Development Finance Institutions: Profitability Promoting Development*

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- Development Finance still plays a critical role in financing private enterprise in Africa and should be further promoted as an important complement to overseas aid.
- Development finance institutions are cost-effective for donor countries and efficiency-enhancing for countries where deployed.
- DFI partnerships with private investors in project finance are a rich potential source of development externalities.

What are DFIs?

Development finance institutions (DFIs) occupy an intermediary space between public aid and private investment, 'facilitating international capital flows' in the words of the Chief Executive of CDC, Britain's DFI (formerly the Commonwealth Development Corporation). Distinct from aid agencies through their focus on profitable investment and operations according to market rules, DFIs share a common focus on fostering economic growth and sustainable development. Their mission lies in servicing the investment shortfalls of developing countries and bridging the gap between commercial investment and state development aid.

DFIs provide a broad range of financial services in developing countries, such as loans or guarantees to investors and entrepreneurs, equity participation in firms or investment funds and financing for public infrastructure projects. DFIs will initiate or develop projects in industrial fields or in countries where commercial banks are reticent about investing without some form of official collateral. DFIs are also active in financing small and medium-size enterprises, supporting micro loans to companies, often viewed as too risky by private sources of financing. A benefit of this approach is that DFIs often find themselves with first-mover advantage in markets with strong growth potential. A case in point is the famous African experience of Celtel telecommunications company, where DFIs invested early as part of their developmental charter and later found themselves ending with enormous profits.

DFIs depend on profits from their investments to ensure resources for further engagements. Currently, this model is proving successful, with institutions such as CDC or the European Bank for Reconstruction and Development (EBRD) outperforming emerging market indices (see Box 1 below).

Box 1: DFIs are outperforming

- *Britain's CDC showed a return of 33% in 2007 outperforming the global Emerging Markets Bond Index (EMBI) by 20%*
- *The consolidated portfolio of European DFIs at year end 2006 reached €12.3 billion, up from €10.6 billion in 2005.*

Bilateral development finance institutions are majority-owned by national governments and have historically served to implement government foreign development and co-operation policies. Multilateral DFIs, also known as international finance institutions (IFIs), usually have greater financing capacity and provide a forum for close co-operation between governments.

Both types of institutions retain operational independence from their funding governments. Backed by government funds and guarantees ensuring their credit-worthiness, DFIs can raise large amounts of funds on international capital markets to provide loans or equity investment on competitive, even subsidised, terms.

Risk & Investment Practices

Through their developmental mission and public funding, DFIs have, by definition, a higher risk tolerance and a longer investment horizon. DFIs can call upon the guarantees of the state and are free from the short-term constraints of private investors. Thus, DFIs have the capacity to make long-term investments at attractive rates in markets to which the private sector find too risky to commit. Furthermore, DFIs pay no corporate tax or dividends[1].

Bilateral DFIs tend to make partnerships with the private sector in developing countries, while the regional development banks (see Table 1) generally focus primarily on loans to the public sector (e.g. via sovereign loans for commercially –run public enterprises). The Asian Development Bank also has major exposure to equity investments in the private sector. The EBRD provides direct investment on commercial terms to public and private sector projects, such as backing infrastructure plans, but also large commercial ventures in its region of specialisation (Eastern Europe through to Central Asia).

Table 1: Development Finance Institutions

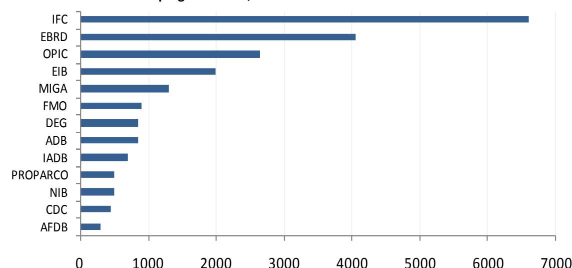
Bilateral	Regional
CDC - Britain	**ADB** – Asian Development Bank
PROPARCO – France	**IADB** – Inter-American Devleopment Bank
FMO – Netherlands	**AfDB** – African Development Bank
DEG – Germany	**EIB** – European Investment Bank
OPIC – United States	**EBRD** – European Bank for Reconstruction and Development

Multilaterals
IFC – International Finance Corporation
MIGA – Multilateral Investment Guarantee Agency (World Bank)

The financial support DFIs bring to relatively high-risk projects is intended to serve as a catalyst, helping to attract and mobilise the involvement of other sources of private capital. In addition, development banks often act in co-operation with governments and other organisations in providing funds for management consultancy and technical assistance and serving as channels for policy implementation in areas such as governance, compliance with environmental regulations, good business practices and sustainability.

DFIs' involvement can serve to mitigate risk, serving as a public guarantee in countries and sectors where private sector actors would be unwilling to operate alone. Their public status allows DFIs to make longer maturity loans at good interest rates, advantageous guarantees and undertake high-risk equity investment. DFIs may also help lower the cost of capital for firms through partial credit risk guarantees.

Figure 1. DFI commitments to the private sector, 2005
to developing countries, USD million



Source: Based on Overseas Development Institute, 2007

The IFC and EBRD are by far the biggest DFIs in terms of annual commitments to the private sector (see figure 1). Some concentrate primarily on loans (EIB, Proparco) others primarily on equity (CDC). The equity portion within the total portfolio of European DFIs reached 52 per cent in 2006, up from 41 per cent in 2005[2], a significant shift away from loan finance towards equity stakeholding. AfDB and ADB and IADB lend principally to sovereign states.

DFIs for Africa

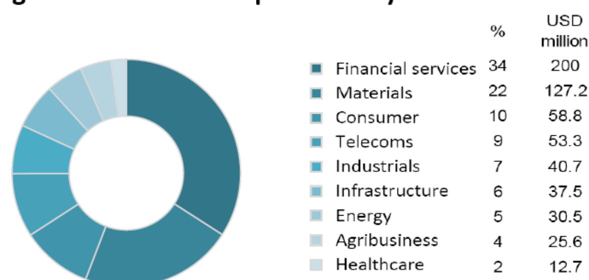
Although Africa remains marginal in the portfolios of some large DFIs (such as the IFC), it is rapidly growing in importance as an investment destination. Britain's CDC in 2007 held half of its total portfolio in African investments. Furthermore, CDC's investments were across a broad range of sectors and industries, underlining the

[1] Only dividend paid out was FMO and Proparco because these are part-owned by private banks. In EBRD, a dividend was discussed, but rejected in favour of a grant fund. Source ODI, interviews with EBRD officials.

[2] Source: European Development Finance Institutions, 2008.

important difference from traditional foreign direct investment which is overwhelmingly directed towards extractive industries such as oil and minerals (see Figure 2).

Figure 2: CDC African portfolio by sector 2007



Issues for DFIs

DFIs must tread carefully to avoid risking crowding out private investors through their subsidised pricing structure. Many DFIs (IFC, EBRD) are explicitely required not to compete or bid against private sector firms and banks and play a delicate balancing act providing finance just beyond the frontiers of private sector involvement. Others, such as Britain's CDC choose to invest through intermediaries, thus mitigating the risks of direct involvement (and economizing on in-house capacity).

The double bottom line pursued by DFIs expresses the contradiction of pursuing both profit and development. On the one hand, DFIs must invest shrewdly and generate returns; on the other they must facilitate the economic development of the countries they invest in. Balancing social and financial returns can be a complex, time-consuming and sometimes contradictory affair for DFIs, especially in light of difficulties in measuring projects' social impact.

DFIs are active in promoting best practices in business and environmental issues. Although it has been argued that strict social and environmental sustainability policies are a constraint on DFIs' flexibility and capacity to close deals, anecdotal evidence indicates no adverse impact on returns to date.

Investor enthusiasm for emerging and frontier markets have helped DFIs in their mission to promote investment in developing countries. Return-hungry private investors have even edged out DFIs in a number of markets (EBRD out of Eastern Europe most notably). This is a sign of success. Experience is building up throughout many developing and frontier markets, and impressive track records are emerging, as many markets become mainstream and better information reduces private investors' fear of committing.

It remains to be seen what position DFIs will adopt in the face of important market shifts such as growing domestic capital sources in the developing world. DFIs will have to adapt to the gradual mainstreaming of many hitherto off limit markets and the very strong commitments of certain emerging countries in developing world infrastructures (China's involvement in African infrastructure, for example). Already much microfinance activity is undertaken by for-profit firms, and small-cap venture capital markets are often covered by high net-worth individuals based in the country (such as Nigeria[3]).

The best way forward for DFIs may be to continue in their catalytic role through tighter collaborations with private sector investors and stakeholders, to share financial risk while maintaining their strong commitment to promoting best practice in their invested funds and projects.

DFIs should not lose sight of their responsibility to expand access to financing through consistently searching out under-invested countries and sectors, while working to maximise the social outcomes of their projects. It is a difficult and sometimes contradictory mission, but one which has proved remarkably successful.

[3] Cf: According to Helios capital, a London-based private equity firm, only mid-size venture capital investment is profitable in Nigeria, as the market for small venture investments (>USD 5 million) is already covered by high net-worth Nigerians.

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