Rethinking Development Finance: Maximising Capital Strategies to Drive Development

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The United Nations asserts that Africa requires an additional USD194 billion in annual investment to attain the Sustainable Development Goals (SDGs) by 2030, representing approximately 7% of its GDP and 34% of its 2021 investments.

Development Finance Institutions (DFIs) have an important role to play in closing this gap – both directly and by mobilising private sector investment. DFIs have of course long played a critical role in Africa's growth and development, injecting trillions across diverse sectors. Given their unique mandates, they operate in territories where private capital hesitates to venture, often serving as indispensable bridges in jurisdictions where high-risk perception curtails private investment. Moreover, DFIs have also evolved into agents of change, driving policy reform via numerous tools – from deploying early-stage development capital to capacity building and more traditional development financing.

And yet, the question remains: Can DFIs make better use of their capital? Earlier this year, DLA Piper partnered with Invest Africa to convene DFIs and other investors, corporates, and policy makers to explore how DFIs should refine their approaches to invest and mobilise more capital to the continent, maximise impact, and better serve as a catalyst for growth and development in Africa.

The Origins of Contemporary Development Finance:

Contemporary development finance traces its origins to the aftermath of World War II, marked by concerted efforts to provide temporary financial and technical aid to war-ravaged Europe. The UK Government's DFI – British International Investment – was among the first of the bilateral DFIs to be established, with a clear mandate from the outset to "do good without losing money." Today, the landscape boasts approximately 30 major international DFIs globally, encompassing both bilateral entities like BII and multilateral institutions such as the World Bank and the European Bank for Reconstruction and Development, with the total portfolio of the DFI sector hovering around USD85 billion by the end of 2021. The US International Development Finance Corporation is the largest bilateral DFI, wielding a lending cap of USD60 billion and a comprehensive suite of financial instruments to support investees – from direct loans and loan guarantees to political risk insurance, equity investment, and feasibility studies and technical assistance. The World Bank is the largest multilateral DFI.

Bilateral and multilateral DFIs occupy a critical intermediary role bridging public aid and private investment. While conventional investors typically pursue profit maximisation and target economically viable ventures, most DFIs navigate the delicate balance between generating impact and ensuring financial returns, with an explicit mandate to support sustainable development and poverty reduction. They aim to fill investment gaps perceived as too risky or unprofitable by private investors by leveraging their capital, expertise, and instruments to structure investments. Simultaneously, DFIs utilise public funds to mitigate risk and enhance returns, helping to make projects more appealing and commercially viable and crowd in private investors.

The advent of the Sustainable Development Goals (SDGs) has catalysed a transformative shift in development discourse. These goals not only advocate for an integrated approach to economic, social, and environmental progress, but also underscore the complementary roles of the public and private sectors in fostering inclusive and sustainable growth. Sitting at the midpoint of the public and private sectors, DFIs have an important role to play here, and there is growing evidence of their contributions towards the SDGs – in gender (SDG 5), energy (SDG 7), economic growth (SDG 8), and climate change (SDG 13). However, as we sit around the halfway point to the 2030 target, the investment chasm confronting developing countries to achieve the SDGs has widened – jumping from around USD2.5 trillion when the goals were first established in 2015 to USD4 – USD4.3 trillion, as per the latest UNCTAD SDG Investment Trends Monitor. Bridging this divide necessitates robust mobilisation of private investment, with DFIs uniquely positioned to assume a pivotal role in this endeavour.

Key Takeaways from the Discussion:

In April 2024, DLA Piper brought together DFIs, investors, corporations, and policymakers to discuss strategies for enhancing DFI investments in Africa, maximising impact, and more effectively catalysing growth and development on the continent. The following summary highlights key questions raised and insights shared during the discussion.

- **Are DFIs veering off course from their development mandate?** As the name suggests, DFIs are tasked with achieving meaningful development impact, while also navigating credit risk and client relevance. DFIs also strive to achieve additionality, ensuring that DFI finance supplements rather than displaces private sector investment. However, many participants argued that DFIs remain overly cautious, fixated on pristine AAA credit ratings, which often leads them to manage their capital in overly risk-averse ways and refrain from investing in potentially impactful initiatives "until they work" and demonstrate guaranteed success. They argued that DFIs with lower credit ratings, despite higher portfolio risks, can yield comparable or superior returns compared to their more risk-averse counterparts and pushed for a shift towards greater risk tolerance – stressing the need for DFIs to align more closely with their development mandates.
- **Do DFIs need to step outside their comfort zones?** Participants also discussed and debated the inherent tensions between shareholders' demands and the complex 'investment trilemma' confronting DFIs. The challenge lies in reconciling the need to mobilise significant capital from private investors with the imperative of fostering greater development impact, which may also involve the acceptance of higher risk to financial return and risk DFI profitability. Similarly, to champion the clean energy transition and bolster development impact, participants questioned if DFIs need to use a more 'venture-like' approach – directing resources towards the advancement of low-carbon technologies and products. However, this path course necessitates a willingness to accept greater financial risk, further challenging DFI profitability. Given the challenging environment in which DFIs are operating, participants felt that it is difficult to envision how DFIs can live up to their development mandates without being more bullish about what, where, and how they invest, with increased allocations to the real economy, support for investment opportunities, high-risk ventures, innovative products, and collaboration aimed at mobilising more capital where it is needed most.
- **How can DFIs mobilise more capital?** Mobilising more capital into emerging markets is a vital to help achieve the SDGs. DFIs occupy a unique position to drive this process, acting as anchor investors in businesses or funds situated in nascent markets or fragile states. However, recent findings from an OECD report reveal a stark reality: bilateral and multilateral DFIs are currently mobilising a mere USD50 billion annually, a fraction of the financing gap required to achieve the goals. In light of this, participants debated strategies DFIs should consider to elevate the quality and scale of mobilisation, including:

- **Introducing leverage to the DFI's balance sheet:** Leveraging shareholder equity can amplify the pool of funds available for investment in developing countries. Moreover, this approach has the potential to stimulate the development of capital markets directly. For instance, leveraging new debt issuance as local currency bonds or development-themed bonds can enhance capital availability and promote investment in crucial sectors.
- **Transitioning from a 'buy-to-hold' model to an 'originate-to-share' model:** In this case, DFIs bolster their capacity to originate and manage impactful investments in emerging markets. Concurrently, they share a portion of the economic interest in these investments with other investors. This collaborative approach enables DFIs to distribute exposure to single assets, existing asset pools, or future blind asset pools aligned with agreed investment strategies.

- **Should DFIs invest in Africa's natural resources?** Currently, many DFIs are reassessing their investment strategies to align with three overarching objectives: achieving universal energy access, fostering widespread job creation, and mitigating global carbon emissions. Africa is a focal point here, being the most energy-deficient continent globally, with 75% of its population lacking access to electricity. In the case of most DFIs, participants stressed a disconnect between their financing mandates and pressing global needs in energy and mineral security. From oil and gas to metals and minerals, DFI investment could have a transformative effect – catalysing high-impact projects that would otherwise not proceed. Most DFIs, however, face stringent constraints on investing in fossil fuels and mining resources due to existing mandates or parameters. The African Union's Energy Transition Program advocates for a unified vision of energy development, prioritising access to affordable and clean energy while emphasising the significance of natural gas as a transitional fuel. Participants stressed the necessity for DFIs to expand financing for gas projects across Africa, alongside other energy and mining ventures, while maintaining a clear exit strategy aligned with evolving sustainability goals.
- **Are DFIs overanalysing and getting slower?** When assessing how DFIs should maximise development impact, participants felt credit risk was one key constraint. Like any lending institution, DFIs inevitably face some level of credit risk. Given their investor status, DFIs typically anticipate returns on their capital, commonly in the form of interest on loans or equity investments. However, the question arises: are DFIs excessively cautious? Some participants argued that DFIs think too much in terms of project financing – prioritising yield over development impact. This tendency, they contended, stems partly from shareholder obligations, which often impose unrealistic or conflicting objectives on DFIs, driven more by political agendas than the needs of the countries they aim to support.

As the deadline for the SDGs draws near, DFIs stand out as crucial players, uniquely positioned to harness their resources and rally additional capital to address urgent sustainable development challenges. DLA Piper would like to thank all participants for their invaluable insights and contributions and looks forward to working with DFIs and other investors, corporates, and policy makers to bridge the SDG financing gap and tackle pressing sustainable development priorities in Africa and beyond.

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