aid agencies have long worked on improving the investment climate in developing countries—this direct work is well outside the mandate or capability of DFIs. Investment climate is a broad and somewhat amorphous term. Nick Stern, former chief economist of the World Bank, defines it as “policy, institutional, behavioral environment, both present and expected, that influences how entrepreneurs perceive returns and risks associated with investment.”<sup>43</sup> Donors can improve the investment climate through a variety of projects aimed at capacity building, support for regulatory reforms, public financing for critical infrastructure (an area where some DFIs do provide support), and policy review work.

One of the more prominent examples of donors working on investment climate is the World Bank's annual survey, the *Doing Business* report that seeks to measure the ease of doing business across 185 countries. The report relies on 11 indicators that measure the complexity and cost of regulatory process and the strength of legal institutions and are then used to determine a country's ranking vis-à-vis the rest of the world. Though the survey has critics, the World Bank has linked *Doing Business* to its investment climate reform work and achieved results spurring 2,600 regulatory reforms over the course of its 13 years in publication.<sup>44</sup> The World Bank's investment climate team used this to help countries such as Côte d'Ivoire, Turkey, Costa Rica, and others implement new regulations and laws that improved investment and business climate. There are, however, limits to how ODA can facilitate improvements to the investment and business climate. Donors cannot force countries to reform their regulatory systems, and in this day and age of “country ownership” there is broad agreement that donor efforts must align with the national government's priorities.

Given their private-sector focus, DFIs are most often structured more like banks or financial firms rather than a typical government agency focused on developing policy and then implementing programs to achieve set objectives. Although DFIs are largely demand-driven organizations, there are plenty of examples where they have found solutions to specific challenges when asked to do so by policymakers, some of which are highlighted above.

## New Directions for DFIs

The growth of DFIs and their increasing prominence in policy conversations is a natural progression as more developing countries become potential destinations of private investment at greater scale. This emergence is, in some ways, the product of decades of (successful) work by traditional development assistance providers. While DFI financing

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<sup>43</sup> Nicolas Stern, “Investment Climate: Lessons and Challenges,” Egyptian Center for Economic Studies, March 2003, 10–11, [http://www.eces.org.eg/MediaFiles/Uploaded\\_Files/%7B917BEE82-38B7-4857-8361-930ED89E16C9%7D\\_ECESDLS19e.pdf](http://www.eces.org.eg/MediaFiles/Uploaded_Files/%7B917BEE82-38B7-4857-8361-930ED89E16C9%7D_ECESDLS19e.pdf).

<sup>44</sup> The World Bank, *Doing Business 2016: Measuring Regulatory Quality and Efficiency* (Washington, DC: World Bank, 2016), vi.

cannot operate as a substitute for ODA—in some environments ODA is still critically important—it can serve as a supplement and successor to traditional development practice. Both DFIs and donor agencies need to continue to adapt and evolve in a mutually strengthening way in the face of these changes. This is especially true given the high importance of private capital in financing development and the outcomes that the private sector can produce in terms of jobs and growth. DFIs must engage effectively in the policy process so that policy makers understand their unique competencies and appreciate the value-added role they play.

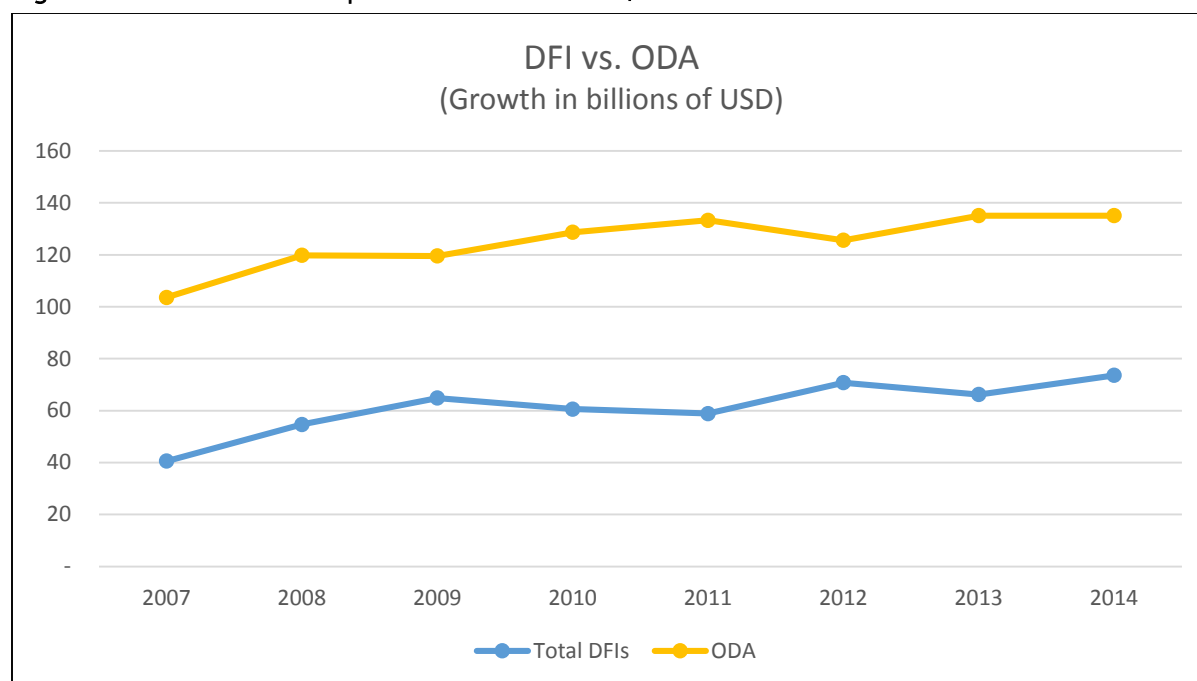
The core mandate of DFIs compels them to play a central role in achieving the Sustainable Development Goals' (SDGs) priority of eradicating extreme poverty by 2030. In certain instances, these new global goals will push DFIs to look for ways to direct a greater share of their investment toward low- and lower-middle-income countries. DFIs are tasked to contribute to lower the global poverty rate and this mandate is likely to remain and perhaps even be strengthened in light of the 2030 Agenda. If a shift in investment priorities were required, then it would not happen immediately. To deliver on their core competencies, DFIs would need to ensure that two things were present in any situation: deal flow (i.e., appropriate deals available for investment) and private investors willing to coinvest.

DFIs, which have seen their transactions and resources grow in the past 15 years at a rate far greater than ODA (see Figure 1), will more than likely reach a point in the next five years where their annual financing into low- and middle-income countries will eclipse ODA commitments. The scale of DFI invest activities will mean that they attract more attention and pressure will mount for DFIs to use their resources to address specific policy priorities, often in areas that involve take greater risk.

## Regions and Sectors of Focus

DFIs play a central role in reducing poverty across low- and middle-income countries. But they will also be challenged to take on a range of specific policy challenges, relating to economic development, as well as related challenges such as climate change and international security. There is no “off-the-shelf” solution to these challenges and DFI investments will not happen immediately. DFIs will have to consider how they can apply their business model, instruments, and competencies to help address these challenges without compromising financial viability. Some particular challenges that DFIs can expect to be called upon to confront include:

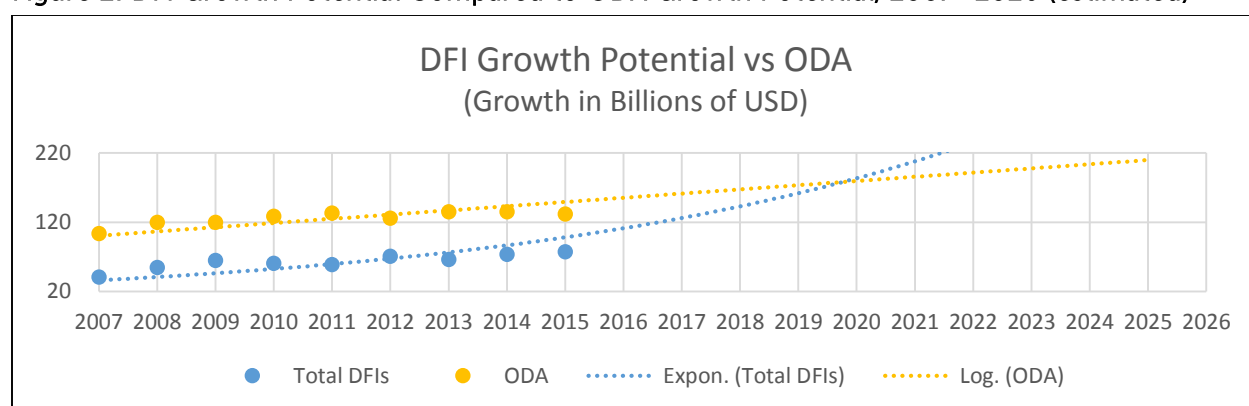
Figure 1: DFI Growth Compared to ODA Growth, 2007–2014<sup>45</sup>



- Regional Focus.** There will be increased pressure on DFIs to focus a larger share of their investments on regions of importance such as sub-Saharan Africa, the Middle East, and the poorest countries in Asia. This will be particularly true when sub-Saharan Africa is experiencing an economic slowdown after the relatively high-growth levels of the past decade. The European DFIs and OPIC already have a significant presence in Africa (approximately one-third of their total portfolio), but policymakers will look to DFIs to increase their investments beyond what they already do in these regions. The expectations are also in some cases clashing with the risk management and regulatory frameworks that several DFIs must comply with.

<sup>45</sup> To assemble this chart, CSIS relied upon the annual reports for the following bilateral and multilateral DFIs: Asian Development Bank, African Development Bank, BIO, Black Sea Trade & Development Bank, CAF, CDC, Cofides, DEG, EBRD, EIB, Finnfund, FMO, ICD, IDB, IIC, IFC, IFU, JBIC, MIF, MIGA, NIB, Norfund, OeEB, OFID, OPIC, Proparco, SBI-BMI, SIMEST, Sofid, Sedfund, and SIFEM. For multilateral DFIs such as ADB, AfDB, and IDB, CSIS included only private-sector financing. EIB figures include only financing that the bank provided to developing regions such as Africa, MENA, Asia, and Latin America and the Caribbean.

Figure 2: DFI Growth Potential Compared to ODA Growth Potential, 2007–2026 (estimated)<sup>46</sup>



- Climate and Energy.** DFIs have supported new energy technologies for decades, and will remain critical funders for wind, solar, and other renewable energy projects in the foreseeable future. With the recently agreed Paris climate agreement, requests for greater DFI investment will likely increase especially as policymakers look to draw on DFIs' knowledge and resources to meet new demand. The 15 European DFIs already provided one-third of all private-sector climate finance in sub-Saharan Africa in 2014, for example. This is also an area where DFIs can still play a key supporting role in "crowding-in" private investors, many of whom remain wary of providing support to large-scale renewable energy projects without the kind of risk mitigation DFIs can provide. If DFIs do succeed in raising the level of investment around climate change mitigation and energy access, it will include supporting new projects in regions or countries, including the Andes, Northern Triangle (Guatemala, El Salvador, and Honduras), Maghreb, MENA, Sahel, Horn of Africa, and South Asia.
- Conflict and Fragility.** Despite a global reduction in overall conflict, DFIs can expect to be pulled into investment projects in fragile and conflict-afflicted states that are home to a large share of the world's poorest and most vulnerable populations. These states frequently lack access to the capital necessary to generate sustainable, private sector-led economic growth. Although emergency and humanitarian aid are critical to addressing basic needs and enhancing stability in these countries, DFI investment can play an important role in creating jobs and providing access to basic economic

<sup>46</sup> The DFI Growth Potential line is a comparison of when total DFI might intersect and pass ODA. Here is the methodology behind how we constructed both lines. ODA statistics are based on what is publicly available from the OECD every year. DFI data was pulled together from the time period between 2000 to now, across the financial reports for all the EDFIs and other multilaterals and institutions. We totaled those numbers annually, then calculated average annual growth. ODA has been on a steady average annual growth of 1.72 percent, while DFIs grow at 4.9 percent annually. Between 2000 and 2014, DFIs grew by 500 percent while ODA grew by 150 percent. Corresponding to how we built the chart, DFI has an average growth, but it also is an exponential increase, meaning DFIs are growing at a faster rate every year. ODA, in comparison, has a steadier tapered growth. This determined how we chose our trend lines. Although ODA has the steady growth with such a broad base that won't hit large inflection points, DFI though does. DFI has been known to increase by 34 percent and 18 percent in some cases. We therefore chose an exponential line to demonstrate DFI growth potential. We used the window of 2007–2014 as we were able to collect the most financial information for that period. If DFIs continue on this rapid growth trend, and ODA remains steady, DFI investment will pass ODA levels by about 2020. Based only on average annual growth, the DFI levels would pass ODA in 2033.

infrastructure that will help to spur growth. This is an area where DFIs will need to carefully consider how they can be a value-add, and they may be limited in terms of what they can do immediately given limited deal flow and private investors who are willing to coinvest.

- **Refugees and Migration.** The global refugee crisis has reached 65 million displaced people, the highest total since the aftermath of World War II. This is directly connected to the issues surrounding fragile and conflict-afflicted states described above, representing one of the most tangible results of their inability to provide economic opportunity for their citizens. Given the immense demands this is placing on the international system, DFIs may increasingly be asked to target root causes of migration in order to reduce the flow of migrants and refugees. This will mean investments in fragile and conflict-afflicted countries that could create the sort of economic opportunity many migrants are seeking in Europe and elsewhere. DFIs alone will not solve these crises, but without DFI-supported investment it will be far more difficult.

Meeting each of these challenges will require DFIs to operate to a greater extent and with a greater share of their portfolio in sometimes-uncomfortable economic environments. This need to shift focus is not new for DFIs; they have shifted their portfolios over time to take advantage of new opportunities. DFIs will be engaging with policymakers to calibrate the direction and rate of change. At the same time, they should expect to have to evolve their own processes and systems in response.

## Growth in Blended Finance

DFIs can easily see what will happen if they are unwilling to increase their focus on these emerging policy priorities and new demands. Other development institutions, including bilateral aid agencies, foreign ministries, and multilateral development agencies are increasingly moving into the private-sector investment space by making financial contributions to funds or other vehicles that use ODA financing to mobilize more private capital for specific priorities relating to low- and middle-income countries. There are efforts underway, including the apparent inclusion of a \$2.5 billion “private-sector window” in the IDA-18 replenishment at the World Bank, the Green Climate Fund, the EU blending facilities, and a number of bilateral donor efforts such as DFID and AFD.

There is a risk that this trend toward greater use of ODA for private finance activities will disrupt markets and “crowd out” genuine private investment as potentially “free money” comes in. This does, together with the risk that interaction with the private sector is not as well managed or that money could be lost through bad deals. DFIs need to consider how they will operate in a world where free money or “overly blended” money is increasing. DFIs will need to decide whether they should oppose these blended finance facilities or get involved in the implementation of them.

If DFIs do decide to engage more in implementation of blended finance, then the DFI mindset would be valuable to aid agencies that want to deploy ODA in ways similar to private

capital, especially through “blended” facilities. One common criticism, by some, of DFIs is their so-called fixation on generating profit from their investments, sometimes to the detriment of development. But profit mindedness is not a bad thing; ultimately it helps to ensure the long-term financial stability of projects and it is central to the way DFIs achieve development impact. In many instances, aid agencies have relied upon NGOs and other nonprofit actors to help improve electrification in rural areas, but without a private-sector partner (who had a profit motive) there was no long-term sustainability; all progress achieved vanished when there was no one to maintain the improvements achieved. Engaging DFIs in these sorts of ventures by tapping their knowledge and skills would help to ensure future success. One recent example of where aid agencies are working closely with DFIs to achieve success is through Power Africa, a U.S. government initiative designed to address sub-Saharan Africa’s widespread lack of access to electricity.

This may be an area where DFIs and aid agencies can find common ground. Given their long investment experience, DFIs have clear skills and competencies that can help maximize the impact of these types of facilities. This may also be one way in which DFIs can begin to move into more challenging sectors and regions, especially fragile and conflict-afflicted states. On the risk side, by blending their resources with ODA it could help to expand the range of investable project opportunities. On the skills side, DFIs could gain experience working in frontier market countries or regions by learning from aid agencies and others who have deeper knowledge. While there are outstanding questions (and some genuine objections) to blending facilities, this may present a “win-win” type of arrangements for DFIs and their shareholders.

# 06

## Recommendations: Shaping the New Landscape

On a strategic level, DFIs should maintain their core competencies, business model, and instruments. This will ensure that as DFIs expand they do not simply become another aid agency. More importantly, though, it will help them shape the new landscape of international development. As DFIs evolve to play a central role in achieving the SDGs and advancing international development policy, they and their shareholders need to consider the following.

Through this experience and expertise, DFIs should take the lead or be the main partner of aid agencies in designing private-sector development policy. This will require a direct dialogue between the DFIs and aid agencies on private-sector development and will take multiple forms. In some instances, DFIs should play a direct role in helping to determine how their resources will be allocated to support broader development policy priorities. In other instances, such as investment climate work, DFIs will play an indirect advisory role by consulting with aid agencies to determine the direction of policy reforms. Finally, while DFIs should be engaged in policy formation, they are not equipped to fully to serve as implementers of policy; this will remain with the aid agencies. Two points are worth keeping in mind in closing.

First, policymakers must better understand the DFI model described in this paper and how it can be deployed to support development objectives. The reality, of course, is that DFIs already do support development policy by investing in regions and countries that receive lower amounts of private investment or in priority sectors that need investment. Within the aid agencies or ministries that are “owners” of DFIs, there are individuals who understand these issues and this dynamic, but ensuring that this knowledge percolates up to the top is critical. Giving DFIs a “larger seat” at the policy “table” would allow them to engage earlier in the policy process and ensure that the requests they receive are more fully in line with their capabilities and their expected outcomes.

Second, this is not a one-way street: just as senior policymakers do not understand the DFI model well enough to maximize the impact of DFI instruments in pursuit of policy objectives, the DFIs themselves remain wary of engaging more fully in the policy process and must become more sophisticated when it comes to describing their capabilities and limitations to a policy audience. This will require DFI leadership to clearly articulate the model described above, where they have success, and where they have not had success. In many ways this is simply serving as ambassadors for the organization and helping to educate the policymakers placing new demands on DFIs. But more importantly, it will require DFIs to develop a deeper



bench of staff members who can comfortably operate in a policymaking capacity; this has not always been easy for DFIs in the past.

With a greater role for DFIs will come increased scrutiny by NGOs and other members of the development community, many believing that DFIs should operate under the same rules as aid agencies. This perspective stems from a general misunderstanding of the basic functions and objectives of DFIs: this desire for greater transparency from a desire for full disclosure of project information, alignment with host-country ownership and approval of projects, and willingness to approve projects due to political considerations rather than commercial merit. In response, DFIs must be more willing to engage publicly by clearly explaining their unique and powerful approach to economic development and be better at communicating the impact they already have on the SDGs. This will require a shift in the way DFIs communicate their own impact: they will need to move from the micro to the macro level. By extension of how DFIs do deals, they are naturally project-focused, but they will also need to articulate a clear, strategic vision in the policy realm. DFIs offering active strategies to address the top concerns of policymakers will be better able to maintain their operational independence from political processes.

**Risk Tolerance/Returns.** Fundamentally, DFIs may need to assume a higher tolerance for risk and, in some instances, lower returns if they put a lot of emphasis on tackling the new challenges requested of them by policymakers. To be sure, higher risk will not always generate lower returns. In some cases, DFIs have been too risk averse and sought investments in projects that might guarantee a high return, but a more limited development impact, for instance, in their investments in upper-middle-income countries. There is a concern that if DFIs do not take on greater risk either their shareholders will force them to do so (by taking more direct control of the investment process) or their shareholders will create new vehicles that will make riskier investments. This is not to suggest that the DFIs' entire business model is shifting or that their entire portfolio will change as a result. DFIs have been able to generate high returns from investments in low- and lower-middle-income countries and may continue to do so in the future. But gradually they may need to consider more investment projects that have a higher risk (on a country or sector specific basis) than they have done in the past.

There is also a chance that by making higher risk investments, DFIs will see lower returns or in some instances failure of an investment altogether. It may also require consideration of smaller deals, especially as DFIs gradually move out of the larger, established middle-income markets. For many DFIs, used to relatively high returns and gains, this may be challenging. It is also important to keep in mind that the reasons DFIs are attractive is because of their success and balance sheets. There will need to be a balance struck between maintaining this success and seeking new investments. This will also require that shareholders, from an oversight perspective, accept this same paradigm.

**Resources.** DFIs and policymakers need to consider both the financial resources available to DFIs and the human resources. Although DFIs have experienced exponential (mostly organic) growth over the past 15 years, if they are to make the desired impact, they will need more financing. Some DFIs may remain small given their government's resources. But the ones that

can grow will need to be scaled up with additional capital if they want to make a bigger impact. This is especially true if returns decline because of the issues discussed above, along with the overall economic environment which seems headed toward lower returns overall. This would also require governments and shareholders to be prepared to replenish DFI resources. From a financial resource standpoint, DFIs may also need to think about the types of capital and instruments they can deploy: if they expand their investments, do DFIs need to consider new types of capital to achieve success? This might include, for example, various types of early-stage capital to help better support entrepreneurs.

On the human resources side, DFIs will need to consider how they incentivize and grow their staff, especially investment officers. For most DFIs, investment officers are rewarded based on the volume or number of smaller deals they conclude in a given year. If DFIs are directed toward investing in countries where fewer deals are available on a yearly basis, this would require them to rethink how they incentivize their staff. The same would go for looking for deals that have a higher development impact. DFIs will need to hire more staff in order to handle an increased number of deals, as well as hiring individuals who have a new skill set to deal with the new investments and instruments they might deploy.

**Lessons Learned/Impact.** An important consideration for DFIs assuming a greater role in the policy realm is how they deal with lessons learned from their activities and how they convey their impact. Are DFIs learning from the successes/failures? Are they equipped to do so? If not, then their broader impact may be limited. How do they make their lessons learned a public good across other DFIs and as part of the larger conversation on development? Some of this is cultural: DFIs tend to not disclose information on project-level success, because of the confidentiality associated with commercial investment. But if DFIs are able and willing to explain and document their impacts, this will help to manage their relationship with policymakers and preserve their independence in the long term. Moreover, it will help policymakers better understand where DFIs can and cannot do and strengthen DFIs' ability to participate in policy discussions.

There is no doubt that DFIs will change because of the new environment and it is unlikely that the ways in which they do some of their business will remain the same. But by being confident in their unique abilities and impact, DFIs can weather these changes as they have before and they can confidently contribute effectively to the major development challenges outlined in this paper.

# Annex: The Project

In order to complete this project, CSIS and ODI agreed to a joint research effort given their extensive work on the evolving role of DFIs.

Founded in 1962, CSIS is a bipartisan, nonprofit organization with a long history of assisting leaders to think strategically about the most difficult challenges that face the international community. Every day, CSIS works with stakeholders from across the policy world, in both the public and private sectors, to tackle the toughest global challenges. In this capacity, CSIS provides thoughtful, independent analysis and subject-matter expertise on a wide range of functional and regional issues. Over the past 10 years, CSIS has grown a large international development program that seeks to look at the vital role that the private sector plays in confronting and solving development challenges.

ODI is Britain's leading independent think tank on international development and humanitarian issues. Founded in 1960, it has made major contributions to research, dissemination, and policy change, on all aspects of development and humanitarian policy. Since 1963, the ODI fellows have provided economic policy support to governments in low-income countries. The Institute has a staff of more than 200, around 120 of whom are researchers and with the remainder providing a wide range of support services. ODI's mission is to "inspire and inform policy and practice that leads to the reduction of poverty, the alleviation of suffering, and the achievement of sustainable livelihoods in developing countries. We do this by locking together high-quality applied research, practical policy advice, and policy-focused dissemination and debate. We work with partners in the public and private sectors, in both developing and developed countries. ODI has five strategic priorities, all of whom involve an increased focus on "beyond aid" issues as well as increased engagement with private-sector actors. ODI has over the last decade developed a program of work on development finance institutions on: use of subsidies of DFIs in infrastructure; advantages of bilateral versus multilateral DFIs; role of CDC in the DFI architecture; impact of DFIs on economic growth, structural transformation, jobs, and other global challenges.

To accomplish this project, CSIS and ODI initially held a scoping session with members of EDFI's Strategy and Policy task force and OPIC in Paris in March 2016. This session helped to refine the focus of the project and how to structure the future roundtable meetings. The main focus of the project centered on three roundtable meetings in Washington, D.C., London, and Brussels. The three roundtables sought to bring together a diverse group of DFI stakeholders including representatives from the EDFIs, OPIC, the multilateral institutions (EBRD, EIB, IDB, World Bank, and IFC), aid agencies, private-sector financial institutions, and NGOs and the advocacy community. These meetings examined the following topics:

1. International development policy and the private sector, CSIS, Washington, D.C. (May 2, 2016)
2. DFIs' contribution to global development, ODI, London (May 24, 2016)

### 3. DFIs' competencies, experience, and partnerships, CSIS-ODI, Brussels (June 28, 2016)

Finally, CSIS and ODI had the unique opportunity of attending EDFI's Annual General Meeting held in May 2016 in Oxford. This included a presentation on the project by Dan Runde and Dirk Willem te Velde, project directors, and a day listening to discussions by the EDFIs on their priorities, concerns, and opportunities. This paper is based on the working group sessions, our attendance at the Annual General Meeting, a series of stakeholder interviews, and extensive desk research.

# About the Project Directors and Authors

**Daniel F. Runde** is director of the Project on Prosperity and Development and holds the William A. Schreyer Chair in Global Analysis at CSIS. His work centers on leveraging American soft power instruments and the central roles of the private sector and good governance in creating a freer and more prosperous world. Previously, he led the Foundations Unit for the Department of Partnerships & Advisory Service Operations at the International Finance Corporation. His work facilitated and supported over \$20 million in new funding through partnerships with the Bill & Melinda Gates Foundation, Rockefeller Foundation, Kauffman Foundation, and Visa International, among other global private and corporate foundations.

Earlier, Mr. Runde was director of the Office of Global Development Alliances at the U.S. Agency for International Development (USAID). He led the initiative by providing training, networks, staff, funds, and advice to establish and strengthen alliances, while personally consulting to 15 USAID missions in Latin America, the Middle East, and Africa. His efforts leveraged \$4.8 billion through 100 direct alliances and 300 others through training and technical assistance. Mr. Runde began his career in financial services at Alex. Brown & Sons, Inc., in Baltimore and worked for both CitiBank and BankBoston in Buenos Aires, Argentina. He received an M.P.P. from the Kennedy School of Government at Harvard University and holds a B.A., cum laude, from Dartmouth College.

**Dirk Willem te Velde** is a senior research fellow and head of the International Economic Development Group at the Overseas Development Institute (ODI). He is the director of Supporting Economic Transformation and a research leader for the DFID-ESRC Growth Research Program. He has published widely on trade, investment, and economic transformation. He has advised country governments and parliaments in Africa, Asia, and the Caribbean, and donor agencies such as DFID, European Commission, the United Nations, and the World Bank. He was also team leader for the European Report on Development (ERD) 2015 on Combining Finance and Policies to Implement a Transformative Post-2015 Agenda. In his 13 years at ODI, he has advised donor agencies (e.g., DFID, Sida, and Dutch Ministry of Foreign Affairs), developing country governments (e.g., Malawi, Cambodia), and multilateral bodies (e.g., World Bank, European Commission, UN Conference on Trade and Development, UN Department of Economic and Social Affairs, UN Industrial Development Organization, International Labor Organization, Asian Development Bank, World Trade Organization-Least-Developed Countries group). He has written and edited several books, 30 peer reviewed articles, and 40 book chapters related mainly to investment, trade, and growth issues. He holds a Ph.D. from Birkbeck College, University of London.

**Conor M. Savoy** is deputy director and fellow with the Project on U.S. Leadership in Development (USLD) and Project on Prosperity and Development (PPD) at CSIS. He joined CSIS in September 2011 as assistant director of USLD. At CSIS, he focuses on the day-to-day management of the two projects, as well as implementing and guiding USLD's and PPD's research agenda. His research includes the role of the private sector in international

development, governance and rule of law, trade and investment, and development finance. In his time at CSIS, Mr. Savoy has authored or contributed to several reports, commentaries, and critical questions. He is the author of a number of CSIS publications, including *Private-Sector Development and U.S. Foreign Policy* (April 2015), *Taxes and Development* (December 2014), and *Combating Global Poverty* (December 2013). In addition, he is the coauthor of *The Ecosystem of U.S. International Development Assistance: A Development and Foreign Policy Strategic Asset* (CSIS, October 2012) and *U.S.-China Parallel Development Assistance Goals: Building on Common Interests* (CSIS, March 2012).

Prior to CSIS, he worked in energy consulting and as a research associate at the Council on Foreign Relations (CFR) in Washington, D.C. At CFR, he focused on broad issues impacting U.S. grand strategy, the effect of emerging nations on U.S. foreign policy, as well as U.S.-Russia relations and NATO. In May 2010, he was selected as a fellow for the Manfred Worner Seminar. Mr. Savoy holds a B.A. with honors in history from George Washington University and an M.A. in international relations from Boston University. He is a term member of the Council on Foreign Relations.

**Paddy Carter** is a research fellow at the Overseas Development Institute in London. He specializes in aid allocation, domestic revenue mobilization, and development finance more generally. He is also interested in public-sector reform, monetary policy in developing countries, and structural change. Before joining ODI, Carter was a British Academy Post-Doctoral Fellow at the University of Bristol, where he also did his Ph.D. Both his doctoral thesis and research under the B.A. fellowship was focused on optimal dynamic aid allocation, and has produced papers published in leading economic journals. Before entering academia, Carter spent a decade working as an equities analyst at a London-based stockbroker and a journalist for *Investors Chronicle*, *Financial Times Business*.

**Alberto Lemma** specializes in private-sector development, specifically in access to finance, business partnership programs, and the interplay between the private sector and climate change adaptation and mitigation. His work on finance focuses on Development Finance Institution impact assessment and the role of DFIs in development, SME finance and access to innovative sources of finance such as crowdfunding or alternative financial mechanisms to SMEs. Lemma previously worked in Vietnam and Cambodia as an economic development consultant and holds an M.Sc. in political economy of development from SOAS and a B.Sc. in geography with economics from the London School of Economics and Political Science.



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1616 Rhode Island Avenue NW  
Washington, DC 20036  
202 887 0200 | [www.csis.org](http://www.csis.org)