

Development Finance Institutions and Covid-19: Time to reset

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Introduction

Between 9 and 12 November 2020, over 400 Public Development Banks (PDBs) will be gathering (virtually) at the first Finance in Common summit to discuss how they will contribute to the global Covid-19 recovery effort. Development Finance Institutions (DFIs) – an important part of the diverse PDB landscape – are called upon by policy makers to play a key role in these efforts, fostering growth and job creation.¹ However, an analysis of how DFIs are responding to the Covid-19 crisis suggests they are unable to foster inclusive and sustainable businesses and spur a much-needed transition to low-carbon economies.

As the world struggles to contain the coronavirus and recover from its social and economic impacts, DFIs are positioning themselves as the “vital frontline in the struggle to preserve [firms]” in developing countries and calling on government shareholders to increase funding capital.² Similarly, proponents of the DFIs role in development argue for more risk taking by DFIs, loosening credit criteria and scaling-up blended finance.³ Policy makers are also looking at DFIs to play a leading role in supporting the private sector, reducing risks and improving the business environment under the broad headline of ‘building back better’.⁴

The rise of DFIs is not new. In past decades they have become a key part of the development finance architecture as a consequence of a broader shift in the development narrative and practice prioritising the private sector. Between 2003 and 2018 the consolidated portfolio of European DFIs has increased fivefold.⁵ In 2018, five bilateral DFIs in the US, UK, Germany, France and the Netherlands committed over US\$12 billion to private sector companies, an equivalent of over ten per cent of total Official Development Assistance (ODA) from these countries.⁶

Eurodad has criticised this trend underlining the risk of diverting scarce development resources away from interventions and modalities that have proven to be effective in delivering development results. The role of DFIs as development actors has been called into question as evidence highlights a lack of development impact, as well as a lack of alignment with effectiveness and responsible financing principles, including poor accountability and transparency, potential aid tying, increasing debt burdens and contributing to unfair tax practices.⁷ Moreover, DFI interventions should be seen as complementary to much broader systemic measures such as broadening and deepening debt relief that could create the fiscal space for countries to develop domestic schemes to support those who are losing their jobs and livelihoods and strengthen the companies with the potential to bring economies to a sustainable path.

This briefing offers an analysis of the response of five major DFIs to the pandemic since March and finds that DFIs struggle to ‘demonstrate their value as development actors’.⁸ This briefing also finds that these institutions and their business models are insufficiently equipped to demonstrate additionality and support those local economic actors that are worst affected by the pandemic and are crucial for a people-centred recovery that puts developing countries on a more sustainable and inclusive pathway. This briefing concludes by presenting key elements of an urgent reform agenda for DFI’s as development actors.

What are Development Finance Institutions?

Development Finance Institutions (DFIs) are a sub-set of public development banks. They are specialised institutions set up to support public policy objectives, mainly private sector activities in developing countries. They are usually majority-owned by governments and benefit from public guarantees, while some source their capital from public development funds reported as official development assistance (ODA).

Bilateral DFIs are commonly from Northern countries, such as the Dutch FMO or French Proparco, or part of a larger bilateral development bank, such as the German DEG – all three are among the largest in the world. The US Development Finance Corporation was formed in 2018 after a merger of the independent Overseas Private Investment Corporation and several other funds and agencies. Multilateral DFIs are the private sector arms of multilateral and regional development banks, owned by national governments. The main multilateral DFI is the World Bank’s International Finance Corporation (IFC).

How are Development Finance Institutions responding to Covid-19?

Between March 2020 – when Covid-19 was declared a global pandemic and lockdown measures were implemented outside China – and early October, four major bilateral DFIs and the IFC committed at least \$7 billion in additional investments.

Types of investment

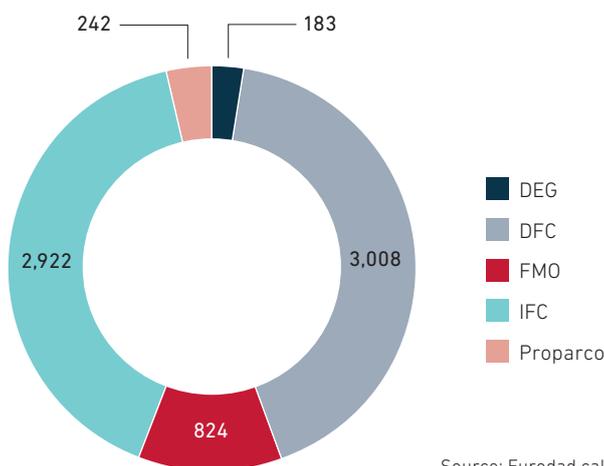
Describing an average DFI investment is difficult, but investees tend to be large companies or leading firms in a national domestic market. Many DFI clients are publicly listed allowing them to access substantial commercial finance. Earlier research, based on data from 2012 to 2018, found the median commitment size ranges between \$7.6 million and \$22.8.⁹

In responding to Covid-19, selected DFIs have first focused on supporting existing clients by providing liquidity to overcome the immediate impacts of the crisis. This is reflected in the fact that 78 per cent of investment projects comes in the form of loans, while 90 per cent of investments for this was possible to trace involves existing clients.

In their response plans, selected DFIs also focused on the need to provide grant-based finance, including technical assistance, to help companies mitigate the effects of the coronavirus on their business operations. This type of investment appears marginal as only 0.1 per cent of investments for which we were able to identify the financial instrument used, was in the form of grants. A third element of the response focuses on learning, exchange of information and coordination between DFIs themselves and DFIs and client companies.¹⁰

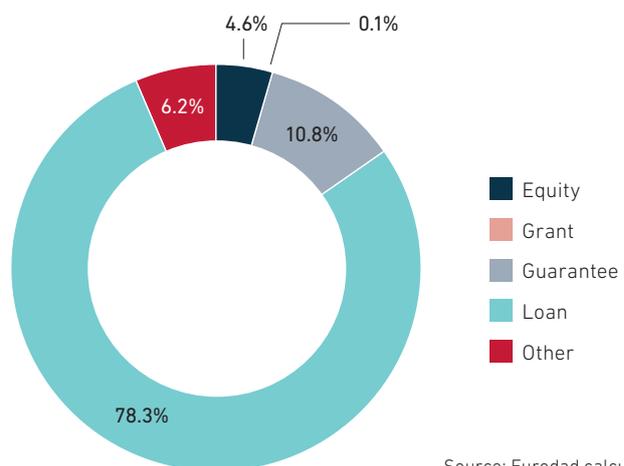
Some DFIs planned to shift their investment focus to the health sector. The UK’s CDC, for instance, has been providing guarantees to medical suppliers – such as BASF – to increase access to medical supplies in developing countries. In July, it provided a \$50 million guarantee enabling UNICEF to procure supplies from commercial manufacturers.¹¹

Figure 1
Total investments of four DFIs and IFC between March and October 2020 (US\$ million)



Source: Eurodad calculations

Figure 2
Financial instruments used by DFIs and IFC



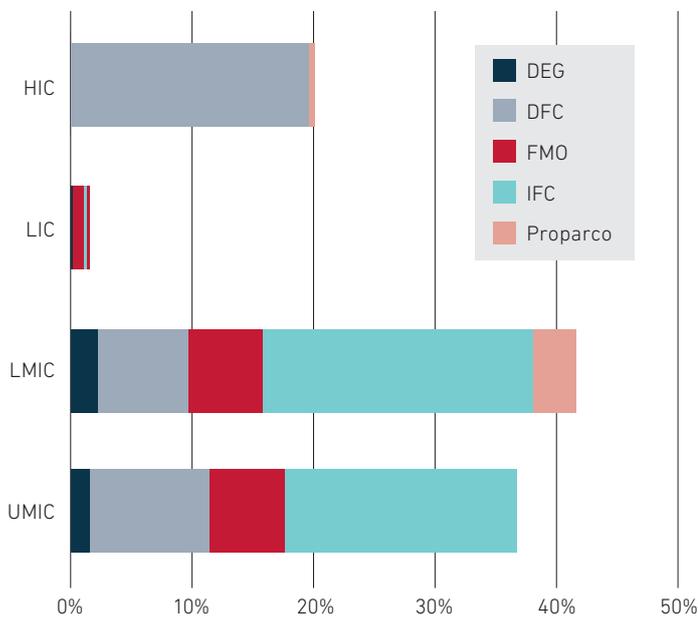
Source: Eurodad calculations

Beneficiaries of investments

DFIs are often criticised for concentrating investment in developed and more mature markets, while additionality and potential development returns are expected to be much higher in low-income economies. Our analysis of the DFI response to the Covid-19 pandemic paints a similar picture. Taking into account that over 30 per cent of investments in our sample has a regional or global scope, over 75 per cent of investments with a national scope is directed to middle-income countries. A substantial part also services high-income economies, mainly as a consequence of an executive order expanding the US Development Finance Corporation's remit to funding projects related to the domestic US response to Covid-19. Only two per cent of total investment with a national scope is in low-income countries.

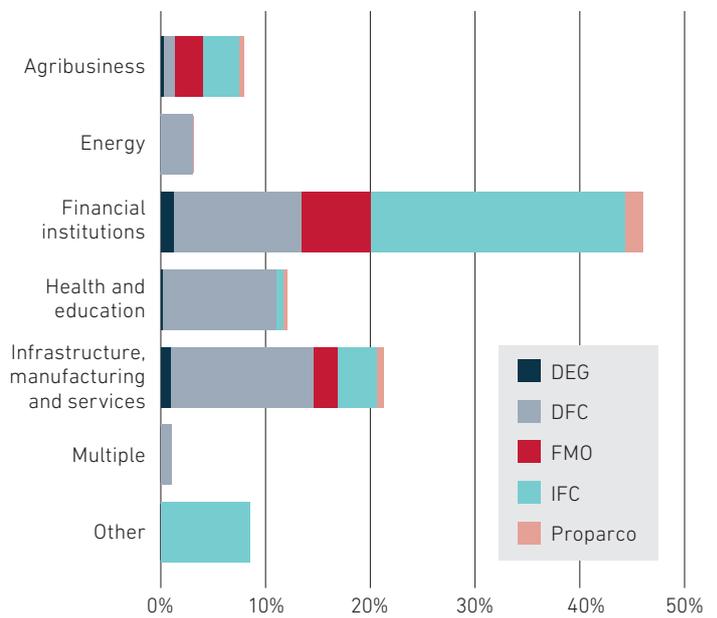
In a similar vein, DFI investments concentrate in a limited number of sectors that are likely to be commercially viable, such as financial services and infrastructure. The rationale for the dominant focus on financial sectors is the need to address access to finance for Micro-, Small and Medium-sized Enterprises (MSMEs) to which the financial sector will on-lend. Our data shows that this heavy concentration on the financial sector remains unchanged in response to Covid-19, with over 65 per cent of investments in our sample target financial institutions and infrastructure. Interestingly, health and education amount to 12 per cent of total investments. Earlier research by the Overseas Development Institute based on commitments of eight DFIs between 2012 and 2018 found less than three per cent of total investment targets the health sector directly.¹²

Figure 3
DFI investments by country income status



Source: Eurodad calculations (excluding investments with regional/global scope)

Figure 4
DFIs by sector



Source: Eurodad calculations

Although the mission and objective of DFIs is to finance poverty-reducing projects in developing countries' local private sector for which private capital is not available on reasonable terms, evidence shows some DFIs serve donor interest.¹³ In the case of the IFC, as of end June 2020 around 50 per cent of IFC Covid-19 supported companies were either majority owned by multinational companies or were themselves international conglomerates.¹⁴ The five largest investments made by DFC between March and October 2020 include two investees based in the US (the Kodak Company and the Nevada-based Trans Pacific Network) and one in the UK (Prodigy Finance, a specialised fintech platform providing student loans). The German DFI DEG has a specific programme – AfricaConnect – to provide support to European companies that operate in Africa and offers crisis financing as part of its response to Covid-19.

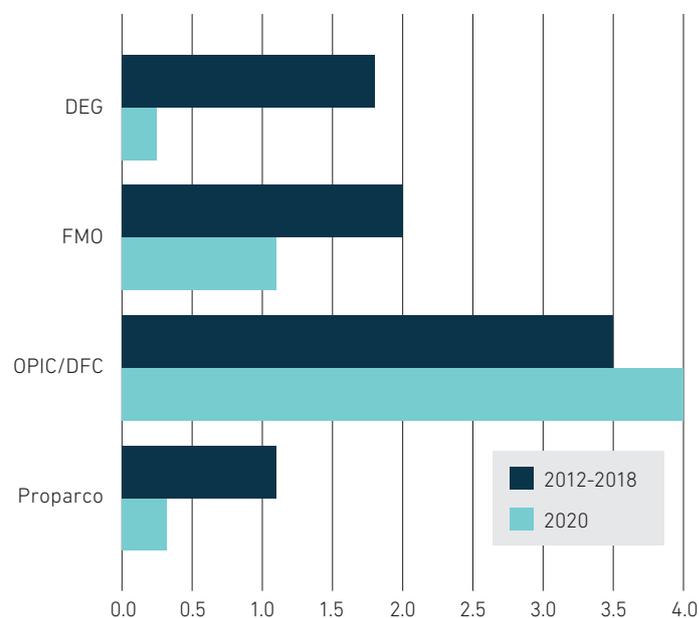
This analysis raises questions about whether the countries, sectors and clients most in need are actually being reached by selected DFIs. The strong reliance of DFIs on the financial sector risks making them ineffective. Recent research by the World Bank shows that the MSME's that are hit hardest by the crisis need grant-based finance rather than loans to make it through the pandemic. The analysis demonstrates that the majority of MSMEs are not turning to banks for support.¹⁵ This indicates that DFI responses are off target and add to existing inequalities in terms of access to finance for MSMEs. Furthermore, the strong focus on financial intermediaries comes with particular challenges with regards to transparency and accountability.¹⁶

An additional reason for concern is the increased focus of DFIs in the health sector. Although the private sector can play a role in the provision of healthcare, DFIs need to be extremely cautious in stepping into the healthcare sector as this may contribute to further privatisation or commercialisation of public health services, create financial barriers to those in need of such services and unintentionally obstruct necessary efforts to reduce inequalities in healthcare access.¹⁷

What about additionality?

DFIs explain their development rationale primarily based on 'financial additionality'. This means that DFIs need to support investment that would not have happened if the market would have its way. Prior to the Covid-19 crisis, DFIs struggled to demonstrate their financial additionality.¹⁸ In their response to the 2007-2008 financial crisis, DFI additionality was also limited.¹⁹ Our analysis suggests the questionable financial additionality in the current responses to the Covid-19 crisis, given the strong concentration in mature markets. In addition, the argument that DFIs are counter-cyclical in times of crisis is not convincing. With the exception of the US DFC, expected total commitments of the selected bilateral DFIs in 2020 are far below the 2012-2018 average (see Figure 5). The fact that only ten per cent of investments for which this was possible to trace involved new new clients, casts further doubt on the additionality of DFI operations in response to the crisis.

Figure 5
Are DFIs counter-cyclical?



Source: Eurodad calculations²⁰

Conclusion: The need to rethink DFIs

As the international community is called to face an unprecedented health, humanitarian and economic crisis, DFIs have the responsibility not only to respond adequately, but also to rethink the way in which they operate and how they can best support the design of a more just and sustainable economic system. Covid-19 will result in an increase of global poverty for the first time in over two decades. As development actors, DFIs have a mandate to fight poverty and contribute to an economy that is sustainable and equitable. Based on this analysis of the response of DFIs to the pandemic, we have found little evidence that DFIs are up for this task, both in terms of the size as in terms of the way in which support is being allocated.

There is little doubt that DFIs can play a role in some areas, including provision of capital to innovative sectors that support the much-needed transition to low-carbon economies or capital to constrained MSMEs. However, the DFI business model seems unsuited to responding to crisis as they are not ready to take risk in their operations and tend to focus on 'low-hanging fruit'. To take up a role as development actor, an urgent rethinking of DFIs is needed based on a more realistic understanding of their role and a transformation of their business model.

In the coming days and weeks, policy makers will have an opportunity to embark on an ambitious effort to rethink the role and place of DFIs in the development finance landscape. We provide key recommendations to feed into these discussions:

► DFI's need to be reoriented to support a different private sector

DFIs need to go beyond a narrow focus on economic growth and prioritise investments that promote the transition to a sustainable and inclusive economy in developing countries. This requires a focus on development returns instead of financial returns and adapting business models to allow for more risk-taking. Donor government's funding decisions should be based on an assessment of development results while avoiding the reduction of investment in other modalities such as budget support or grant-based finance for social infrastructure with demonstrated development impacts.

► DFI's need to go beyond 'do no harm' and be transformative

DFIs need to take responsibility for the social and environmental outcomes of all their activities, including human rights, labour rights, climate and gender impacts. Their policies and operations should be aligned with the Paris Agreement and actively contribute to the fight against climate change. DFIs need to ensure that the companies they work with, as clients or partners, do not avoid or evade taxes. DFIs should promote gender equality and women's rights, where possible, and make sure investments are gender inclusive. DFIs should also refrain from investments that may further contribute to the privatisation and commercialisation of public services such as health and education.

► DFI's need to improve governance and accountability

DFIs need to urgently fix the many gaps that have been identified by civil society organisations and other stakeholders in terms of human rights obligations, stakeholder engagement and accountability. This needs to go beyond the clients of DFIs and include affected communities. DFIs need to have the internal capacity to assess and systematically show the impacts of their policies and investment decisions and have effective human rights, environmental, gender-sensitive and fiscal due diligence procedures, accompanied by supervision and monitoring mechanisms.

Annex: Methodological note

The findings presented in this briefing are based on an analysis of the response of four major bilateral DFIs (FMO in The Netherlands, DEG in Germany, Proparco in France and the US Development Finance Corporation) and the World Bank Group's International Finance Corporation (IFC). The four bilateral institutions represent approximately 60 per cent of the total portfolio of European Development Finance Institutions (EDFI) in 2015. Including the UK CDC, this would amount to 76 per cent. Unfortunately, detailed information about CDC's 2020 investment projects is not publicly available.

DFC is the single largest bilateral DFI in the world and IFC is the largest multilateral DFI. For each of the five DFIs in this report we assembled a dataset of investment projects signed between March and October 2020 using publicly available data. In the event that detailed information on financing instruments or sectors was lacking, we screened project descriptions to identify sector and instrument whenever possible. In these cases, there is some room for error or subjective interpretation. Given the nature of available data sources, the presented data may underestimate real values of DFI responses.

DFI	Data	Source
FMO	92 projects included in the FMO Worldmap	https://www.fmo.nl/worldmap
DFC	31 projects covered in press releases by DFC	https://www.dfc.gov/media/press-releases
DEG	11 projects covered in DEG's Newsroom	https://www.deginvest.de/International-financing/DEG/Presse/
Proparco	14 projects featuring on Proparco's interactive map	https://www.proparco.fr/en/page-thematique-axe/investment-funds
IFC	50 projects featured on IFC's website under 'Covid-19 response projects'	https://www.ifc.org/wps/wcm/connect/e8a18446-a180-468f-a86d-1da3ddd5ee99/20200929-IFC-Covid-19-Response-Projects.pdf?MOD=AJPERES&CVID=njr15Ap

Endnotes

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