



## **Tri Hita Karana Working Paper For Development Finance Institutions**

### **The Role of DFIs and their shareholders in building back better in the wake of Covid-19**

21 October 2020

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## Disclaimer and Acknowledgement

This report is the result of discussions and input by a wide range of development finance actors and members of the THK Working Group as listed below. It comprises their inputs, insights and practices as participants in consultation calls and meetings throughout the process. While this paper cannot reflect the views of any particular institution, it does express the shared ambition to improve development co-operation in response to the Covid-19 crisis and to propose some innovative thinking to support DFIs and shareholders at the forefront of these challenging issues.

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The views expressed in the paper do not necessarily represent the views of their respective organisations.

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## Executive Summary

**The Covid-19 pandemic is historic, with the potential to fundamentally reshape the world as we know it.** The World Bank declared Covid-19 to be “the most adverse peacetime shock [...] in a century”<sup>1</sup>. The challenge is three-pronged, impacting the core of health systems, economies, and societies across the world. Longer-term, it bears remembering that fiscal space is limited, particularly amongst the least-developed countries (LDCs), who are unable to match developed countries’ economic stimulus packages. Altogether, while official development assistance (ODA) and international aid policies can assist in the short term, a robust private sector is a fundamental motor of longer-term sustainable and inclusive economic growth.

**Development Finance Institutions (DFI) have reacted quickly. Still important questions remain on whether their business models will allow them to be sufficiently countercyclical and impactful to help address the Covid-19 crisis and contribute in building back better in the riskier conditions it creates,** in particular in poorer and more fragile countries. First, the Covid-19 financial packages announced by DFIs are mostly about a much-needed emergency reallocation of funding but are seldom related to new commitments. Important questions remain as to what extent the aggregated volumes announced will allow DFIs to be sufficiently countercyclical. Moreover, in order to respond to the financial needs in the wake of the Covid-19 crisis as effectively as possible, DFIs are expected to lend countercyclically and at scale—in other words, take outsized risks, invest in micro, small and medium-sized enterprises (MSMEs), and put greater emphasis on their development mandate while avoiding effects on balance sheets and ratings. It will be even harder to continue to serve existing middle-income countries (MICs) clients that are struggling and to find new projects in low income countries (LICs) hard hit by the global recession. In this riskier context, DFIs are also meant to help the recovery by contributing to build back better, emphasising the sustainability, resilience, inclusivity, gender dimension. As a result, critical questions remain as to whether their business models are currently truly fit for purpose.

### **Box 1: Definition of DFIs**

*In this document, national and international development finance institutions (DFIs) are understood as publicly funded, specialised development banks or subsidiaries set up to support private sector development in developing countries. DFIs in this definition includes members of the European Development Finance Institutions (EDFI) as well as members of the DFI Working Group on Blended Concessional Finance for Private Sector Projects (which comprises a range of Multilateral Development Banks and Regional Development Banks such as IFC, AfDB, EBRD, EIB, IDB apart from EDFI members).*

**Tentative guidelines are presented by the Tri Hita Karana (THK) Community in order to strengthen DFI roles in a post-pandemic rebuilding effort.** Primarily, this paper outlines and discusses how DFIs have and can most effectively respond to Covid-19 in the short-to-medium term. Consideration is given to innovative ideas beyond the status quo, primarily how DFIs can use the crisis to reshape their business models and more effectively fulfil their stated development purpose. Key suggestions discussed in the paper include (i) greater risk taking capacity, (ii) increase exposure to micro, small and

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<sup>1</sup> World Bank. 2020. Global Economic Prospects 2020. June, Washington, D.C. World Bank.  
<https://openknowledge.worldbank.org/handle/10986/33748>

medium sized enterprises<sup>2</sup> (MSME) financing and support the sustainable rebuilding and resilience of local economies, contributing to address rising inequality and the gender gap, (iii) building stronger local partnerships, including with national development banks and other local financial institutions, and (iv) support for new policy reforms to improve a sustainable investment climate in developing economies and foster private sector mobilisation at scale with a view to building back better. Finally, the paper offers an innovative example of a new off-balance-sheet superstructure, designed to strengthen risk-absorption capacity in light of the magnitude of Covid-19 induced financial needs.

**This paper reflects the current thinking of the THK community and will require further consultations with DAC Donors and DFIs regarding how to move forward.** The introduction outlines the predicted impact of the Covid-19 crisis for developing countries, in particular MSMEs, which act as the backbone of their economies. It demonstrates the critical need to use development finance in order to recalibrate these economies back towards achievement of the sustainable development goals (SDGs) and 2030 Agenda. What follows in the first section is an examination of the initial DFI response, including action taken to support existing and new clients through the maintenance of local presence and greater collaboration. The second section outlines current structural constraints that prevent DFIs from harnessing their full development potential, including balance sheet concerns, limitations on the use of catalytic blended finance, as well as general risk aversion and a tendency towards conservative lending practices. The third section highlights what needs to change, including the creation of better enabling environments, the strengthening of local partnerships and the mobilisation of private finance at scale to invest in MSMEs, with a focus on sustainability and resilience, as well as gender. The final section suggests how such reforms could be realised, most notably in the creation of a Covid-19 stretch fund. Finally, the conclusion distils the findings of the paper into recommendations for stakeholders across DFIs and their shareholders, with a view to triggering discussions amongst stakeholders.

## Introduction – The Covid-19 Context

**Covid-19 outbreak caused an unprecedented health, economic, and social shock in developing economies.** Declared by the World Health Organisation (WHO) to be a global emergency on January 30, 2020, Covid-19 is a crisis “without precedent in living memory”<sup>3</sup>. The pandemic is set to induce a triple negative shock for developing countries, spanning healthcare, the economy, and society. In terms of economic impact, UNCTAD estimates the result of the crisis to be a USD 2.5 trillion financing gap to developing countries<sup>4</sup>. Further to this, the World Bank predicts the first recession in 25 years for sub-Saharan Africa, and a decline in economic growth from 2.4 % in 2019 to between -2.1 and -5.1 % in 2020.<sup>5</sup> Across the African continent, 19 – 22 million jobs are at risk.<sup>6</sup> The jobs crisis is also highly likely to transform into a social one, as society’s most vulnerable bear the brunt of the economic

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<sup>2</sup> Defined as organizations with less than 10 staff (for micro businesses), between 10 and 50 staff (for small businesses) and between 50 and 250 staff (for medium businesses). Reference:

[https://ec.europa.eu/growth/smes/sme-definition\\_en](https://ec.europa.eu/growth/smes/sme-definition_en)

<sup>3</sup> OECD Secretary General 2020. Coronavirus (COVID-19): Joint actions to win the war. 21 March.

<https://www.oecd.org/about/secretary-general/Coronavirus-COVID-19-Joint-actions-to-win-the-war.pdf>

<sup>4</sup> UNCTAD 2020. The UN calls for a \$2.5 trillion coronavirus crisis package for developing countries. 30 March.

<https://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=2315>

<sup>5</sup> World Bank 2020. Carting the road to recovery. Africa’s Pulse. October.

<https://www.worldbank.org/en/publication/africa-pulse>

<sup>6</sup> Bilal, S., Griffith-Jones, S., Kapoor, S., Karingi, S., Songwe, V. and te Velde, D.W., 2020. Saving Africa’s private sector jobs during the coronavirus pandemic. ECDPM, ODI, Re-Define, UNECA paper. 15 April

<https://www.uneca.org/publications/saving-africa%E2%80%99s-private-sector-jobs-during-coronavirus-pandemic>

downturn. For instance, the World Bank predicts that the pandemic will push 26-39 million people into extreme poverty in Sub-Saharan Africa<sup>7</sup>.

**Unlike in the global financial crisis, the effects of the pandemic are much more severe for poor countries, now more integrated into the global financial system and facing a debt crisis.** Poor countries are experiencing a perfect storm of collapsing export demand, commodity prices, remittances, and tourism, as well as supply shocks and import shortages, increasingly unsustainable debt, and vanishing fiscal space. We can expect severe setbacks in global progress in reducing poverty. The economic risk of the pandemic is particularly high in poor countries, in sub-Saharan Africa and the poorest parts of South Asia.<sup>8</sup> In addition, for low and middle-income countries, this crisis comes at a time of rising concern for the sustainability of public debt, and especially external public debt<sup>9</sup>. Total debt in emerging and developing economies has risen by 54 percentage points of GDP to a historic peak of almost 170 percent of GDP in 2018<sup>10</sup>.

**The Covid-19 crisis risks creating major setbacks in financing for sustainable development and compromises our ability to reach the SDGs.** The Covid-19 crisis is not only generating a major global recession which is badly affecting developing countries. It is also leading to increased inequality across and within countries, to the detriments of the poor and the more vulnerable ones, with women being disproportionately impacted. In the wake of the Covid-19 crisis, not only will domestic resource mobilisation suffer as economic activity is reduced, but inflows of external private finance are projected to drop by USD 700 billion compared to 2019, exceeding the impact of the 2008 Global Financial Crash by 60%.<sup>11</sup> This is particularly problematic when considered in the context of the pre-Covid-19 USD 2.5 trillion financing gap for the SDGs. For low-income countries, such as Rwanda and Benin, the percentage point gap to deliver the SDGs was already estimated to be as high as 15.4.<sup>12</sup> Compounding this problem, the margins of manoeuvre to close the SDG financing gap are severely constrained by high debt levels. It is clear, now more than ever, that in order to close the gap – exacerbated by Covid-19 – and deliver the 2030 Agenda, it will be critical to leverage more private finance.

**As was the case in the 2008 Global Financial Crisis, external finance flows to developing countries are proving particularly susceptible to shocks.** Investment project portfolio and investment flows are expected to drop by 80% and 123% compared to 2019, respectively. Similarly, UNCTAD data notes foreign direct investment (FDI) to Africa fell 58% year on year in the first quarter of 2020<sup>13</sup>, and FDI is

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<sup>7</sup> Mahler, D.G., Lakner, C., Aguilar, R.A.C. and Wu, H., 2020. Updated estimates of the impact of COVID-19 on global poverty. World Bank Data Blog. 8 June <https://blogs.worldbank.org/opendata/updated-estimates-impact-covid-19-global-poverty>

<sup>8</sup> Noy, I., N. Doan, B. Ferrarini and D. Park 2020. The economic risk of COVID-19 in developing countries: Where is it highest? In Djankov, S. and U. Panizza eds. *COVID-19 in developing economies*. Centre for Economic Policy Research. CEPR Press <https://voxeu.org/content/covid-19-developing-economies>

<sup>9</sup> OECD 2020. A “debt standstill” for the poorest countries: How much is at stake? OECD Policy Responses to Coronavirus (COVID-19). 27 May <https://www.oecd.org/coronavirus/policy-responses/a-debt-standstill-for-the-poorest-countries-how-much-is-at-stake-462eabd8/>

<sup>10</sup> Kose, M.A., Nagle, P., Ohnsorge, F. and Sugawara, N., 2020. Global Waves of Debt. Washington, DC: World Bank. <https://www.worldbank.org/en/research/publication/waves-of-debt>

<sup>11</sup> OECD 2020. The impact of the coronavirus (COVID-19) crisis on development finance. OECD Policy Responses to Coronavirus (COVID-19). <http://www.oecd.org/coronavirus/policy-responses/the-impact-of-the-coronavirus-covid-19-crisis-on-development-finance-9de00b3b/>

<sup>12</sup> *Ibid.*

<sup>13</sup> Munshi, N. 2020. Africa must boost internal trade to recover from Covid slump, AU says. Financial Times. 16 August 2020 <https://www.ft.com/content/1e94048a-8cc4-4e6e-a2df-5509974e62b1>

predicted to drop by as much as 30% even in the most optimistic scenario.<sup>14</sup> Further to this, remittances – defined as payments in cash or in kind by migrants to their country of origin - have dropped by roughly USD 100 billion following the outbreak. The United Nations has even projected a fall of almost 20% for global remittances. The severity of the impact on remittances is linked to the global nature of the crisis. For example, in the US, where most remittances originate, job losses within the four weeks following mid-March 2020 equalled the number of jobs created since the 2008 Global Financial Crisis.<sup>15</sup> Altogether, the picture is bleak.

**In the short term, official development finance should be leveraged to contain the drop in other sources of financing.** Previously, official development assistance (ODA) has proven to be a key resource in alleviating the impact of past crises<sup>16</sup>. With this in mind, earlier this year members of the OECD Development Assistance Committee (DAC) pledged to support LDCs and other countries with specific needs by responding to their immediate needs as the pandemic evolves, including care and vaccines when available, and support crisis transition and recovery.<sup>17</sup> However, the likelihood of their ability to deliver this pledge is severely circumscribed by the struggle to mitigate the effects of the crisis within their own borders. The coming year(s) are likely to be characterised by a marked increase in domestic spending accompanied by a simultaneous reduction in official development finance budgets. As a result, remaining on track to achieve long-term development goals will require, among others, to use ODA to leverage private finance for sustainable and resilience development at scale.<sup>18</sup>

Micro, small and medium-sized enterprises (**MSMEs**), which are the backbone of developing economies, are being severely hit by the effects of the pandemic and the current liquidity crisis could turn into a solvency crisis. MSMEs play a critical role in emerging economies, with a contribution of up to 40% of GDP<sup>19</sup> and are estimated to provide two-thirds of all formal jobs in developing countries in Africa, Asia and Latin America<sup>20</sup>. However, the coronavirus is set to cause sharp adverse impacts on MSMEs, as economic recession, unemployment and reduced income and market demand threaten their survival in the medium term. At the same time, the emergence from lockdown is increasing pressure on companies' liquidity, as <sup>21</sup>the sudden Covid-19 shock of historic proportions is likely to have lasting effects, worsening the business insolvency outlook in developing economies.

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<sup>14</sup> OECD. 2020. Foreign direct investment flows in the time of COVID-19. OECD Policy Responses to Coronavirus (COVID-19). <https://www.oecd.org/coronavirus/policy-responses/foreign-direct-investment-flows-in-the-time-of-covid-19-a2fa20c4/>

<sup>15</sup> *Ibid.*

<sup>16</sup> OECD. 2020. "Six decades of ODA: insights and outlook in the COVID-19 crisis", in Development Co-operation Profiles, OECD Publishing, Paris. <https://doi.org/10.1787/5e331623-en>.

<sup>17</sup> OECD. 2020. COVID-19 Global Pandemic: Joint Statement by the OECD Development Assistance Committee on the Covid-19 crisis. <https://www.oecd.org/dac/development-assistance-committee/daccovid19statement.htm>

<sup>18</sup> OECD. 2018. Making Blended Finance Work for the Sustainable Development Goals, OECD Publishing, Paris, <https://doi.org/10.1787/9789264288768-en>.

<sup>19</sup> World Bank. 2017. What's Happening in the Missing Middle? Lessons from Financing SMEs. <https://www.worldbank.org/en/topic/financialsector/publication/whats-happening-in-the-missing-middle-lessons-from-financing-smes>

<sup>20</sup> ILO, GIZ, Kok, J. de, C. Deijl and C. Veldhuis-Van Essen. 2013. Is Small Still Beautiful? Literature Review of Recent Empirical Evidence on the Contribution of SMEs to Employment Creation. International Labour Organisation (ILO) and Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ). [https://www.ilo.org/global/about-the-ilo/newsroom/comment-analysis/WCMS\\_218252/lang--en/index.htm](https://www.ilo.org/global/about-the-ilo/newsroom/comment-analysis/WCMS_218252/lang--en/index.htm)

<sup>21</sup> Allianz Research. 2020. Calm before the storm: Covid-19 and the business insolvency time bomb. [https://www.allianz.com/en/economic\\_research/publications/specials\\_fmo/16072020\\_Insolvencies.html](https://www.allianz.com/en/economic_research/publications/specials_fmo/16072020_Insolvencies.html)

**Development finance institutions (DFIs) have a specific role to play to provide countercyclical support both in the short term and for the building back better recovery, which needs to be prepared now.** DFIs have a historic role to play in stimulating developmental investment and supporting the private sector in developing economies. Working in the veins of developing country economies, they support a country’s sustainable transformation path. The large global liquidity crash we are currently witnessing means it is imperative for DFIs to engage to an unparalleled degree to incentivise sustainable private investment, both consolidating their portfolios and providing assistance to new clients, especially MSMEs, for the rebuilding and resilience of local sustainable economies, helping address rising inequalities and the gender gap. Moving forward, as the situation gradually improves, DFIs will need to prioritise the development of a robust pipeline for post-crisis investments. A promising set of investments ready for when growth resumes is critical to attracting responsible private investment back to developing countries. Complimentary policy reforms will also be necessary to improve the overall investment climate. However, memories of the “insufficient”<sup>22</sup> DFI response to the 2008 crash suggest important questions remain as to the extent to which DFIs can be countercyclical, increasing the volume and the quality of their investments in a time of crisis. These questions primarily relate to DFI’s governance structures and traditional ways of working. In general, DFIs tend to be risk averse as they follow the commercial bank business model, favouring robust returns. Although some DFIs have a high allocation of risk capital to vulnerable countries, they face high risk constraints, having adopted a disciplined approach to manage risk and ensure their high institutional credit rating (for most of them AAA, which is not affected by the Covid-19 crisis).<sup>23</sup> This prudential, arguably conservative attitude towards risk also translates into a conservative attitude towards capital adequacy.<sup>24</sup> It has now been over a decade since the last Global Financial Crisis, and the role of DFIs have greatly expanded as capital increases in all the major multilateral DFIs have given them the capacity to significantly increase lending. The question today for DAC donor governments, as shareholders of DFIs, is firstly, how best to support DFIs in becoming more countercyclical. And secondly, more broadly, how to enable the DFIs to fulfil the greater responsibility they have been afforded: contributing to building back better in the wake of the Covid-19 crisis.

## 1. The Response of Development Finance Institutions to the Crisis

### Supporting existing and new clients

**DFIs appear to have acted urgently by making several announcements in terms of financial commitments.** In anticipation of the release of aggregate data,<sup>25</sup> we can only point to individual

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<sup>22</sup>Griffith-Jones, S. and te Velde, D.W., 2020. Development finance institutions and the coronavirus crisis. ODI-SET paper. 30 March <https://www.odi.org/publications/16844-development-finance-institutions-and-coronavirus-crisis>

<sup>23</sup>Fitch Ratings. 2020. Coronavirus Crisis Has Limited Impact on Ratings of Supranationals but Adds Pressure. Non-rating commentary. 23 July. <https://www.fitchratings.com/research/sovereigns/coronavirus-crisis-has-limited-impact-on-ratings-of-supranationals-adds-pressure-23-07-2020>

<sup>24</sup>Lee, N. 2020. Eight Principles for the DFI Crisis Response. CGD Note. 14 April. <https://www.cgdev.org/publication/eight-principles-dfi-crisis-response>

<sup>25</sup>Bilal, S. and Di Ciommo, M. 2020. Following the money: Why a COVID-19 marker might not help. ECDPM blog, 29 June 2020. <https://ecdpm.org/talking-points/following-money-why-covid-19-marker-might-not-help/> and Segal, S. and Negus, O. 2020. Tracking International Financial Institutions’ Covid-19 Response, CSIS Commentary, 21 July <https://www.csis.org/analysis/tracking-international-financial-institutions-covid-19-response>



examples to demonstrate the urgent action of DFIs in response to Covid-19. However, these indications show positive signs. For example, by the end of August 2020, the European Bank for Reconstruction and Development (EBRD) new investment activities were up 40% from the same period in 2019, with over EUR 7 billion (USD 8.4 billion).<sup>26</sup> Moreover, it anticipates committing all activity during 2020/2021 to countering the economic impact of coronavirus, with a total allocation of EUR 21 billion. At the same time, the International Finance Corporation (IFC) has increased the amount of financing for companies to help fight the pandemic by USD 8 billion. The African Development Bank (AfDB) has raised an additional USD 3 billion by issuing its *Fight Covid-19 social bond*.<sup>27</sup>

**However, in most cases, these are speedy reallocations of funding to address the COVID-19 emergency, and not new commitments from additional funding.** The EU as an example has announced that it is seeking to mobilise EUR 15.6 billion for its global package and will reallocate, front-load and fast-track its existing aid. As an immediate response, donor countries are shifting currently planned aid towards the Covid-19 response, with little indication so far that they are increasing budgets. Similarly, Covid-19 packages announced by DFIs are mainly reallocation of funding. **DFIs have also largely aimed their initial response at helping existing clients to protect those investments, preserve the development impacts and speed up disbursement processes.** Many DFIs have announced additional commitments to counter the economic impacts of the coronavirus for their clients. Altogether, most DFIs have taken to assisting their existing clients as an immediate priority. They are generally working with current clients to restructure loans, increase the flexibility of the terms of their financing and determine needs as necessary (as in the case of Dutch DFI FMO). They have put greater emphasis on lending to and investing in portfolios and working capital facilities. They have often adopted simplified procedures and implemented a fast-track investment process to approve some deals faster (e.g. within 60 days in the case of FinDev Canada<sup>28</sup>) and disburse more quickly.<sup>29</sup> Such assistance has two principal aims, addressing increased risks and financial constraints prompted by the crisis, and preventing overall project collapse. That said, mitigating efforts to try to manage the immediate fall out of the crisis has been, at least in part, hampered by almost universal border closures.

**Alongside supporting their existing clients, some DFIs are also trying to target new clients,** which is not an easy task in an emergency situation, with travel and contact restrictions. Increasing funding to existing clients should not prevent DFI from also considering new clients requests, especially those at the forefront of the fight of the pandemic, although deal activities are slowing down as a result of the crisis. A pertinent example is the Industrial Development Cooperation (IDC), a South African national development finance institution, which established a Covid-19 Small Industrial Finance Distress Fund to assist old and new clients negatively affected by the Covid-19 pandemic. The fund totals approximately USD 180 million, and offers concessionary finance to cover the short-term operating costs of struggling small industrial businesses in crisis-induced distress. Financing facilities available under this fund include, amongst others, revolving credit facilities, guarantees, asset-based finance

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<sup>26</sup>Chadwick, V. 2020. Exclusive: UAE applies to join European Bank for Reconstruction and Development. Devex. 5 October. <https://www.devex.com/news/exclusive-uae-applies-to-join-european-bank-for-reconstruction-and-development-98242>

<sup>27</sup>AfDB. 2020. African Development Bank launches record breaking \$3 billion “Fight COVID-19” Social Bond. 27 March <https://www.afdb.org/en/news-and-events/press-releases/african-development-bank-launches-record-breaking-3-billion-fight-covid-19-social-bond-34982>

<sup>28</sup>Saldinger, A. 2020. How DFIs are responding to the COVID-19 crisis. Devex. 29 April <https://www.devex.com/news/how-dfis-are-responding-to-the-covid-19-crisis-97081>

<sup>29</sup>Coralde, J.L and Tamonan, M.A. 2020. MDBs: Fast-tracking procurement in the time of COVID-19. Devex. 10 July <https://www.devex.com/news/mdbs-fast-tracking-procurement-in-the-time-of-covid-19-97635>

facilities, and working capital facilities limited to roughly 36 months. The IDC is working closely with its principal shareholder, South Africa's Department of Trade Industry and Competition (DTIC) to manage funds made available under the Manufacturing Competitiveness Enhancement Programme. The aim of the fund is to assist companies in setting up manufacturing capacity to produce essential goods necessary during the pandemic.

## Maintaining a local presence

**DFIs lacking a local presence or whose international staff were repatriated, have quickly adapted to the travel restrictions by exploring new ways of working.** Even for those DFIs with a more robust local presence, personal contact with clients and/or local authorities has either been impossible or extremely limited. In response, several strategies have been successfully pursued by DFIs in order to maintain a strong local connection during the initial, emergency response to the Covid-19 crisis. One of the most practical means of achieving this is to foster digital connections or to rely more heavily on local networks. Beyond their direct clients, DFIs have also had to reach out to new ones and connect to local initiatives. Several have done so either relying on their existing networks or joining new ones. Networks can be reached via clients and local contacts (such as business associations) or working with other DFIs and donors with a strong local presence. Local networks are crucial to remain informed and alert to emergency needs.

## Improving collaboration amongst DFI

**Over the course of the last six months, DFIs have demonstrated an effort to collaborate more in response to the Covid-19 pandemic.**<sup>30</sup> Whereas previously DFIs acted in competition for the most creditworthy clients and profitable activities, there are definitive signs that DFIs have recognised the scale of this crisis. For instance, they are starting to pursue more collaborative initiatives in a bid to mitigate Covid-19 induced risks. For instance, on 16<sup>th</sup> April OECD Member States, 'the DFI Alliance', jointly declared their commitment to working collaboratively in order to increase market liquidity, support companies directly affected by the coronavirus, and promote new investment in global health, safety, and economic sustainability.<sup>31</sup> Likewise, on 5<sup>th</sup> May the EDFI group committed to jointly leverage their strengths and geographies.<sup>32</sup> DFIs are also piloting country-level collaboration, where they will work across institutions at the country level to strengthen private investment flows. The seven pilot countries include Democratic Republic of Congo, Ethiopia, Lebanon, Madagascar, Nepal and Sierra Leone, all notably fragile contexts. Despite the disruption caused by Covid-19, work is already under way, with IFC and Proparco, the French Development Agency (AFD) private sector arm, examining co-investment opportunities in the DRC. Elsewhere the UK's DFI, CDC, is leading on the Ethiopia pilot. Several joint exploration trips have already been undertaken to support the work. In the longer-term, DFIs will continue to work on strengthening collaboration via the development of more robust common standards and operating principles. Joint Collaboration Framework Agreements (JCFAs), which broadly facilitate coordination between IFC and DFIs to create markets, mobilize private

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<sup>30</sup> Saldinger, A. 2020. How DFIs are responding to the COVID-19 crisis. Devex. 29 April <https://www.devex.com/news/how-dfis-are-responding-to-the-covid-19-crisis-97081>

<sup>31</sup> EDFI. 2020. Development finance institutions join forces to help alleviate the impact of COVID-19 in developing countries. 6 April <https://www.edfi.eu/news/development-finance-institutions-join-forces-to-help-alleviate-impact-of-covid-19-in-developing-countries/>

<sup>32</sup> EDFI. 2020. Scaling up cooperation among Development Finance Institutions in response to COVID-19. 18 May. <https://www.edfi.eu/news/scaling-up-cooperation-among-development-finance-institutions-dfis-in-response-to-covid-19/>

investors, and then co-finance projects, complement these Pilots. Co-financing of projects will be underpinned by shared standards, especially for blended finance.<sup>33</sup>

## 2. The current constraints of DFIs

### The current constraints on DFI balance sheets

**DFIs are grappling with potential losses to their balance sheets.** The Covid-19 crisis and the uncertainty surrounding it presents DFIs with a greater volume, and more diversified set, of risks. These include a higher risk of default from borrowers and thus potentially higher losses and lower returns. A higher currency risk, increased macroeconomic instability, and higher political risks also contribute to the uncertainty of the environment for DFIs to navigate<sup>34</sup>. This is a stark challenge for DFIs, institutions which are generally risk averse and practice conservative lending in order to protect their balance sheets<sup>35</sup>. However, in a global crisis of these proportions, damage to DFI balance sheets are inevitable. The challenge is how to identify and respond in the most effective manner; to prepare shareholders and rating agencies to accept a certain level of loss, but ultimately give them confidence of the plan to recover.<sup>36</sup>

**Prominent voices are therefore currently calling for additional capital for DFIs to respond more effectively to the crisis.**<sup>37</sup> In order to more effectively respond to the crisis, DFIs need to stretch their balance sheets, increase their prudential flexibility while maintaining their credit rating, enhance their responsible investment, notably in MSMEs, add concessional tools to be able to invest more in difficult and low-income environments, increase their equity investments, and lower (temporarily) their return requirement.<sup>38</sup> In order to manage this, however, additional capital resources will be required, as noted by a call from high-level personalities about European DFIs in May: "...governments, as DFI owners and through their donor agencies, need to take steps to reinforce DFIs' capacities to respond. Governments should consider the need for capital increases and top-up risk-sharing schemes for European DFIs"<sup>39</sup>. Given the scarce concessional resources available from donor countries, the key question is whether capital increases should be enacted in conjunction with other reforms to stretch

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<sup>33</sup> Lawrence, D. and Germanetti, E. 2020. DFI Partnerships Point to a New Way of Doing Business. IFC Blog. June

[https://www.ifc.org/wps/wcm/connect/news\\_ext\\_content/ifc\\_external\\_corporate\\_site/news+and+events/news/insights/i13-dfi-partnerships](https://www.ifc.org/wps/wcm/connect/news_ext_content/ifc_external_corporate_site/news+and+events/news/insights/i13-dfi-partnerships)

<sup>34</sup> Bilal, S. 2020. Towards an EU global COVID-19 response 2.0: Boosting smarter finance. ECDPM Discussion Paper No.273, June. <https://ecdpm.org/publications/towards-eu-global-covid-19-response-2-0-boosting-smarter-finance/>

<sup>35</sup> Lee, N. 2020. Eight Principles for the DFI Crisis Response. CGD Note. May.

<https://www.cgdev.org/publication/eight-principles-dfi-crisis-response>

<sup>36</sup> *ibid*

<sup>37</sup> See EDFI. 2020. *A call for action to European governments and their Development Finance Institutions - Saving jobs in Africa*, 30 April, <https://www.edfi.eu/news/callforaction/> and Bilal, S., S. Griffith-Jones, S. Kapoor, S. Karingi, V. Songwe and D. W. te Velde (2020), *Saving Africa's private sector jobs during the coronavirus pandemic*, ECDPM-ODI-ReDefine-UNECA paper, 15 April

[https://www.uneca.org/sites/default/files/PublicationFiles/saving-jobs-during-pandemic\\_te-velde-et-al\\_15-april-2020.pdf](https://www.uneca.org/sites/default/files/PublicationFiles/saving-jobs-during-pandemic_te-velde-et-al_15-april-2020.pdf)

<sup>38</sup> Bilal, S. 2020. Towards an EU global COVID-19 response 2.0: Boosting smarter finance. ECDPM Discussion Paper No.273, June 2020. <https://ecdpm.org/publications/towards-eu-global-covid-19-response-2-0-boosting-smarter-finance/>

<sup>39</sup> EDFI. 2020. *A call for action to European governments and their Development Finance Institutions - Saving jobs in Africa*. 30 April <https://www.edfi.eu/news/callforaction/>

the development impact and mobilisation performance of DFI capital when needed. Policy proposals regarding this topic are considered in greater detail in Section 4 of this paper.

## The constraints on DFI use of blended finance

### **Even before the global pandemic, blended finance played a marginal role in development finance.**

The volume of blended finance transactions is about USD 15 billion a year according to Convergence.<sup>40</sup> In the development finance ecosystem, DFIs deploy the largest proportion of blended finance. The DFI Working Group Joint Report on Blended Concessional Finance for Private Sector Operations, October 2019 Update<sup>41</sup> shows that in 2018, the combined project volume using blended finance of the major multilateral DFIs<sup>42</sup> totalled USD 6 billion, less than 10 % of their total project volume of about USD 100 billion, including both their own commitments and private finance mobilized.<sup>43</sup> This compares to USD 150 billion in annual development aid, roughly USD 40 billion in annual DFI finance for the private sector, and annual SDG financing gaps for developing countries estimated at USD 2.5 trillion.

**Beyond its small volume, the catalytic power of concessional finance has proven limited<sup>44</sup>.** While DFI concessional finance commitments totalled USD 1.1 billion in 2018, private finance mobilized by these commitments totalled USD 1.7 billion. The same projects also received about USD 2.4 billion of DFI non-concessional commitments. In total, for every dollar of DFI concessional and non-concessional commitments, about 50 cents were mobilized in private finance. This is a long way from the orders of magnitude implied in the original “billions to trillions” vision.

**Current data does not suggest that private finance mobilisation benefits are concentrated in the poorest countries.** At present, the use of concessional finance in blended finance transactions is not concentrated in low-income countries. In 2018, LICs received USD 203 million in concessional finance commitments from DFIs, or 19 % of the total, while MICs received USD 859 million or 81 %, most of which went to lower middle-income countries (LMICs). About the same volume of DFI concessional commitments went to LICs as to upper middle-income countries (UMICs). The disparity is even greater for DFIs’ own account (non-concessional) commitments, 93% of which went to MICs while 7 % went to LICs. Overall, DFI blended finance projects mobilized USD 74 million in private finance in LICs and USD 1.54 billion for MICs.

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<sup>40</sup> Johnston, J. 2020. Seven blended finance trends for 2020. Convergence Blog. 15 January.

<https://www.convergence.finance/news-and-events/news/11BdH52b1ApZYisLr7Kggc/view>

<sup>41</sup> MDBs, 2018. DFI Working Group on Blended Concessional Finance for Private Sector Projects Joint Report. October 2018 Update. <https://www.convergence.finance/resource/6o8IH6vpQytSGRSYEcUcb8/view>

<sup>42</sup> The Working Group of Development Finance Institutions (DFIs) is composed of the African Development Bank (AfDB), the Asian Development Bank (AsDB), the Asia Infrastructure Investment Bank (AIIB), the European Bank for Reconstruction and Development (EBRD), European Development Finance Institutions (EDFI), the European Investment Bank (EIB), the Inter-American Development Bank Group (IDBG), the Islamic Corporation for the Development of the Private Sector (ICD), and the International Finance Corporation (IFC).

<sup>43</sup> The report notes that if portfolio guarantees were included, the concessional funding would have been higher by about USD 35 million and DFI financing would have increased by about USD 168 million. The total volume of projects would have been higher by at least USD 260 million, and private sector mobilization by more than USD 60 million (total volume and private sector mobilization for portfolio guarantees is under-reported this year as some DFIs have yet to begin tracking indirect private mobilization for portfolio guarantees).

<sup>44</sup> This paragraph covers only DFI operations that include blended concessional finance. An examination of mobilisation associated with all DFI operations is contained in the report MDBs and DFIs. 2019. Mobilisation of Private Finance by Multilateral Development Banks and Development Finance Institutions. August 2019. <https://www.adb.org/sites/default/files/institutional-document/521051/mobilization-private-finance-mdbs-dfis-2018.pdf>

*Because blended finance transactions represent such a small share of DFI operations, it is important to understand the overarching characteristics and incentives of DFI financial models, which in turn explain much of the constraints on DFI use of blended finance.*

## Risk aversion

**DFIs essentially follow the commercial bank business model**, funding themselves through the spread between their borrowing costs and their returns on lending and investments. They have a strong interest in keeping their cost of capital low, and their public shareholders have a strong fiduciary interest in preserving their capital. Most multilateral DFIs have AAA institutional ratings, which they strive to protect.

**Shareholders are also interested in robust returns**, as retained earnings are the most important source of finance for expanding DFI equity and therefore lending capacity. Shareholders prefer this route to expansion rather than frequent general capital increases, which are difficult, protracted, and politically sensitive processes for governments to manage.

**These forces result in a DFI organisational and lending culture that can be stacked against innovative projects** in difficult environments with potentially low risk-adjusted returns. It can be challenging in cultures rooted in commercial bank incentives to pivot toward higher risk projects and MSMEs that prioritise impact over returns. That can potentially include blended finance projects where concessional finance is used for de-risking. However, it should be noted that the crisis could contribute to triggering a positive change in culture, as evidenced by the recent changes operated by DFIs.

**The mere presence of concessional finance does not transform DFI cultures or make it easy for staff to find viable projects with high development impact.** The IDA Private Sector Window example, which allocates USD 2.5 billion in concessional finance for de-risking IFC projects in poor countries, demonstrates that it still proves difficult to ramp up IFC operations in IDA countries and in fragile and conflict affected states.<sup>45</sup>

Besides the financing issue, a common challenge is the lack of bankable projects, let alone innovative and sustainable ones. Support to project identification and preparation should become a higher priority for donors, based on domestic public and private sector initiatives, to help generate a transformative pipeline of projects, which could benefit, when needed, from DFIs support. Without such concerted efforts, it will be difficult to build back better in the wake of the Covid-19.

## Conservative lending policies

**The conservative attitude toward risk carries over into a conservative attitude toward capital adequacy.** Multilateral DFIs hold more equity relative to loans than commercial institutions do.<sup>46</sup> For the multilateral DFIs that only or mostly finance the private sector—the EBRD, the IFC, and IDB Invest—equity/loan ratios are two to six times higher than commercial banks. For those banks that combine their sovereign and private operations on the same balance sheet—EBRD, AfDB, AsDB—equity in these ratios includes only paid-in capital and accumulated earnings, not callable capital. Callable capital is a contingent commitment by shareholders to provide the capital if the institution itself is at risk of default, something which has never occurred, even during the global financial crisis.

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<sup>45</sup> Kenny, C., Ramachandran, V., and Masood, J.S. 2020. Making the International Finance Corporation Relevant. CGD Blog. 7 July. <https://www.cgdev.org/blog/making-international-finance-corporation-relevant>

<sup>46</sup> Lee, N. 2020. Can DFIs Be First Responders in a Crisis? CGD Blog. 19 May. <https://www.cgdev.org/blog/can-dfis-be-first-responders-crisis>

It accounts for an average of 89 % of the total capital that shareholders commit to these three institutions. However, as a matter of policy, risk-averse finance departments in these institutions do not include it in calculating prudential lending limits. These policies significantly constrain overall DFI lending capacity, with or without blending with concessional funds. The addition of concessional finance in blended finance transactions so far has had a marginal impact on the scale of DFI operations, including in LICs, and on the supply of what DFI credit committees consider bankable projects. Altogether, it would be challenging to argue that concessional finance would have a transformative impact in and of itself at a time of much higher risks and uncertainties associated with the global pandemic.

## Instrument mix

**Lending dominates the operations of most DFIs, which act as an important contributor to relatively low mobilisation ratios.** Loans averaged 85 % of the financing commitments for the private sector of the five major multilateral DFIs in 2017.<sup>47</sup> Yet, loans, especially senior loans, occupy the space of most interest to private commercial lenders. DFIs, therefore, face criticism for potentially crowding out, rather than crowding in, private finance. In fact, most of the mobilisation of private finance by multilateral DFIs comes from other instruments, especially guarantees.

**Loans also dominate DFI concessional finance commitments.** The DFI Blended Finance Working Group reports that about 60 % of DFI concessional commitment volumes takes the form of senior loans.<sup>48</sup> A shift in DFI instrument mixes toward guarantees and equity would likely increase mobilisation ratios, but also likely increase risk and lower risk adjusted returns.

## 3. What needs to change?

### Focus on building resilience of MSMEs as the backbone of developing economies

**The current COVID-19 pandemic is a test of business resilience for MSMEs.** Resilience is the capacity of a business to innovate and adapt to a shock as quickly as possible and continue operating while under stress. It helps businesses outperform their peers during an external shock. More resilient MSMEs are characterized by being able to: i) quickly repurpose and reallocate their resources; ii) develop teams that can operate independently of each other and without the need to coordinate centrally; and iii) depend on inputs that are abundant, renewable or re-usable, among others<sup>49</sup>. A distinction should also be made between the financial and operational resilience of MSMEs.

**DFIs should use this crisis as an opportunity to improve the resilience to future shocks of MSMEs and local economies.** MSMEs are a key source of local jobs, lead the implementation of environmental and social (E&S) best practices on the ground, and constitute a key source of revenues for the public sector. However, many MSMEs have found themselves unprepared and/or under-prepared for the Covid-19 shock of unprecedented magnitude. In addition, the negative supply-side and demand-side effects of Covid-19 have resulted in a significant jump in job losses and reduced working hours in MSMEs.

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<sup>47</sup> Lee, N. and Sami, A. 2019. Still Lending (Mostly) After All These Years. CGD Blog. 26 February. <https://www.cgdev.org/blog/still-lending-mostly-after-all-these-years>

<sup>48</sup> *Ibid.*

<sup>49</sup> Orlando, V.R. 2020. How does resilience add value to a business in times of change? <https://www.linkedin.com/pulse/how-does-resilience-add-value-business-times-change-ramundo-orlando/?trackingId=45UDVnixkvJolJpZRn6mYA%3D%3D>



**The adoption of good Environmental, Social and Governance (ESG) practices by MSMEs will result in more resilient businesses and local economies.** Good ESG practices increase MSME resilience and add value to a business. These practices demonstrate how the business interacts with society, including its own staff, suppliers, customers, and the environment. Overlapping practices may include access to natural resources, social support for company operations, sound human rights practices across the supply chain, and financial transparency and reporting, to name a few. The adoption of ESG practices has been shown to build company resilience and help them outperform their peers during an external shock, like Covid-19.<sup>50</sup> DFIs, and their shareholders, can play an active role, together with other governments, regulators and investors, to better align methodologies, practices and the transparency of ESG principles, and promote their uptake to stimulate investments with sustainable long-term value.<sup>51</sup>

**Focusing on the financial resilience of MSMEs is required despite potential low risk-adjusted financial returns.** Most development programmes seek to support MSME development to advance local and sustainable economic growth. However, these programmes are often limited in size and scope due to MSME's comparatively low financial risk-adjusted returns. In some cases, the programmes have not prioritized initiatives to support MSMEs after an external shock.

**MSMEs should be included in the consultation process for the design of blended finance vehicles towards local rebuilding and resilience.** DFIs go through several rounds of consultations with local and international stakeholders during the design process of blended finance vehicles to support local economies, including public and private sector experts, technical specialists, and non-profits. MSME owners and associations are typically not part of this process, and when they are their role is often peripheral and limited. This negatively impacts the ability of the vehicle to deploy capital to MSMEs and generate the projected environmental and social returns.

**Social blended finance vehicles targeting MSMEs should focus on inclusive growth, providing a safety net to local communities, and/or ensuring the continuity of financial and capital markets for SMEs.** As part of its social mandate against Covid-19, such vehicles may focus on supporting local incomes either directly by engaging relevant MSMEs, or indirectly by supporting key local financiers. This may include, among others:

- mitigating the negative economic impact of the shock on vulnerable local population groups, including women, minorities, and indigenous people by supporting MSMEs that are a source of jobs and income to the vulnerable population;
- ensuring the provision of critical goods and services to local communities, potentially including medical services and products, water and sanitation, or basic foods;
- encouraging MSME formalization. This is expected to result in improved business practices, increased productivity, and higher salaries and access to social security coverage for employees;
- ensuring that local financial institutions remain solvent and operational and continue funding MSMEs with positive environmental and social practices; and
- reactivating capital markets for MSMEs by supporting the renewal of maturing loan products and reducing additional (real or perceived) COVID-19 risks for the financial sector.

**Environmental Blended Finance Vehicles targeting MSMEs should focus on encouraging the adoption of good environmental practices and green infrastructure investments.** As part of its

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<sup>50</sup> Blackrock. 2020. Sustainable investing: Resilience amid uncertainty, Blackrock. Available at:

<https://www.blackrock.com/corporate/about-us/sustainability-resilience-research>

<sup>51</sup> See OECD reports on ESG investing published at the end of September 2020, and notably the *OECD Business and Finance Outlook 2020: Sustainable and Resilient Finance*, all available at

<https://www.oecd.org/finance/esg-investing.htm>

environmental mandate against Covid-19, such vehicles may focus on supporting the sustainable management of natural resources and the health of the underlying ecosystem. This may include, among others:

- reducing MSMEs resource intensity (energy, water, raw materials) by supporting the adoption of improved environmental practices, and/or reducing greenhouse gas emissions;
- protecting and conserving local biodiversity, maintaining ecosystem services on which economic activity depends (e.g. freshwater reserves), and improving the management of natural capital, including by supporting MSMEs that source inputs from natural capital that is sustainably managed and/or MSMEs that use inputs that are abundant, renewable and/or re-usable;
- supporting green infrastructure investments that can help restore and conserve natural capital, and/or increase resilience against climate change risks.

## Taking on more risks and being countercyclical

**For DFIs to be able to play a significantly countercyclical role, stimulating more and better quality investment in the wake of Covid-19, their business model must be adjusted to enable them to face greater risk for higher impact.** While DFIs will not initiate or lead the recovery, the extent to which they can be countercyclical to build back better will help shape the overall development community response. Given the magnitude of the Covid-19-induced financial needs in developing economies, DFIs will need to be able to support businesses, and in particular MSMEs, hit by the crisis and take on more risks in terms of geographies or instruments. However, the unprecedented crisis generated by the pandemic has significantly increased the risk exposure of financial institutions, including DFIs, with expected greater credit losses and revenue falls.<sup>52</sup> This also requires a change of perspective from their shareholders.

**The crisis could be an opportunity for DFI to rise to the occasion and revisit their business models.** This would require DFI shareholders to take on action that is more decisive to allow DFIs to be countercyclical and accept more risk, including by investing in MSMEs, to address additional development needs in the Covid-19 crisis. This is not only a development imperative, but is also partly self-serving, as it contributes to support a global recovery that will also benefit advanced economies and their private investment in poorer countries. DFI shareholders should therefore be prepared to accept the consequences of taking on more risk for higher leverage and impact in more vulnerable environment. This could entail a possible downgrade in institutional ratings, unless more public guarantees are provided to cover the balance sheet of DFIs, or more frequent capital increases are considered.<sup>53</sup> It would also require shareholders to accept less or stagnant DFI financial profitability and perhaps even decreasing lending capacity, with higher equity stakes. Greater attention should be paid to bridge the disconnect between the finance and policy side of investment. In particular, greater synergies could be found between DFI operations and other development cooperation instruments and policy engagement, notably to build back better, develop human capital, foster green and inclusive policies, help the establishment of sustainable financial markets and improve the investment

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<sup>52</sup> Allianz Research. 2020. *Calm before the storm- Covid-19 and the business insolvency time bomb*, 16 July 2020, <https://www.kreditwesen.de/bank-markt/marktberichte/research/calm-storm-covid-19-and-business-insolvency-time-bomb-id65812.html> and Morris, S. and Walker, O. 2020. Banks braced as pandemic poses biggest test since financial crisis. *Financial Times*. (Free to read) 10 August 2020, <https://www.ft.com/content/b0b241d9-7c94-4b91-b727-d39245005d07>

<sup>53</sup> See for instance EDFI 2020, "A call for action to European governments and their Development Finance Institutions - Saving jobs in Africa", 30 April 2020. <https://www.edfi.eu/news/callforaction/> and Bilal, S., S. Griffith-Jones, S. Kapoor, S. Karingi, V. Songwe and D. W. te Velde (2020), *Saving Africa's private sector jobs during the coronavirus pandemic*, ECDPM-ODI-ReDefine-UNECA paper, 15 April [https://www.uneca.org/sites/default/files/PublicationFiles/saving-jobs-during-pandemic-te-velde-et-al\\_15-april-2020.pdf](https://www.uneca.org/sites/default/files/PublicationFiles/saving-jobs-during-pandemic-te-velde-et-al_15-april-2020.pdf)



climate and economic governance of developing countries, drawing on the ‘cascade principle’ of the World Bank.<sup>54</sup>

The European External Investment Plan (EIP) provides an interesting attempt to incentivise DFIs to take more risk for greater impact. It allows for blended finance under the European Fund for Sustainable Development (EFSD) combined when needed with a guarantee for private investment and sovereign lending. The European Union (EU) approach, which will be extended under the new long-term budgetary period 2021-2027, combines this with technical assistance and policy dialogue to improve the investment climate, with a view to harness DFIs investments to a transformative agenda at the local level, in term of project quality, capacity building, institutional development and regulatory reforms.<sup>55</sup> The *Team Europe* approach, adopted by the EU as a response to the Covid-19, also emphasises the synergies between the actions of the EU, its member states and their financial institutions for development, in cooperation with other international actors and DFIs.<sup>56</sup>

DFIs have also been active in stimulating cooperation among them to achieve higher impact, as in the case of the *DFI Alliance* (mentioned above), the MDB Infrastructure Cooperation Platform (bringing together seven MDBs), the *Western Balkan Investment Framework* (a joint initiative of the EU, financial institutions, bilateral donors and the governments of the Western Balkans), syndication facilities such as the *Interact Climate Change Facility* (between the EIB, AFD and several EDFI members) and the *European Financing Partners* (between the EIB and several EDFI members), as well as mutual reliance agreements, such as the *Mutual Reliance Initiative* (between the EIB, AFD and KfW) and other cooperative arrangements and important initiatives, such as the *2X Challenge financing for women* and the *Gender Finance Collaborative*.

**Adding another financial structure to the DFI toolkit could also be explored.** Such financial structure would make better use of DFI capital, take risk off-balance-sheet, make more projects bankable, and facilitate targeting of the most important gaps in capital markets<sup>2</sup>. This option is discussed further in Section 4 of the paper.

## Building stronger local partnerships

**The Covid-19 crisis calls for the international response to be anchored in local contexts, needs and realities.** DFI operations should be tailored to accompany and complement initiatives undertaken at the local levels, by domestic actors, as well as in tandem with other international actors where relevant. In line with the OECD-DAC Blended Finance Principles, and in particular Principle 3 on tailoring blended finance to local context, DFIs should ensure that their actions support local

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<sup>54</sup> Carter, P. 2018. The World Bank’s Preference for Private Finance: Explained. CGD Blog, 27 March <https://www.cgdev.org/blog/world-bank%E2%80%99s-preference-private-finance-explained>

<sup>55</sup> Große-Puppenthal, S. and Bilal, S. 2018. What is the European External Investment Plan really about? ECDPM Briefing Note No.101, March, <https://ecdpm.org/wp-content/uploads/ECDPM-2018-BN-101-What-Is-The-European-External-Action-Plan-EIP-Really-About.pdf> and European Commission website at [https://ec.europa.eu/eu-external-investment-plan/home\\_en](https://ec.europa.eu/eu-external-investment-plan/home_en)

<sup>56</sup> See for instance Jones et al. 2020. The challenge of scaling up the European Union’s global response to COVID-19, ECDPM Briefing Note No.116, April <https://ecdpm.org/publications/challenge-scaling-up-european-union-global-response-covid-19/> and Bilal, S. 2020. Towards an EU global COVID-19 response 2.0: Boosting smarter finance, ECDPM Discussion Paper No.273, June, <https://ecdpm.org/wp-content/uploads/Towards-EU-Global-COVID-19-Response-2.0-Boosting-Smarter-Finance-Discussion-Paper-273-ECDPM.pdf>, as well as the high-level interventions in the EBRD-ECDPM-EDFI-EIB joint webinar on *Team Europe: Joining forces for financing the global recovery*, 11 September 2020 <https://ecdpm.org/events/team-europe-financing-global-recovery/> and the DAI-ECDPM webinar on *How Covid-19 calls for an alliance for financing*, 29 June 2020 <https://ecdpm.org/events/how-covid-19-calls-for-an-alliance-for-financing/>

development initiatives (Principle 3A), and are consistent with the aim of local financial market development (Principle 3B). Cooperation with local actors can serve different purposes, such as better identifying the local systemic needs and opportunities, supporting MSME pipeline building, strengthening and complementing local initiatives, fostering more effective deployment of activities, enhancing the enabling environment, sharing expertise and developing skills, building institutional capacity, as well as improving monitoring and reporting. To do so effectively, DFIs must primarily relate to local actors and local initiatives to maximize their impact.

**One notable prospective area of work for DFIs is increasing the volume of local Covid-19 related initiatives.** In doing so, they can enhance their credibility, reduce perceived risks, strengthen local implementation mechanisms and institutions, and promote innovative approaches and other demonstration effects. EBRD provides a pertinent example of such approach, which has secured agreements with three central banks in the economies where it invests to gain access to local currency that it can use for lending to local companies<sup>57</sup>.

Some recommended DFI initiatives in this context include:

- **Enhance relationships with private sector, notably financial institutions and associations,** to better identify and respond to local needs and help strengthen their resilience. This includes partnering with capital deployment partners, notably financial institutions with wide geographic and population coverage, such as Postal Banks and cooperative banks (capillarity, ability to reach rural areas and deploy fast - simple financial products), as well as nonbank financial institutions, microfinance institutions, and mobile service providers, which can more easily and on a large scale reach out to the poor and vulnerable people, including in rural areas, most affected by the Covid-19 socio-economic crisis.
- **Reach out more systemically to local institutional investors and domestic financiers,** with a view to leverage at scale their investment and enhance their sustainability dimensions, including in terms of environmental and social criteria, and promoting gender finance.
- **Boost local currency financing,** working when necessary with currency hedging partners, who use diversified currency pools and differences in currency risk across regions for hedging purposes, such as TCX.
- **Cooperate with local public and private initiatives** that DFIs can contribute to strengthen or expand, such as private sector guarantee schemes and prudential funds, Central Banks support to private banking.
- **Team up whenever possible with regional and national development banks,** as well as other local public finance institutions such as Sovereign Wealth Funds and Caisses des Dépôts, to leverage their initiatives, build on their strategic connection with public authorities, and enhance their credibility.
- **Partnering and working with UN institutions with a local presence.** Several UN institutions have a local presence and are developing local initiatives and establishing local coordination mechanisms to respond to the Covid-19 health, social and economic emergency. DFIs can join forces with them for specific initiatives. Alternatively, DFIs can use UN networks and platforms to reach out to new potential clients and stakeholders.

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<sup>57</sup> Williams, A. 2020. EBRD ups drive to source local currency financing and strengthen economies against coronavirus. EBRD. 21 May 2020. <https://www.ebrd.com/news/2020/ebrd-ups-drive-to-source-local-currency-financing-and-strengthen-economies-against-coronavirus.html>

- **Connecting with local authorities.** Governments in developing countries have set numerous initiatives to enable a multi-pronged response to the Covid-19 emergency. DFIs can draw upon information and insights from local authorities and, when relevant, compliment their actions.

## Focusing on creating a sound enabling environment

**DFIs should put greater emphasis on creating conditions that lead to investments.** This higher-level upstream approach represents the most pressing bottleneck in DFI work. However, in the wake of the Covid-19 crisis, DFIs have a responsibility to shift their focus away from the transaction level and towards a more-forward looking, transformative and upstream approach. That is, DFIs should consider not only the immediate impact of their transactions, but also how they contribute to more transformative outcomes, through demonstration effects and systemic effects of their interventions (as in the case of the transition impact of the EBRD<sup>58</sup>). DFIs should also work in synergy with other DFIs, donors, governments and local institutions and investors, giving more attention to pre-investment work such as preparing project pipelines, improving legislative and regulatory environments, enhancing the focus on greening, sustainability, resilience, inclusivity and gender, contribute to sustainable economic transformation and industrial development, and building capacity where it is lacking. Overall, this involves working together on improving investment conditions, and creating a pipeline of sustainable bankable projects aligned with a country's development priorities. This can also be done through participation in policy dialogues, through linkages with local public authorities, donors' policy engagement and public-private dialogue platforms, including MSMEs, such as those fostered by the World Bank Group or by the EU (e.g. the EU External Investment Plan).

**To stimulate the recovery, DFIs should therefore be less project/transaction driven, and concentrate their effort on the systemic effects of their interventions** on the recovery, i.e. on local economies, market conditions and building, institutional setting and investment climate. Systemic impacts necessitate a strong anchorage of DFIs actions in local contexts, in cooperation and partnership with local stakeholders.

## Focus more on blended finance and private sector mobilisation at scale

**Blended finance has a pivotal role to play to speed up the recovery.** Before the Covid-19 pandemic, progress towards the 2030 Agenda was already considered slow and uneven, with an estimated USD 2.5 trillion annual funding gap. In this context, the health crisis enacted a triple blow, spanning health systems, economies, and societies across developing countries. Given this and the increasing scarcity of concessional resources, the SDG financing gap is likely to expand further, with the additional risk that efforts focus on the volume only, at the expense of the quality, of investment, missing on the opportunities to build back better. Consequently, support from all stakeholders, including private investors through blended financing, will be required in order to deliver the SDGs in developing countries. As a reminder, the OECD defines blended finance as the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries.

**Private sector mobilisation will also depend on the types of geographies targeted.** Although private sector mobilisation is particularly challenging currently given the high risks levels in fragile developing

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<sup>58</sup> EBRD. How we assess transition impact. <https://www.ebrd.com/what-we-do/economic-research-and-data/transition-impact.html>

countries, there is still some appetite from investors in more advanced economies. The catalytic effect of DFIs should therefore be concentrated to the most vulnerable geographies.

## 4. How a new Covid-19 fund could help DFIs respond more effectively to the crisis

**The deployment of blended finance must be accompanied by other changes in DFI operations in order to achieve scale in finance, impact, and mobilisation.** Such changes have taken on increased urgency in the wake of the economic and financial impact of the pandemic, and the associated deep and lasting reversal of poverty reduction progress. Chief among these changes are:

- (i) the ability to manage increased risk;
- (ii) tolerance of lower risk-adjusted returns;
- (iii) an enhanced focus on MSMEs for rebuilding more resilient and sustainable local economies;
- (iv) a willingness to make more efficient use of, and stretch, existing capital;
- (v) a readiness by shareholders to consider an increase in capital to allow more countercyclical transactions;
- (vi) additional guarantee mechanisms, easily accessible, to cover DFIs activities in riskier and more fragile environments, when needed;
- (vii) a change in the DFI mix of instruments;
- (viii) a change in DFI cultures and staff incentives to place a higher priority on impact, and
- (ix) a stronger capacity for innovation to build project pipelines that work in LICs and in serving poor and vulnerable populations; and
- (x) renewed efforts to pursue opportunities for syndication, joint risk-sharing mechanisms, alliances and cooperation with other DFIs and development financiers.

Several current initiatives by DFIs are aiming at pursuing some of these changes. Additional ones could be envisaged, to unleash the critical potential of DFIs in the wake of the Covid-19. For instance, a new **Covid-19 Stretch Fund, purpose-built to stretch the capital of existing DFIs could help address some of the current challenges faced by DFIs in response to the Covid-19 crisis.** Such a new fund could stretch the capital of existing DFIs in two ways: (i) expanding the spectrum of investments and environments in which DFIs can participate; and (ii) taking on high-risk tranches to open up more DFI investment opportunities.<sup>59</sup> Unlike most donor trust and guarantee funds, the Stretch Fund would also have the mandate to originate a limited number of projects on the riskier, more innovative end of the spectrum. This is important for reaching investees that DFIs would normally not touch and for expanding the boundaries of market-making impact. Rather than operating solely as passive project takers, staff would be encouraged and empowered to develop some emblematic investments with exceptional impact and demonstration effects.

**Such a fund would specifically target MSMEs and financial institutions that support MSMEs.** As discussed previously, supporting MSMEs is critical to speed up the recovery in developing economies, given their central role in terms of growth and job creation.

Shareholders of existing DFIs could consider capitalizing a new Covid-19 Stretch fund which would act as a partner to multiple DFIs for the purpose of helping them manage increased risk, mobilize greater multiples of private finance, add more equity and guarantees to their instrument mix, focus more on innovation that works for the poor, and expand their operations in lower-income countries.

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<sup>59</sup> Lee, N. and Preston, D. 2019. The Stretch Fund Bridging the Gap in the Development Finance Architecture. CGD Brief, December, <https://www.cgdev.org/sites/default/files/Lee-Preston-Stretch-Fund-Full.pdf>

Alternatively, shareholders could build on an existing fund that has the right financial and development impact goals, structure, and operating characteristics. One such fund might be the Global Innovation Fund, which invests in low-income and lower middle-income countries, including in early stage finance for new business models, technologies, and products that can reach and benefit the poor. It offers financing for smaller investments of a more appropriate size for lower income countries — USD 50,000 to USD15 million. It focuses on scalable investments with the potential for broad market-building impact.

In order to ensure that MSMEs are effectively benefiting from such financial support on the ground, DFIs would need to request seats on the boards of the financial institutions supported. This will allow for a better level of oversight and monitoring. A pertinent example of such an initiative is the German KfW Development Bank and its participation to the establishment of the new development bank in Tunisia, the Banque des régions (BdR) - the Bank of Regions. The BdR, set up by the Tunisian government, aims to provide access to finance and support to micro, small and medium-sized enterprises (MSMEs) at a regional level in Tunisia. This is an underfinanced segment of the market, notably due to weak performances by current public institutions, which will be absorbed by the BdR. KfW's role is to provide technical assistance, including in knowledge transfer and support to the establishment of strong governance structure and principles (independent from the state). Following this, KfW will provide a substantial line of credit to the BdR. The advantage of KfW's approach ensures is that it helps to create stronger public financial institutions as well as financing MSMEs. Overall, this enhances the credibility and sustainability of the BdR for longer-term impact.

*The Covid-19 Stretch Fund would look very different from existing DFIs, donor trust funds, or structured finance funds. Initial details on the way it would operate are as follows:*

- **Focus on capital market gaps and MSMEs.** *The Stretch Fund's investment strategy would target the most pervasive capital market gaps— early stage finance for MSMEs and infrastructure, the highest risk project tranches (top of the capital stack), and local currency products. It would not target particular countries, regions, or sectors. As capital market development tends to increase with country income levels, it follows that low-income and lower-middle-income countries would be the principal investment destinations.*
- **Target a different financial goal.** *The Stretch Fund would be financially sustainable. It would preserve capital at the portfolio level, cover its administrative costs, and not require regular replenishments. However, its risk-adjusted returns at the portfolio level would be below-market or zero. Any returns would be retained and added to capital for expanding operations.*
- **Pool public and private funds.** *The Stretch Fund would be a pooled investment vehicle, serving as a platform for aggregating capital. It would combine capital from public and private investors that are like-minded in prioritizing development impact over returns, such as governments and risk-tolerant philanthropic and foundation investors. Investors interested in commercial returns would invest alongside the Stretch Fund, not as part of a structured fund with different investors reaping different risk-adjusted returns. Governments would bring experience and emphasis on accountability; transparency; and environmental, social, and governance standards. Private investors would bring strengths in innovation, market adaptation, and efficiency. All shareholders in the fund would participate in governance commensurate with their equity share.*
- **Deploy a flexible range of catalytic financial instruments to meet clients' needs.** *In contrast to the dominance of senior lending in existing DFI portfolios, the Stretch Fund would deploy mostly subordinated products: equity (including early stage equity and quasi-equity), guarantees and first loss protection, and subordinated debt, including in local currency.*

- **Align human capital with instrument requirements.** *Stretch Fund investment officers and managers would specialize in deploying these instruments, which require different skills than standard senior lending in dollars or euros. The differences in skills and in portfolio management objectives, in fact, are a principal reason that DFIs find it so difficult to shift significantly away from their existing instrument mix.*
- **Seek DFI deal proposals and originate some innovative and sustainable deals.** *Most of the investment origination would come from DFIs interested in partnering with the Stretch Fund in order to access its risk-tolerant capital. That would allow the Stretch Fund to capitalize on the reach and on-the-ground presence of existing DFIs in building deal flow and keep the Stretch Fund's overhead manageable. It would also allow the Stretch Fund to build on best practices and incentivise higher quality investment, in terms of innovation, sustainability, gender and inclusivity approaches. DFIs could compete for access to the Stretch Fund to promote a race to the top in investment impact. Alternatively, high-impact investments at scale proposed collectively by multiple DFIs could receive preferential access.*
- **Increase mobilisation ratios.** *To play a meaningful role in mobilizing private finance for development, growth, and the SDGs, the Stretch Fund would aim to catalyze five dollars of finance from other investors for every dollar it commits. It would invest by targeting an unfunded risk tranche or catalytic part of the capital stack.*
- **Be a permanent capital vehicle.** *The Stretch Fund would be a permanent capital vehicle with capital contributions in the form of equity. This would enable the fund to play the patient investor role that is so often missing and so critical to unlocking commercial finance.*

## Conclusions

Over six months since the official declaration of the crisis, the world remains in the early stages of what is set to be a potentially highly unpredictable and long-lasting crisis. During this unprecedented shock in a highly globalised economy, the only certainty we have at this stage is that emergency and recovery needs will be immense.

However, although a “Great Disruptor”, Covid-19 looks set to catalyse fundamental and much needed changes in the development community and its ways of working. Now is the time to explore innovative ideas, to provide emergency relief and good practice for the recovery period. In doing so, DFIs can be instrumental in helping to leverage private finance, create more sustainable economies, and ultimately, help deliver the SDGs.

There are encouraging signs from DFIs that they are exploring new ways of doing business, including speeding up disbursements, supporting new clients in fragile contexts and collaborating to previously unforeseen levels.

However, if we are to avoid the pitfalls of 2008, governments and shareholders have an obligation to release DFIs from their traditional constraints and help them to become truly countercyclical.

In the pursuit of more countercyclical behaviour, DFIs should focus their work on private finance and MSMEs, encouraging the adoption of positive social and environmental practices that can help increase the resilience of MSMEs and local economies, building local partnerships and fostering new policy reforms in developing markets. In parallel, DFIs need to take more risk, and mobilise at greater scale. This may involve creating a new off balance sheet superstructure, additional guarantee mechanisms for DFIs, with simple procedures, and capital increase. Most of all, it involves changing DFIs culture, staff incentives and shareholders attitude to risk and development, towards more



effectively supporting transformative agendas in poorer countries and those most vulnerable to the Covid-19 crisis.

This paper has provided a brief outline mapping of DFI response to the crisis and current challenges. Building on this, policy recommendations are proposed with the aim of triggering a debate around these critical issues. Given the early stages of the crisis, feedback on these initial ideas is welcome.

**The key recommendations for DFIs and shareholders** to best speed up sustainable and resilient recovery in developing economies, provide countercyclical finance to the most vulnerable, and meet their development mandates are as follows:

Adopt measures and processes allowing DFIs to respond to the protracted Covid-19 crisis in a more **countercyclical, sustainable and impactful** way, tackling the gender and inequality dimensions of the recovery;

**Undertake activities in riskier, more fragile, and low income environments** targeted at actors and countries more severely hit by the crisis. Use a combination of financing mechanisms appropriate to each institution, such as accepting lower risk-adjusted returns, stretching balance sheets, and benefiting from enhanced guarantee mechanisms or capital increase, and when appropriate with the support of blended concessional finance;

**Increase support and exposure to private sector and in particular MSMEs**, with a focus on sustainability, gender and building resilience (without compromising on other types of financing);

**Focus even more on building stronger and innovative local partnerships**, including with national and regional development banks, emerging market sponsors, local financiers, etc.;

**Enhance the capacity for innovation to build project pipelines**, in synergy with local actors and donors, partnering with other DFIs, that work in LICs and serve poor and vulnerable populations;

**Concentrate efforts on the systemic effects of interventions on the recovery**, beyond the immediate impact of single transactions. This could include building back better, by improving the investment climate in developing economies, and preserving already achieved gains.

**Pursue opportunities for syndication, risk-sharing mechanisms, alliances and cooperation with other DFIs and development financiers**. This may include, as appropriate to individual institutions or groups of institutions, special purpose vehicles and financial structures to be added to the DFI toolkit, which would contribute to stretch DFI capital, take risk off-balance-sheet, make more projects bankable, and facilitate investment, in particular to address at scale the critical situation of MSMEs and firms in LICs. As one option, shareholders could consider allocating additional risk-tolerant capital to an MSME COVID-19 facility that would help interested DFIs manage more risk and mobilize more private finance through the use of subordinated instruments like guarantees and equity. This could be done by leveraging and expanding existing facilities that have the right capabilities, and when appropriate with the support of blended concessional finance.

**Focus on opportunities that a more efficient and expanded use of blended finance, including with concessional support, can bring**, notably to mobilise sustainable private finance at scale for greater sustainable and transformative impact.