

# Literature review on development returns to DFI investments in private sector enterprises

*Department for International Development*

**DRAFT REPORT**

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**Executive Summary**

[To be finalised after comments are received]

## Introduction

The Department for International Development (DFID) is currently undertaking a review of the Commonwealth Development Corporation (CDC) aimed at radically increasing its development impact. To inform this process, DFID is commissioning four studies. This report provides the findings of one of those studies.

Nathan EME Ltd was contracted by DFID to prepare a literature review on how the development finance institutions (DFIs) and Multilateral Development Banks (MDBs)<sup>1</sup> define and measure the development impact of their investments in private sector enterprises, especially in poor and fragile countries; and the development outcomes that they have been able to generate for the poor through investing in particular sectors or by the use of different asset classes. In order to serve this purpose, the terms of reference (TOR) required this study to provide answers to a set of questions that would help DFID to take an informed position on what CDC needs to do in order to maximise its impact on economic development and poverty reduction and how its development returns and outcomes need to be measured and reported against. Therefore, we have structured this report along the questions included in the original TORs.

The research process and report writing were undertaken between 29 November 2010 and 21 December 2010. The short calendar time available for the review and the approaching year-end with generally heavy work-loads in the DFIs and MDBs allowed for only limited direct consultations with these institutions. The review therefore has relied on mapping the approaches and practices of the institutions mainly based on the reports available in the public domain. We reviewed all the information and reports available on the MDBs and DFIs websites, the Evaluation Cooperation Group and the European Development Finance Institutions websites as well as the literature on the role of the financial sector in promoting development impacts, including socially responsible investments. In addition, we reviewed the academic literature on the private sector operations of DFIs and MDBs, the process of technology transfer to developing countries and the role played by FDI and the processes of financial sector development and its impact on business and poverty reduction.

While DFID has set up CDC with the purpose of contributing to economic development and poverty reduction in poor countries, it should be noted that there is a clear distinction between the role played by the development agencies and the role played by the DFIs and the private sector operations of the MDBs. The institutions covered by this study are primarily financial intermediaries that invest in private enterprises. As financial intermediaries, they are expected to earn a reasonable financial return from their investment and ensure that they remain financially viable. Therefore, they are different from the public sector operations of development agencies. DFIs and the private sector operations of MDBs are complementary to the mainstream development cooperation programs and therefore, should have realistic strategic goals for their contribution to development finance. Investment in the private sector can be seen as a third pillar in international development policy, standing alongside:

- Aid – donations provided to public and civil society partners through bilateral and multilateral channels
- Development bank public sector lending and guarantees

All three of these pillars are valid and important components of international development policy. They represent very different and highly complementary approaches to fighting poverty. All three recognize

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<sup>1</sup>The DFIs and MDBs reviewed included: DEG (Germany), Proparco (France), FMO (Netherlands), Swedfund (Sweden), SIMEST (Italy), COFIDES (Spain), Grassroots Business Fund, European Investment Bank, European Bank for Reconstruction and Development, International Finance Corporation, Industrial Development Corporation of South Africa, Development Bank of Kenya, Development Bank of Zambia, African Development Bank, the Inter-American Development Bank and the Asian Development Bank.

the role of private sector growth in ensuring sustainable development. However, DFIs are the channel that most directly delivers private sector finance where it is most needed in developing countries.

*Question 1: How different agencies define ‘development impact’, and how they seek to measure this? How do they measure the direct economic impact of their operations (e.g. goods and services produced, employment, income, taxes paid)? How do they measure wider economic impact of private sector investments on the regional or national economy (for example market development)?*

### 1.1. Most institutions take a similar approach to defining development impact

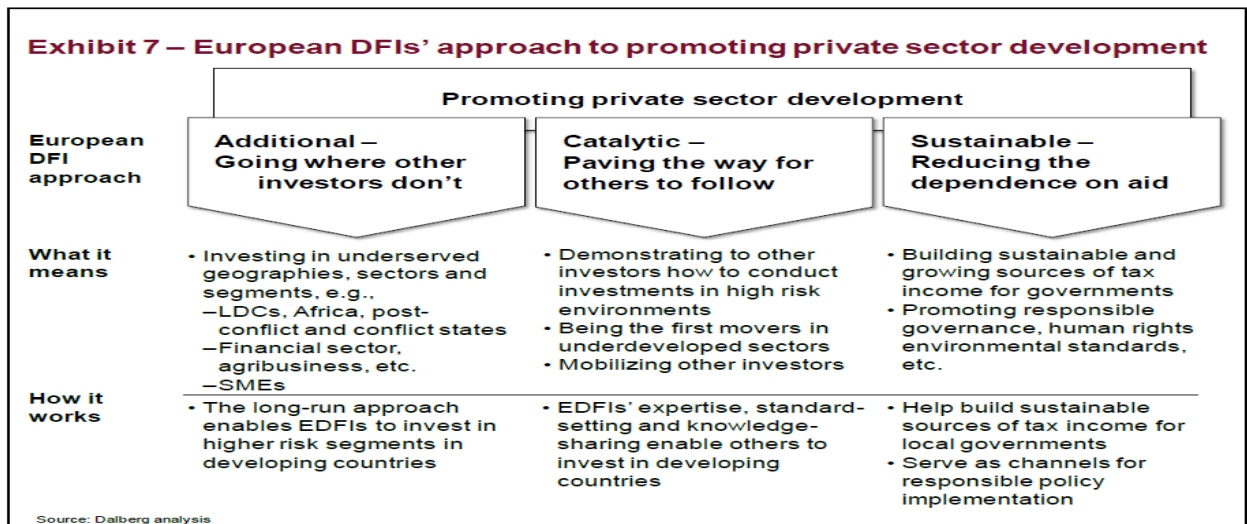
The charters or founding documents of the DFIs and the private sector operations of the MDBs set out their objectives for development impacts. In essence, all the institutions seek to use their investments to promote private enterprise with the objective of sustaining economic growth, make it more inclusive and delivering improvements in living conditions for the local population<sup>2</sup>. All of them include the creation of jobs to provide greater economic opportunity for the workforce, and some, such as the IFC, also seek to provide goods and services to meet the needs of the underserved. In addition, all are committed to investing in projects that are financially, economically, socially and environmentally sustainable.

Some institutions take on a wider development mandate in terms of improving policies or conditions for private enterprise. For Instance, DEG only takes on commitments to projects that make an effective development policy impact and the IFC seeks to promote open and competitive markets in the developing countries. Among the institutions covered, the EBRD has the clearest focus on bringing about policy and institutional change. It requires that all its investments contribute to the transition of what were formerly planned economies to a market economy and it measures their “transition impact”.

In addition, as financial intermediaries with a developmental mandate, the institutions view their role as pioneers that serve to overcome the market failures that prevent commercial investors from investing in the developing countries or in particular types of projects with potentially high developmental impact. By way of example, as shown in the figure below, the European bilateral DFIs view this pioneering role as consisting of three key elements: i) **additional**, pioneering investment in countries, regions and sectors that are considered to be too high risk by commercial investors; ii) **catalytic**, crowding in commercial investors by demonstrating the feasibility of such investment and iii) **sustainable**, providing the means for national governments to invest in development and set appropriate policies, thereby providing an exits strategy for aid.

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<sup>2</sup>This is stated on the DFIs and MDBs websites.



It is their role of crowding in other investors that the institutions co-invest with each other, with commercial investors in the developed world and with commercial investors in the developing countries. CDC has been particularly notable in its role of crowding-in commercial investors from the developed world.

The IFC provides a good example of how the institutions seek to combine all these wider developmental impacts. The IFC defines its purpose as creating opportunity for people to escape poverty and improve their lives by:

- i) Promoting open and competitive markets in developing countries;
- ii) Supporting companies and other private sector partners where there is a gap;
- iii) Helping generate productive jobs and deliver essential services to the underserved;
- iv) Catalysing and mobilizing other sources of finance for private enterprise development.

### 1.2. Similar constraints but varying approaches to measurement

All the institutions suffer from two common challenges to measurement: i) the time and cost involved in rigorous measurement, especially beyond the project impacts; ii) the problem of comparability of costs and benefits between sectors, especially with respect to wider development impacts. In general, the institutions have adopted a pragmatic approach attempting to ensure financial, economic, environmental and social impacts are captured at the project level. The size and capacities of the institutions themselves and their opportunity to collaborate work with others on measuring development impacts tend to influence their approaches and methods more than any sharp differences in underlying approach.

Basically, the institutions have adopted one of two main lines of approach to measurement:

- *The sustainable development approach.* This is the most common approach among the MDBs. It seeks to assess ex-ante, monitor and evaluate (ex-post) the impact of their private sector operations in terms of contribution to sustainable development. For example, IFC’s Development Outcomes Tracking System (DOTS) for monitoring as well as the IFC-influenced Evaluation Cooperation Group (ECG) standards for independent evaluation, address outcome and impact across four main pillars: i) financial; ii) economic; iii) environmental and social; and iv) private sector development impact. “Additionality” of the institution and its own investment returns are subsidiary elements. The focus is on capturing data for projects based on the sector of

- *The contribution to development approach with standard scoring and weights.* Among the group of European Development Finance Institutions (EDFI), a common approach is to follow DEG's Corporate Policy Project Rating (GPR) system that scores development outcomes and impacts. This is done *ex-ante*, during regular monitoring, and *ex-post*. GPR captures and scores profitability and return on equity, development impacts and the strategic role of the DFI. GPR employs numerical scores based on standard indicators, including some that are specific to sectors. It also uses standard weights to arrive at an overall GPR score. The approach gives prominence to "hard" indicators, such as taxes paid, net foreign exchange effects and employment as they stand as proxies for wider development impact. It also uses qualitative indicators for assessing benefits to communities and, like the ECG approach, checks for compliance against standards set by the institution in terms of environmental and social sustainability and governance (ESG).

The two approaches share many common features. They differ mainly with respect to how the wider development impact is treated. The ECG approach addresses wider, beyond the project impact or "externalities" mainly by use of sector-based "proxy" indicators. These sector based indicators are quantified but the ratings arrived at from them are, by and large, subjective. This does, however, enable those undertaking the assessment to score on the basis of the local context.

The GPR approach is more objective in setting out hard indicators that must be used to score the project. Its key strength is that it enables a single project score to be arrived at across differing types of projects and sectors. But that does beg the question whether the hard indicators are appropriate to the context. For example, in a country where government investment in pro-poor social services is revenue constrained, the payment of taxes may be of crucial importance for development but of minor importance in a country where government is running a fiscal surplus already.

To some extent, because of greater demand from their shareholders for reporting on results, the ECG approach may be coming closer to the GPR. For example, more ECG members are now including in their published annual reports a range of standard indicators arrived at by aggregating project level outputs and outcomes, such as numbers of SME loans provided, patients treated, households connected to electricity etc. And there is evidence of some the European DFIs combining both approaches. One example is FMO that has developed a scorecard which also assesses FMO's role as a DFI, monitors ESG performance, measures a range of hard sector outreach indicators and includes employment and taxes paid as quantitative indicators of wider development impact. This is not unlike CDC's approach.

Additional notes on institutions subscribing to each of the two main approaches are presented in Appendix 1.

### **1.3 Focus on direct impacts, but the focus on outputs rather than outcomes and impacts**

The institutions tend to focus on direct impacts such as employment, goods and services produced, foreign exchange generation and taxes paid. In the interests of being able to capture data cost effectively, the emphasis is on monitoring outputs that can be easily captured by the project or

companies in which the institution is investing: employment, taxes paid, foreign exchange generation, power generated and households supplied are examples.

There is evidence of eschewing the capturing of quantified outcome indicators such as income effects (producer surplus) or benefits to consumers (consumer surplus) because they require more extensive evaluation. For example, IFC measures the numbers of farmers served but not the increase in incomes of farmers. DEG's indicators for infrastructure tracks the effect on tariffs but not the effect tariff reduction has on the consumption patterns of households served.

Neither the ECG nor the GPR assess whether the beneficiaries of their investments are poor and what impact the projects have on their ability to escape poverty though they both assess social performance in terms of qualitative impacts on local communities and on gender empowerment.

#### **1.4. Limited evidence of impacts on regional or national economies.**

Because of the cost of measurement, there is little evidence of empirical research to quantify impact on regional or national economies. Instead, the GPR approach attempts to measure impacts on the national economy, not only quantitative indicators such as effects on government revenue, value added and foreign exchange, but also qualitative contributions such as training, transfer of technology and know-how and effects on markets and structures.

The key concern this raises is that there is often no baseline against which to measure the contribution of the investment and no attempt to measure the counterfactual in terms of what would have happened without the project or has happened as a result of other projects in that country. In ECG evaluations, there is an attempt made to compare with and without project cases, but the extent to which this is applied to beyond the project impacts is not certain<sup>3</sup>. In the GPR method, the only comparative assessment of the investment is with other projects in the portfolio and these may well be similar in approach. So it is not easy for the institutions to assess which represent the best value for money.

Both the GPR and the ECG approach also attempt to develop indicators for investment by sector. The GPR approach, for instance, differentiates between investment in productive enterprises, infrastructure, the financial sector and private equity funds. For all its attempt at quantification, the GPR approach does not track numerical indicators of outputs. Instead it focuses on subjective assessments of outcomes.

The IFC provides guidance on measuring the financial, economic, social and community and private sector impacts of 22 industries and it is the basis of the ECG approach. This guidance includes quantified outputs of indicators but, once again, the assessment of outcomes is subjective.

Attempts at more rigorous analysis, such as developing control groups for beneficiaries of micro finance, have also led to methodological challenges that have dissuaded the institutions from undertaking them regularly. The usual practice therefore is to resort to case studies and subjective proxy indicators of outcomes and impacts. In some instances, the proxy indicators are relatively easy to assess. For example, where a project is large in scale, addresses a major national priority or introduces a new technology, system of charging or business model that has now been adopted widely, it is relatively straight forward to give the project a high score in terms of contribution to the national economy. Unfortunately, the average project does not have such easily rated proxy indicators of national or sector impact.

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<sup>3</sup> Development impacts are evaluated on a "with versus without project" comparison, i.e. considering (i) what happened with the project and, (ii) counterfactually, what would have happened without it. The system distinguishes, to the extent possible, the project from the company's performance. Considering the four types of performance indicators, the operation's overall impact on the development is rated on a six-point scale: Highly successful; Successful; Mostly successful; Mostly unsuccessful; Unsuccessful; Highly unsuccessful.



The measurement of regional impact is weaker still. The attention of the institutions tends to move from impact on beneficiaries and local communities straight to the national level. Some allowance may be made for regional impacts in assessing impacts on national economies but, if that is the case, few state that as an explicit objective. Some institutions do use regional impacts as part of their assessment of wider development impacts but do not measure regional impacts.

***Question 2: What good evidence exists to indicate that certain sectors are more, or less, likely to produce strong development impact, especially for poor people?***

## **2.1. Sectors that the literature shows produce strong development impacts**

Over the past decade, the evidence that certain sectors are more or less likely to produce strong development impacts has increased dramatically. The use of data recorded across countries and time periods (panel regressions) has enabled rigorous econometric analysis of outcomes in a sector and their effect on growth. Moreover, the use of household surveys over time has enabled academics and development agencies to understand the correlation between sector outcomes and the incomes of the poor<sup>4</sup>. The way sectors contribute is by supporting faster growth and impacting directly on the income of the poor. They also have an indirect impact on the income of the poor through the growth impact. A summary of findings (both from cross-country studies and individual country studies), that considers the contribution of each sector to growth and poverty reduction is presented below:

### 2.1.1 Agriculture:

A wealth of literature recognises the role that agriculture plays in inclusive growth and given that most of the poor are in the rural areas, growth in this sector remains central to ensure high levels of poverty reduction. The agricultural sector (including both crops and livestock) can contribute significantly to economic growth (World Bank, 2005), particularly in less developed countries where it accounts for a large proportion of GDP and an even larger proportion of employment (up to 50% and 85%, respectively). The way agriculture contributes is through productivity increases. These help make the workforce more productive, by reducing the cost of food (keep wages low) and by supplying cheaper raw materials to other sectors (such as manufacturing: food and beverages). Gallup et al. (1997) showed that a 1% growth in per capita agricultural GDP translated into a 1.61 % growth in the incomes of the poor. Several studies further argue that growth in the agricultural sector contributes proportionately more to poverty reduction than growth in any other economic sectors. For example, Ligon and Sodoulet (2007) found that a 1% GDP growth originating in agriculture increased the expenditures of the three poorest deciles at least 2.5 times as growth originating in the rest of the economy. In the Sub-Saharan countries, where most agricultural growth came from export crops, the deepest cuts in poverty in the 1990s were for those growing them (cotton in Burkina Faso, coffee and cotton in Uganda, cocoa in Ghana). Earnings from agricultural activities dominate for poor households in low income countries, but as countries grow and become more urban, the importance of non-agricultural earnings rises. For example, 96 % of the poor were engaged in agriculture in Burkina Faso (2003), but only 77 % in Ghana (1999). Shifting from agriculture to non-agricultural employment was an important avenue for poorer households to benefit from growth. In Vietnam between 1993 and 1998 about 15 % of the workers exited agriculture into informal non-agricultural employment, where earnings were higher. (Pro-Poor Growth in the 1990s: Lessons and Insights from 14 countries., 2005).

Using different econometric and statistical methods, a number of country studies<sup>5</sup> have explored the link between public expenditure in different sectors and growth and poverty reduction. They concluded that,

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<sup>4</sup> The Operationalising Pro-Poor Growth (OPPG) studies of 14 countries are excellent examples of this.

<sup>5</sup> China, Cross-country, Ghana, India, Sub-Saharan Africa, Tanzania, Uganda, Vietnam, Zambia

overall, investing in agricultural research seems to yield the highest returns in terms of both growth and poverty reduction. A cursory look at the main findings revealsthat investing in agriculture, education<sup>6</sup> and infrastructure has a positive effect on poverty reduction andgrowth.

### 2.1.2 Infrastructure:

There is ample evidence in the literature that infrastructure contributes significantly to improve income distribution as it helps poorer individuals and underdeveloped areas to get connected to core economic activities and access additional productive activities (Estache, A, 2003) and reduces transaction costs (Gannon, C. and Liu, Z, 1997). (Lopez, H, 2003) uses telephone density as an infrastructure indicator and finds that infrastructure both raises growth and reduces income inequality. They find that the volume of infrastructure stocks has a significant positive effect on long-run economic growth and a positive effect on inequality (i.e. inequality declines). Cramer and Sender (2010) suggest that provision of infrastructure for agriculture, especially as it benefits medium and large farms and industrial factories could help increase the demand for female labour since many crops, agro-processing and other export industries employ relatively large numbers of women for wages<sup>7</sup>.

There is also evidence that infrastructure affects non-income aspects of poverty, contributing to improvement in health, nutrition, education, and social cohesion. Indeed, Willoughby (2004) confirms that infrastructure makes valuable contributions to all the MDGs. Brenneman and Kerf (2002) summarise recent evidence and find that a better transportation system and safer road network raises attendance to schools; and Lee et al. (1997) observe that access to clean water and sanitation reduces child mortality. (World Bank, 2009) confirms once more that infrastructure, and more specifically energy and transport, remains a major obstacle to competitiveness in Africa.

### 2.1.3 Financial sector:

Financial deepening has a positive impact on growth. There is a wealth of literature showing that financial deepening, measured as the ratio of private credit to GDP is associated to faster growth (Beck, Demirgüç-Kunt, and Levine (2004); Ayyagari, 2008). In general, the ration is lower in the poor countries of Africa and Asia than in reacher countries. Increased private sector credit enables greater private investment, a key driver to growth.

Financial sector development has a positive direct and indirect impact on poverty reduction. Given that economic growth and poverty reduction are strongly correlated (Dollar and Kraay, 2002), improvements in financial sector development can have an indirect impact on poverty reduction. Several authors also argue that financial sector development can directly contribute to poverty reduction by providing or broadening the poor's access to financial services (Fields, 2001). Honohan (2004), for example, shows a robust effect of financial depth (measured as the ratio of private credit to GDP) on headcount poverty incidence. The regression results suggest that a 10 percentage-point increase in the ratio of private credit to GDP could lead to a 2.5–3.0 percentage-point reduction in poverty incidence. Similarly, using data for 58 developing countries, Beck, Demirgüç-Kunt, and Levine (2004) show that countries with better-developed financial systems (measured as the ratio of private credit to GDP) experience faster declines in poverty by disproportionately boosting the incomes of the poor as access to credit is likely to become more broad based, although they recommend further research to identify which policies induce poverty-alleviating improvements in the financial system.

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<sup>6</sup>We did not look in more details as the education sector as part of this review, as IFC is the only MDB/DFI with a significant share on investment in this sector.

<sup>7</sup>Sender and Cramer (2010) further argue that donors have failed to develop effective policies to promote the massive investments in agribusiness and rural infrastructure required to increase the demand for female wage labour in rural Africa. In fact, they claim, the share of official development assistance (and of government public expenditures) devoted to agricultural investments in Africa has remained remarkably small. It is negligible in conflict affected areas.

Development of the financial sector has also shown to have positive effects on poverty reduction, although it is difficult to split out the direct effect of access to financial services on poverty from the indirect effect via overall economic growth, partly because of lack of data. (OECD, 2007)

#### 2.1.4 Manufacturing:

Manufacturing sector is central to providing productive urban employment and is the sector that provides the greatest potential for technological development, learning, and dynamic specialization of employment (Kaldor 1966, Aoki et al. 1997; Amsden, 2001; Dasgupta and Singh, 2006). In the early stages of development, labour-intensive manufacturing can generate substantial employment.

Manufacturing contributes to the diversification of production and exports, which lessens the dependence on volatile primary export commodities. Export volatility can lead to macroeconomic instability, balance-of-payments crises. These factors can slow the long-run growth rate, which in turn negatively affects the demand for wage labour. This matters for inclusive growth because wage labour is the main source of incomes for many vulnerable and poor workers, especially female workers. As well, macroeconomic instability often coincides with inflation, which negatively affects the real incomes of the poor

Manufacturing can produce strong development impact for the poor . (UNIDO, 2009) argues that one important sector where countries of the bottom billion have the potential to seize opportunities for industrial development is agro-industries. According to the International Labour Organization, on average, 60 per cent of workers in food and beverages in developing countries are employed in the informal economy, while employment in the formal food and beverages sector is estimated at 22 million. The non-traditional sector (horticulture, fruits and fish products), one of the most dynamic in terms of exports from developing countries, is characterized by high levels of female employment, a percentage that can range from 50 per cent to as much as 80-90 per cent. Gender stereotypes, however, tend to relegate women to the lower paid, labour-intensive segments of food and beverages preparation and/or processing. (Alfaro, 2003) concluded that FDI flows to manufacturing have a positive effect on growth but the 47 countries in the sample did not include countries in SSA and SA. (Islam.R., 2004) also found that structural transformation of employment towards manufacturing makes a positive contribution to poverty reduction.

Other literature reviewed tried to argue that investment in other sectors (e.g. tourism) can also have a wider development impact, but the evidence is less conclusive.

## **2.2. Sectoral distribution of DFIs and MDBs portfolio**

The DFIs/MDBs under review invest in the sectors mentioned above.

### **Sectoral distribution of IFC, EDFIs and EIB**

	<b>IFC (2010)</b>	<b>EDFI (2009)</b>	<b>EIB IF (2003-2006)</b>
Financial sector	55%	32% <sup>8</sup>	49%
Industry/Manufacturing	11%	29%	18%
Infrastructure	13%	26%	26%
Agribusiness	4%	7%	3%
Other	17%	6%	4%

<sup>8</sup> Half of the EDFI financial sector investments went into investments funds and one third into commercial banks. (Dalberg Global Development Advisors, 2010)

However, the distribution of their portfolio tends to be concentrated mainly on financial sector and infrastructure projects, while investments in agriculture and to a certain extent the industry/manufacturing are lower than what the above literature may suggest as being appropriate. A key reason is that primary agriculture and agri processing investments can be overly risky when considering that the DFIs and MDBs are mandated not to erode their capital and only to invest in financially and economically sound projects. Also, some bilateral DFIs and MDBs<sup>9</sup> achieved low success rates on their investments in industry and manufacturing.

As mentioned above, both the DEG-GPR model and the IFC model have developed sector-specific assessment parameters.<sup>10</sup>

The DFIs/MDBs cannot base their strategy simply on the bases of the literature that shows that one particular sector generates more development impact than others. They need to take account of:

- The actual returns that they have been earning in that sector. Some sectors (e.g. agriculture) are intrinsically more risky than others.
- The DFIs/MDBs need to develop expertise in lending to that sector<sup>11</sup>. For example, FMO has decided based on a 2008 portfolio review to focus mainly in 3 sectors: access to finance<sup>12</sup>, access to energy and access to housing as the returns on other sectors in the previous years has been inadequate. Similarly, IFC and EBRD having experienced above average risks and poor financial sustainability of direct investments in manufacturing and agribusiness have reduced their portfolio shares in those sectors.
- The necessity of having a diverse portfolio and not becoming too limited in their sector focus. In addition, these institutions have to be opportunistic as it would be wrong to turn down projects with strong developmental impact even if the project is not in one of their focused sectors.
- Expertise and activities of other DFIs/MDBs. They may well choose to avoid particular sectors and countries where others are stronger.
- The views of investors they partner with. When they are partnering with commercial investors, the commercial investors may indicate a preference for certain sectors.

***Question 3: What good evidence exists to indicate whether certain types of investment (or other funding) are more powerful in encouraging a wider development impact?***

MDBs/DFIs do not often report their development impacts by instrument, as they believe that the instruments should be selected based on what is appropriate for the investment or country in question, not an a priori basis using criteria such as leverage. Even more, some of the MDBs/DFIs interviewed explicitly mentioned that they saw no direct relation between the type of financial product offered and wider development impacts (these are project-specific and cannot be attributed to different financial product/different financiers). So, even if there is some evidence of differing development impacts, it may not be causal. In view of this, we will focus on this section on the main financial instruments used by DFIs/MDBs and the market failures those instruments are addressing.

### **3.1 Main financial instruments used by the DFIs and MDBs**

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<sup>9</sup> MDBs such as AsDB and AfDB lack specific sector expertise in manufacturing/industry. Therefore, they mainly fund projects in infrastructure and financial sector via financial intermediaries such as banks and funds.

<sup>10</sup> DEG-GPR scoring system and IFC's sector specific indicators are included in the appendix 2 and 3 respectively.

<sup>11</sup> For example, FMO has built strong financial sector expertise, which is leveraged in projects such as the TCX fund (see TCX case study in Appendix 4) and also in its 2009 US \$10mn investment in Zanaco, Zambia's oldest and largest bank, aimed at improving access to financial services. Norfund has developed its expertise in the renewable energy sector through its multiple investments in SN Power, which has projects and operations in Asia, Africa and Latin America.

European DFIs have equity and quasi-equity representing 55%, loans 43% and guarantees 2% of their combined 2009 portfolios. However, individual European DFIs have quite varied mixes, with the equity portion ranging from 100% at SIMEST and 96% at CDC to 0% at SOFID (Dalberg Global Development Advisors, 2010). DFIs invest in local companies in developing countries both directly and through intermediaries. Most DFIs' loan activities focus on strengthening physical infrastructure (energy, telecoms, transport) and financial infrastructure (banks) and on financing projects in industry and service sectors which create high levels of employment or are of particular importance for a region (agribusinesses and tourism in particular). DFIs also provide senior, subordinated and participative loans. Many of them combine loans and equity investments despite the inherent risk of conflicting interests if the borrower defaults.

The MDBs that use the equity instrument on any significant scale are IFC<sup>13</sup> and EBRD. IFC takes equity stakes in private sector companies and in intermediaries such as banks, other financial institutions and private equity funds. Like the other reviewed institutions, IFC and EBRD must look to financial viability of the investees and their own investments. When investing in direct equity they do not take any lead sponsor roles, mostly confining their stakes to about 1/3 of the investee companies' share capital. They also invest in indirect equity via a wide range of private equity funds with different investment models and strategies. Equity is a potent instrument for influencing deep reform and setting of good industry, corporate governance, environmental, and other standards of private investee enterprises, including via enhanced competition and demonstration. As such, equity brings a good potential for beyond-enterprise impact. Helping the investee companies to achieve and demonstrate good standards can also benefit MDB financially when the time comes to sell its holdings. These developmental and financial benefits are particularly evident when the MDB participation helps underpin reform of investee enterprises for their successful later initial public offerings (IPOs) of their shares.

The other MDBs mainly focus on direct loans and indirect investments. As the regional development banks (AfDB, AsDB and IDB) have comparatively small private sector departments, for efficiency reasons, they typically resort to doing mainly loans. These loans have been concentrated on infrastructure, where the institutions have good overall insight and the wider development indicators are easier to construct and monitor compared to other sectors (such as general industry or the financial sector). As for the equity instrument MDBs generally invest in equity via private equity funds. For efficiency reasons, they also do most of their SME finance via intermediaries, as banks or designated micro or SME (MSME) institutions or funds.

Capabilities and capacity constraints also determine which instruments the DFIs/MDBs are able to use. Efficient handling of direct equity needs critical mass volume to enable the institution to build good systems and capacity. The requirements included active management of direct equity investments, knowledge of the sectors they invest in and local presence. Quite often the MDB, as others with public sector operations as their main activity seemed to be at an advantage in combining direct equity with debt and technical assistance, especially for complex PPP operations in infrastructure. Investments in

<sup>13</sup> IFC investment services include: Equity; Short-term Liquidity; Loans and Intermediary Services; Syndicated Loans; Structured Finance; Risk Management Products; Trade Finance; Subnational Finance; Treasury Operation; In addition, IFC provides advisory services on access to finance and investment climate. The DOTS data as of 30 June 2010 for projects approved in 2001-2006 (average IFC development outcomes score is 71%) include the following:

IFC investments	Loans share	Equity share	Guarantees and risk management share	Development outcome scores
SSA region	34%	26%	40%	78%
SA region	68%	14%	18%	79%
Agribusiness	87%	5%	8%	78%
Infrastructure	70%	29%	1%	70%
Manufacturing & services	71%	29%		57%
Financial mkt.	26%	17%	57%	73%

private equity funds could see similar scale advantages and synergy, e.g. in structuring and contracting of the investments whether in funds for SMEs generally or in specialized funds in areas such as energy conservation. Also, IFC and EBRD have achieved best success rates when combining finance to SME orientated banks with TA to develop appropriate capacities and systems. However, as TA handling is quite demanding administratively, there is a need to build adequate organization capacity.

### **3.2. Main financial instruments and the market failures they address:**

#### 3.2.1 Private equity/venture capital funds have become a significant form of portfolio investment in some emerging markets.

Financial economists generally believe that these funds exist to address the substantial information gap between investors and entrepreneurs, especially those in growing and restructuring firms. Equity finance can be a potentially beneficial source of risk-financing for SMEs — including high-risk SMEs — in their early lifecycle stages, when cash flow is not yet regular. For these firms, bank debt often is not available in sufficient amounts for a variety of regulatory reasons, making equity their primary source of finance. However, even well-established and successful SMEs face a number of challenges when trying to access local or international capital markets. To begin with, the cost of raising capital tends to be considerably higher for SMEs, not only because of the perceived greater risk associated with lending to or investing in such enterprises, but also due to the smaller relative amounts of financing that SMEs require in order to fund their growth at any given stage. Since many of the compliance costs associated with accessing capital markets are fixed (e.g., listing and rating agency charges, legal fees, prospectus preparation costs, etc.), SMEs usually find that the all-in cost of using the capital markets is prohibitive (Financial Inclusion Experts Group | SME Finance Sub-Group, 2010). By carefully structuring the initial transaction and intensively monitoring the firm after the investment the private equity fund managers can avoid many of the problems that deter banks and other financiers from investing in these settings (Lerner, 2004). DFIs/MDBs tend to require a higher IRR for these type of investment and the IRR might be different for different regions (Proparco requires a min IRR 10% in West Africa vs 15% in East Africa and Southern Africa both for their investments through FIs and their equity investments in SMEs via partner investment funds).

#### 3.2.2 Loans and syndicated loans.

Firms need to be able to access those financial instruments that they needed in order to invest (e.g. loans, quasi debt). Moreover, the cost of capital needs to be reasonable because if it is too high the expected rate of return to investment will be too low (or even negative) and firms will have a disincentive to invest. However, there is generally a shortage of long-term loans (in local currency and leading currencies) available to greenfield companies and expansion projects in developing countries. Also, SMEs tend to often lack the collateral required by the commercial banks. Beck et al. (2006) also find out that out of 12 constraints to finance, high interest rates top the lists of specific financial obstacles, followed by the lack of access to long term loans.

#### 3.2.3 Striking the right balance between debt and equity financing is the key.

Debt and equity financing play a complementary role in a firm's growth. Just piling more debt onto SMEs without a balanced capital structure may prevent them from securing or repaying the debt, and make them vulnerable to business downturns and changes in interest rates. Carrying little or no debt may be an indicator of risk aversion. Too much equity, on the other hand, dilutes firms' ownership interest. The IFC experience suggests that the lack of equity finance is a binding constraint for many SMEs, in particular for larger SMEs, in developing countries, while extending additional debt financing for undercapitalized SMEs may be counterproductive. Unlike the large-buy-out funds in developed markets, typical SME funds in emerging markets rarely try to use leverage to increase their returns, focusing instead on making money by assisting with operational, management, and marketing improvements.

#### 3.2.4 Credit Guarantee Schemes

These schemes are and should probably remain an important form of intervention. However, there is no clear evidence that provides guidance either on the optimal number of guarantee schemes (some countries maintain several schemes) or on their design features. In this regard, it would be highly desirable for DFIs to coordinate an initiative aimed at developing core principles/ guidelines to orient developing countries in the design of such schemes that also minimize their subsidy component (depending on the guarantee pricing/conditions). These principles would contain guidelines on eligibility criteria, coverage ratios, fees, payment rules, use of collateral/down-payment, and equity ratios, among other parameters. Moreover, these schemes should be subject to more systematic evaluations of impact that assess, inter alia, their degree of outreach, additionality, and sustainability. Finally, credit guarantee schemes can play a much more proactive role in capacity building and training of participating banks, especially in less-developed financial systems. There seems to exist substantial scope for assistance from DFIs in this area provided the DFIs/MDBs can channel or facilitate TA linked to investments in support of capacity development for guarantees.

***Question 4: How much reliance can be placed on measurement of tax payments and employment created to capture development impact, particularly with regard to effects on the poorest people? What account should be taken of so-called 'net currency effect' (balance of payments effect) of agency investments as a 'development return'?***

In general, as noted under question 1, the DFIs and MDBs have selected to focus their quantitative measurement of wider development impact on contributions to government revenues (taxes paid), employment and the net currency effect of the investment.

#### **4.1 Tax Payments**

Data on taxes paid is collected by the European bilateral DFIs only for productive companies and infrastructure projects not financial sector projects and investments by private equity funds. The ECG approach used by the MDBs also includes taxes paid in the economic performance of investments. Taxation is a transfer payment and hence is excluded in the economic rates of return that these institutions calculate for all investments.

There are sound reasons for the institutions to focus on taxes paid. Increased government revenue contributes to macro stability, a necessary condition for increased private investment and poverty reduction (Lopez, 2003). New projects also widen the tax base helping to keep the tax rate down, thus increasing the incentive to invest. (ROMER, 2007)

In addition, the literature reveals that the focus on taxes paid is based on the use of an implicit logic model whereby the revenue they generate enables governments to invest in social services, infrastructure or other sectors which help to generate growth and reduce poverty. There are several shortcomings in using the logic model without additional verification:

- i. Governments may not be resource constrained. This is highly unlikely given the high fiscal deficits that prevail in most low income and conflict affected and fragile (CAF) states. But, given the high commodity prices that have prevailed recently and the fact that many such countries are resource rich, it is not axiomatic that the governments of such countries are always revenue constrained. Nigeria and Sudan are examples of such exceptions.
- ii. Governments may choose to use the revenues generated for other purposes that have much lower development impacts such as paying the salaries of relatively well-off civil servants: in

many low income and fragile states, civil service salaries make up over half the total government expenditure.

- iii. Even if they spend on social services and infrastructure, the poor may not benefit. There is plenty of evidence of governments being biased towards serving the needs of urban elites in providing services and infrastructure at the expense of the peri-urban and rural poor.

Thus, for the logic model to be valid, the institutions need to validate that the government is indeed resource constrained, does spend a high proportion of fiscal expenditure on social services and infrastructure and that that spend does benefit the poor. This need not impose too high a cost burden on the institutions.

#### **4.2 Employment Creation**

All the institutions measure employment creation, both direct jobs and indirect employment generation through the knock-on effect of the investment that increase demand for suppliers of inputs and sub-contractors. ICD SA seems to go one step further and look not only at employment creation but also potential saving of jobs if its investments save firms that may otherwise have ceased operations.

The focus on employment is also sound. Providing employment contributes to growth by moving people from activities with lower productivity to higher ones and providing jobs provides a pathway out of poverty. As shown in the World Bank's "Voices of the Poor", what most poor people want is a job. However, the sheer counting of direct and indirect jobs as testament to benefitting the poor can be misleading for several reasons:

1. The assertion that jobs are good for growth and poverty reduction holds only if those employed are moving from activities with lower productivity to higher ones. The creation of highly skilled jobs in a country short of that skill can have little development impact as it simply moves labour from one highly productive occupation to another without adding to employment. And it is likely to simply drive up the cost of already expensive labour.
2. It is not necessary that the creation of jobs by a single investment adds to the stock of jobs in the country. It is important to examine possible displacement effects which could result in a net reduction in jobs: a few, highly paid jobs might replace a larger number of less paid ones.
3. The jobs created may not benefit the poor. Whilst it may be argued that net job creation will benefit the poor in some way, as it helps to increase demand in the labour market, in practice, rigidities in the labour market are particularly strong in the developing countries so that the poor do not benefit.
4. Whilst the institutions focus strongly on the quality of jobs created by the project, they are more lax in examining the effects of indirect employment. By using full time equivalents of indirect employment, they do not distinguish between short-term and long-term employment or "real" jobs or the incomes resulting from them. As expressed in the World Bank's study "Voices of the Poor" the poor are often rich in jobs; "Very poor often have to work in multiple low-earning jobs (Narayan, 2002). Real unemployment is not an option in the absence of social support systems. The way out of poverty is a "real" job, one that is more productive. Otherwise, one just redistributes misery."



These shortcomings do not detract from the focus on employment. What they call for is better data capture to ensure that what is measured is net job creation, the accessibility of jobs for the poor and the quality of indirect employment created.

### 4.3 Net Currency Effects

The European DFIs using the GPR also collect data and report on net currency effects from investments in productive companies, but not from infrastructure or financial sector investments or those in private equity funds. Among the MDBs, only AfDB reports on the net currency effects of investments.

European DFIs consider net currency effect as a useful measure of contribution to economic development because most low income countries run large balance of payments deficits and foreign exchange can be a constraint on growth and stability. For example, DEG estimates that 91% of African investee countries run balance of payment deficits (Koch, 2009). Many of these countries have had to resort to borrowing from the IMF to prevent balance of payments crises that may have undermined macro stability. Such crises are known to hit the poor especially hard.

However, focusing on net currency effects seems in part to be a legacy from the days of tightly controlled currency regimes and lack of integration of low income countries into the global financial system. As the IMF notes, even the low income countries are now better integrated into the global financial system:

*Low-income countries are joining international capital markets, entering markets for goods and services, attracting foreign investment, nurturing their own private financial sectors, and benefiting from money sent home by citizens working abroad<sup>14</sup>.*

In fact, the rise of commodity prices, greater inflows of remittances and larger aid flows mean that the pressure on balance of payments is far less than it has been in the past. Balance of payments crisis are far less frequent than they were in the past though, no doubt, the IMF still has to step in when shocks occur such as the global downturn between 2008 and 2009, as only 9 countries in Asia and five in Africa are rated as investment grade constraining their ability to borrow from the international market.

With liberalization, depreciation of the exchange rate is no longer a sign of crisis but a mechanism to ensure that the country remains competitive externally. In fact, many low income countries are concerned with possible effects of 'Dutch Disease' as a result of the appreciation of the exchange rate with the influx of foreign currency earned through exporting commodities or brought in through remittances and foreign aid, though the detrimental effects of aid may be overstated<sup>15</sup>.

***Question 5: The evidence for whether DFI and MDB operations encourage technology transfer, faster technology adoption, or other productivity gains.***

### 5.1 DFIs/MDBs reporting

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<sup>14</sup>IMF support for Low Income Countries, factsheet. [www.imf.org](http://www.imf.org)

<sup>15</sup> A Policy Makers Guide to Dutch Disease, Owen Barder, New Economist, 2006.

5.1.1 DFIs and MDBs regularly report that their investments tend to provide on-the-job training of local staff and build skills, including among vulnerable groups like women. The European DFIs highlight that their projects also provide opportunities for home country professionals to develop their skills in a developing country environment. Furthermore, commonly adopted standards by the institutions and their development indicators include encouraging businesses to become socially and financially involved in their communities through demonstration effects and provide a means of transferring know-how and technology. For example, the Aureos Africa Fund is a joint venture with CDC contributing staff and overseas offices and Norfund providing cash to help set up new fund management companies on the ground. This project provided capacity building in the form of on the job training for its staff and built up the local management capacity and know-how in running a fund management company. (Dalberg Global Development Advisors, 2010)

5.1.2 The institutions generally see investments that support technology and management know-how transfer as a key element in their mission to foster development. More recently the institutions have also focused on transferring environmental technology. The ECG monitoring templates include indicators for “Transfer and dispersion of skills”. IFC, EBRD and several other institutions use indicators as: introduction and replicable demonstration of new technology, business know-how, management and employee skills, apart from enhanced private ownership and other wider private sector development indicators. A key reason why the institutions prefer strong strategic sponsors in investments in complex enterprises is the ability of such sponsors to introduce advanced sector know how. DEG-GPR includes indicators for technology and know-how transfer, training and advanced training. High GPR scores in such transfers from past industrial and manufacturing investments have caused DEG to focus continuously on these sectors.<sup>16</sup> In addition, some European DFIs (e.g. Belgium BIO) provide subsidies for technical assistance for training, and technology transfer. Similarly, MDBs like the Asian Development Bank have channelled technical assistance to help prepare and implement complex PPP operations in infrastructure, which involved significant know how transfer to both regulators and the respective private enterprises.

5.1.3 Technology transfer appears, perhaps somewhat contradictively, not to be as prevalent as knowledge transfer. A Swedfund evaluation (Bo Sjö et al, 2008) concluded that 13 of the investments in the sample contained this component, 14 did not provide enough information and on 17 cases they judged this component not be present. This depends of course on how one interprets the concept of technology transfer. It seems however relatively uncommon that a certain technique introduced into a portfolio company has been totally novel to the country in question. The evaluators of Swedfund came across such cases in for example the consumer industry sector, but more commonly the new or expanded companies have brought modified, more effective and in some cases what appears as more environmentally friendly ways as opposed to totally new ways of producing a good or service.

## **5.2 Importance of technology and know-how transfer**

Technology transfers are generally counted as one of the most important channels through which foreign corporate presence can produce positive externalities in the host country (OECD 2002: 12). To what degree these actually takes place is however a contested issue. Four interrelated channels through which technology and diffusion work is identified by OECD, namely “vertical linkages with suppliers or purchasers in the host countries horizontal linkages with competing industries or complementary companies in the same industry, migration of skilled labour; and the internationalisation of R&D (OECD 2002: 13). In the OECD study it is argued that the *evidence for positive technological spill over effects is strongest for vertical, in particular backward linkages with local suppliers in developing countries.* Empirical evidence for horizontal spill over effects is according to the same study hard to obtain (OECD

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<sup>16</sup>The industrial sector vital contribution to supporting the transfer of know-how and technology is one of the reasons for DEG being involved with enterprises in the industrial and manufacturing sectors (DEG Annual report 2009).

2002: 13). This study points out the importance of the relevance of the technologies transferred and argues that “for technology transfer to generate externalities, the technologies need to be relevant to the host-country business sector beyond the company that receives them (OECD 2002: 13). The authors do however not support their argument with any references to empirical studies.

### **5.3 Evidence of technology and knowledge transfer**

5.3.1 Most MDBs and DFIs do not systematically look at the evidence from their investments encouraging technology transfer, faster technology adoption or other productivity gains beyond their projects. Although the ex-post evaluations of their investments tend to cover technology transfer, faster technology adoption or other productivity gains, the evidence provided is mainly in the form of case studies that focus on the technology or know-how transfer at the project level and do not look beyond the project or at the spill over effects.

5.3.2 Despite the focus on training and knowledge transfer, there is still plenty of evidence of reliance on expatriate labour. How much focus there has been on education and knowledge transfer varies substantially between sectors and sometimes even within the same sector. (Bo Sjö et al., 2008). Even companies that have been established in developing countries for many years are often still dependent on expatriate expertise for the management of the company. In Kenya, a recent skill survey found that employers still relied on a significant proportion (16%) on foreign expertise to meet their skill needs (Nathan EME, 2010). Also, when people were trained and they move to another firm, there is no clear evidence gathered that they transfer the knowledge they have gained.

***Question 6: What evidence exists of stronger development impact through financing of start-ups, micro-enterprises or SMEs, compared with larger-scale enterprises?***

#### **6.1 Firm size does not matter**

This is a controversial area in the development literature. Whilst there is a considerable body of literature that argues that SMEs are important for competitiveness and growth, have higher productivity of capital and are more labour intensive, and so create more jobs, there is a small but influential literature that refutes all these claims. The literature that refutes the claims includes cross-country studies that show no correlation between the proportion of output generated by SMEs and faster growth and poverty reduction as well as micro studies of capital and labour intensity, productivity and competitiveness that show SMEs to be no better than their larger peers in terms of productivity of capital, labour intensity and quality of jobs.

Expressions like “missing middle” recognize that a mix of firms from small to large is desirable. Yet they also imply that some part of the distribution of firm sizes is somehow underdeveloped. What, then, do we know about the optimal firm size distribution that supports income growth and poverty reduction?

It is not clear what an optimal firm size distribution is. Comparable data sets on firm size across countries and sectors remain embryonic. The best statistics happen to exist for rich countries. Studies are slowly emerging that allow more useful statements also about developing economies<sup>17</sup>. One observation jumps out from existing data: there is wide variation around the averages. It is clear that in all countries SMEs account for the vast majority of firms. Even in the United States firms with less than 500 employees make up 99.8% of all firms that employ workers. The picture becomes more differentiated when considering the share of SMEs in employment and value-added (GDP), using the World Bank standardized database with a cut-off of 250 employees as the upper limit for SMEs. At one end of the spectrum, Azerbaijan, Belarus, Georgia, Russia and Ukraine record that between 5 and 15% of workers are employed in SMEs. Yet Bulgaria, for example, shows 50%. Nigeria and Zimbabwe say the number is around 15%. At the other end

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<sup>17</sup>Two notable efforts are by Snodgrass and Biggs in 1996 and Ayyagari et al. at the World Bank in 2003.

of the spectrum Chile, Greece and Thailand claim that roughly 86% of all employees work for SMEs. In Germany the per cent is 60%. The measured contribution of SMEs to GDP is similarly all over the place. Belarus and Azerbaijan show 7 and 9%, Australia 23%, Colombia 39%, Hungary 57%, all the way to Luxembourg with 76%. Spain comes in at 65%, Italy and Panama at about 60% and Germany at 42%. Missing observations abound. Averages may not be very meaningful. One may be right on average, but wrong every single time.

Optimal firm size tends to vary with income levels and sectoral composition of an economy. Overall, we may say that SMEs account for more than half of employment in some countries and less in others. Their share in GDP tends to be smaller than that in employment, because larger firms tend to be more productive. The broad historical evidence on the role of large firms suggests that, indeed, average firm size increases with a country's wealth, but clear statistics are still lacking. The Snodgrass/Biggs data set suggests that average firm size measured by employment per firm increases as countries grow richer. The informal sector declines, medium size enterprises become more widespread, but large firms are the big winners<sup>4</sup>.

A more recent study (Klein, 2010) suggests that firm size does not matter and the DFIs/MDBs should support productive growth, particularly when good SMEs can become large. The World Bank's SME dataset with all its limitations also finds no causal effect running from small firm size to productivity even though it suggests that richer countries have a higher share of SMEs (Beck and Demirguc-Kunt, 2004). From this perspective the key in SME finance and support is not the targeting of a particular firm size, but the identification of good firms. DFIs and policymakers should care about productivity and the growth of income and productive employment, not about the resulting firm size distribution. In this sense policy should be size-blind.

## **6.2 Addressing the market failure at the SME level**

The large, well established enterprises, are less affected by market failure. As DFIs/MDBs need to be additional, they may well choose to concentrate on SMEs where the market failure is the greatest. Small and medium firms face more financial constraints than large firms (Levy (1993); Cook and Nixon (2000)). Beck et al. (2005) quantify that financing constraints for small firms have almost twice the effect on annual growth that large firms' financing obstacles do. Similarly, Schiffer and Weder (2001) find that small firms consistently report more constraints than medium-sized firms, which in turn report more constraints than large firms. Other sources of SME finance, such as leasing and factoring, are also less developed in emerging countries.

Investors tend to approach the SME markets from both a direct and indirect perspective. Investing directly in individual companies requires local knowledge and sector specific skills, and tends to be perceived as costly and involving higher risk. Investing indirectly can be done via intermediaries, through existing commercial banks, designated SME finance institutions, SME focused PE funds and other types of financial institutions. The reviewed institutions generally view these means as key to supporting SME financing. Best practices for SME banking are being established by stakeholders in the European DFI communities, global investment NGOs like SEAF and financial associations such as the Emerging Market Private Equity Association (EMPEA) that all specialize in targeting developing countries.

Over the last decade, DFIs have expanded their participation in SME equity funds. While they are considered among the riskier SME finance models and require highly skilled human resources, equity funds that focus on SMEs are being recognized as a potentially profitable asset class with significant development impact potential. Investing via designated MSME intermediaries allow the MDBs and DFIs to connect with SMEs that they otherwise would be unable to reach directly. The SME equity funds have an advantage over designated SME lending institutions in providing more opportunity to strengthen investees' environmental, social, and governance policies. Recent analysis conducted by the Dahlberg

Global Development Advisors suggests that there are close to 192 investment funds supporting small and growing businesses (SGB) in emerging markets, with the majority of funds concentrated in Asia, Africa, and Latin America. These funds are typically willing to make investments smaller than USD 2 million. The cumulative target size of these investment funds is estimated at USD 7 billion. Such funds have seen rapid growth since 2006. However, SME designated private equity funds doing average investments below USD 2 million have generally produced relatively low financial returns<sup>18</sup>. This outcome has been a reflection of i) high transaction costs, ii) comparatively small overall size of the funds with resulting difficulties to attract good managers and iii) the absence of good exit prospects from the investments in the less developed countries without liquid stock markets or readily available options for trade sales (including to strategic investors). As a result, the institutions have been cautious not to over expose their investments to these types of SME private equity funds.

### **6.3 Addressing the market failure at the microenterprise and start-up levels**

Getting down to the microenterprise level involves high transactions costs so the institutions would need a special purpose vehicle or on-lending to microfinance institutions (MFIs) to reach this group. The evidence of MFIs success is mixed. Whilst Grameen Bank showed plenty of evidence that people can be raised out of poverty, good rigorous studies on MFIs show a mixed picture. In particular, when displacement effects are taken out, it may be the case that providing finance to some simply takes away the jobs of others and the evidence of the creation of new jobs is very limited. (Bateman, M. (2010))

Financing start-ups may be useful in increasing competitive intensity and innovating new technology and business models but it is inherently risky. As the investment climate paper (Nathan EME b, 2010) shows, there is a strong correlation between density of business and growth. In addition, the paper points out that the start-ups are very useful for inspiring innovation but failure rates for start-ups are very high (over 60% in the UK and estimated 80% in Africa).

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<sup>18</sup>This was shown in major reviews of the PEF operations of IFC and EBRD, the leading fund investors among the institutions.

*Question 7&8: What evidence exists of DFI and MDB investment encouraging wider adoption of higher standards of labour safety and health, for workers and/or their families or local communities, and what type of investment is most effective in this regard? What evidence exists of DFI and MDB investment encouraging better environmental standards, and what type of investment is most effective in this regard?*

## **7.1 Environmental and social standards used by DFIs and MDBs**

### 7.1.1 The most common E&S standards are the IFC Performance standards

Public development financial institutions such as the OECD Export Credit Agencies and European Development Finance Institutions have publicly referenced the use of the IFC Performance Standards as a benchmark for environmental and social review process in all co-financed projects. Some DFIs, such as DEG (Germany) and FMO (Netherlands), also use the IFC Performance Standards for projects financed unilaterally. Therefore, we will mainly refer to the evidence provided by IFC E&S Performance standards in the paragraphs below.

### 7.1.2 IFC's Performance Standards have been catalyzing the convergence of standards in global financial markets.

The Performance Standards have become a global benchmark for managing environmental and social risk by financial institutions. Previous IFC safeguards were adopted as the basis for the Equator Principles (EP) in 2003. Since 2006, the Performance Standards have formed the basis of a revised set of the EP for financing projects with capital cost above \$10 million. As of June 2009, 68 financial institutions have adopted the EP, including 16 from emerging markets. It is estimated that over 70 % of project finance activity in emerging markets is now carried out in accordance with the EP.

### 7.1.3 Responsibilities for disclosure of Social and Environmental Impact Assessment results and other information throughout the project life cycle rest primarily with the client.

IFC's experience shows that the degree of disclosure, documented evidence of community engagement, and quality of information disclosed varies across clients. Clients with projects that have greater social or environmental impact (such as infrastructure, oil and gas, and manufacturing) tend to report more information regarding their activities. Multinationals, who might be more used to reporting on the E&S standards, also tend to report more information than the local firms. After the project is approved by the DFI/MDB Board or the relevant internal authority, it becomes the client's sole responsibility to report on the project's ongoing social and environmental performance and the implementation of the action plan. As a result, stakeholders must look to both the DFI/MDB and the client to piece together a picture of what the project is, whom it affects, the expected development outcomes, how the project is being implemented, and whether the DFI/MDB achieved the development goals it hoped for with the project. (IFC, 2009)

## **7.2 DFIs and MDBs encourage wider adoption of higher E&S standards**

### 7.2.1 Over 80 % of Financial Intermediaries (FIs) surveyed responded that a Social and Environmental Management System (SEMS) in their institutions helped them better understand risks in their portfolios.

About 85 % of respondents considered an SEMS useful for gaining better access to international finance, and almost 60 % see it as having a positive impact on their brand name and value. On the basis of FIs' general experience with the development and implementation of such management systems, 48 % indicated that the related cost factor would not affect their decision to consider pursuing IFC's financial support in the future. (IFC, 2009)

### 7.2.2 Timing of DFIs/MDBs' involvement and the type of investment it finances impacts the extent to which IFC can influence project design.

In the case of greenfield projects, DFIs/MDBs are usually well

positioned to influence project design, at both the construction and operational phases, and to make the project consistent with E&S performance standards requirements from the earliest stage of project development. The situation is more complex in corporate loans, where the use of proceeds is often not necessarily dedicated to new construction activity. Such a situation requires a screening of the full range of clients' activities, operations of significant subsidiaries, and companies for which the client has management control. The situation can be even more complex in listed equity investments, where DFIs/MDBs' leverage can be limited. Notwithstanding this, DFIs/MDBs engage with clients to develop action plans that capture opportunities for improving E&S performance, leading to more substantive and sustainable development outcomes. Successful implementation of the action plans is therefore an important proxy for effectiveness and for development outcomes. Some DFIs (e.g. FMO) do monitor the implementation of these action plans and, in some cases, action implementation is incentivised by allowing an interest rate reduction upon implementation.

7.2.3 Financial sector/private equity fund investments tend to be more effective in encouraging better E&S standards. If they themselves implement full Environmental and Social Management Systems, the FIs and fund managers tend to incentivise their clients/investees to implement E&S standards (FMO, 2009).

7.2.4 DFIs/MDBs' measurement of E&S-related outcomes is based on the performance of environmental and social management systems at the company/project level. Although all the DFIs and MDBs report the environmental and social impacts (E&S) of their investments, on the whole, this takes the form of verifying whether the ex-ante assessments of environmental and social impacts have materialised. Initial data from 149 IFC projects that have already reached the supervision stage, and for which an ESRR is available, suggests that the portfolio is performing at a high level (IFC, 2009). In most cases this mainly requires compliance with the environmental and social standards and does not look beyond that. Also, such reporting is usually at a project level with little attempt to measure beyond the project impacts. The MDBs/DFIs assess the wider E&S impacts mainly when complaints are received through their ombudsman functions.

The vast majority of DFIs have broad and credible commitments to uphold labour rights in their investments, typically including the ILO core labour standards, occupational health and safety, and substantive working conditions. Most prominent in the standards adopted are IFC Performance Standard 2 (PS2) and EBRD Performance Requirement 2 (PR2). There is a growing understanding of the ways in which labour standards issues can be assessed but there is less experience of monitoring and client reporting.

### **7.3 Labour standards used by DFIs and MDBs**

7.3.1 Increasingly, multilateral and bilateral DFIs require their clients to adhere to national labour laws and international labour standards in their operations. This requirement is encapsulated in various policy statements and standards to which clients are required to adhere, and can also be made a condition of receiving finance. These are re-capped in the Table in the Annex. A key development in DFI commitment to labour rights was the IFC's adoption in 2006 of its Performance Standards. The IFC Performance Standards go beyond the Core Labour Standards to include a series of policy and process requirements, and requires recipients of funding extend labour rights protections to contractor workforces and workers in supply chains to investments.

7.3.2 Performance Standard 2 (Labor and Working Conditions) has been broadly applied across regions and sectors, though the requirements have been challenging for some clients, particularly in countries where enforcement of national laws is weak or where such laws do not exist. Requirements on collective bargaining and workers' organizations, as well as supply chain issues have proved to be challenging. The issue of migrant workers, often hired indirectly through contractors, is another area of challenge for

clients. Clarifications on working and living conditions of “nonemployee” workers might be needed. Moreover, in a time of economic crisis and shrinking labor market, the role of PS2 in the context of large-scale retrenchment should be considered. PS2 seeks to emphasise areas which have not always been included in ‘codes of labour practice’ – in the finance sector or elsewhere – such as measures on responsible retrenchment (IFC, 2009)

7.3.3 Performance Standard 4 was developed to address, in an integrated manner, issues related to community health, safety, and security. PS4 addresses the client’s responsibility to avoid or minimize the risks and impacts to community health, safety, and security that may arise from project activities. Such risks and impacts can arise from project-related activities potentially occurring outside what is traditionally considered the project’s physical boundary. As implementation experience has shown so far, PS4 ensures that some of the most significant issues directly affecting the health and safety of potentially affected communities are now incorporated by the client in its assessment and management of E&S impacts.

7.3.4 The IFC Performance Standards usefully reflect developments occurring in other fields – such as ‘ethical trade’ in global supply chains – recognising that enabling meaningful participation and good management systems are vital practical steps to ensuring compliance with both environmental and labour standards. Moreover, the European multi-lateral institutions, such as EBRD and EIB, are guided by EU policy. In May 2006, the EC Communication ‘Promoting decent work for all’ stated that *‘it will harness its external policies, its development aid and its trade policy for [the promotion of decent work]’*. (DFID, 2010)

7.3.5 IFC has pioneered a ‘performance-led’ approach to labour standards promotion which puts real emphasis on developing systems to enable and ensure compliance with national and international labour standard. In effect, this places labour standards in the context of developing modern and professional systems of HR management, alongside enabling functional systems of industrial relations, rather than approaching compliance solely from the point of view of tickbox-auditing. As such, this approach – which has been pursued by EBRD and many of the European DFIs (EDFIs) – reflects an understanding of developments in private sector supply chain labour standards management (DFID, 2010)

7.3.6 Once a financial relationship is underway, intervention may be more difficult than before it has begun. It is often necessary to extend the intervention mechanisms beyond requirements of improvement before initial disbursements are made in order to ensure sustained improvements. As noted above, the leverage a DFI has over labour practices in its investment is substantially reduced where investment is made via a financial intermediary (FI), such as a Fund Manager or a bank which on-lends to local clients. A good practice example here is OPIC, which actively monitors and conducts periodic reviews of the funds it supports as well as their portfolio company investments to ensure compliance with OPIC’s Investment Policy requirements with respect to environmental guidelines, human and workers’ rights.

#### **7.4 Monitoring compliance and reporting on labour standards**

Significant strides have been made by some DFIs to enable these intermediaries to implement labour standards requirements – amongst others – on behalf of the DFI. These include training the staff of FIs on environmental and social risk assessment and due diligence, as well as providing targeted guidance on the meaningful application of these standards in the local context.

Clients are required to monitor, and report to DFIs/MDBs, compliance with national law and the implementation of the Action Plan alongside the MDBs/DFI’s policy requirements. In addition, where significant issues have been identified during due diligence, DFIs may conduct their own on-site monitoring, or require periodic audits by third-party experts. Unlike environmental performance, labour



performance cannot be easily quantified and 'measured'. DFIs essentially rely on self-reporting from the client and the following indicators: results of any state labour inspections, advent of labour disputes, and information coming through the client's internal grievance mechanism (DFID, 2010). Nevertheless, some DFIs tried to enable the FIs to implement labour standards requirements – amongst others – on behalf of the DFI. These include training the staff of FIs on environmental and social risk assessment and due diligence, as well as providing targeted guidance on the meaningful application of these standards in the local context.

***Question 9: What evidence exists that DFI and MDB involvement in poorer countries has beneficial wider effects on the efficiency of capital markets in those countries?***

One of the main reasons for establishing DFIs and the private sector operations of the MDBs was the presence of market failures in the financial sectors of the developing countries which prevented them from raising sufficient capital (at home and from abroad) and deploying it effectively in the most productive private sector investments. In the interests of additionality and catalysing solutions to development challenges, there is a very good case for all DFIs and MDBs to report the wider effects of their investments on the deepening and efficiency of capital markets in the poorer countries.

Most DFIs and MDBs have financial sector-specific assessment parameters that measure the effects of the projects on financial sector development. For instance, the EDFIs that use DEG's GPR include: mobilisation of savings, sector diversification [broadening]; diversification of credit allocation [deepening]<sup>19</sup>. The IFC measures indicators for access to finance for women through micro finance, access to housing finance as well as monitoring the number of micro and SME borrowers.

**Robust evidence of the systematic impacts of the DFIs and MDBs on the financial sectors of the countries in which they operate has not been found in the literature.** The institutions report the activities they undertake to deepen, broaden and improve the efficiency of the financial sectors of countries in which they operate, and present case studies that testify to their effectiveness. However, we did not come across well thought out evaluations that proved that they had achieved systemic changes in the way the financial sectors operate. There is no evidence, for instance, of their impact on the key measure of financial deepening (private credit/GDP), financial efficiency (interest rate spreads) and they do not report against these key measures. Thus, using the literature, we have documented below the activities they have reported on.

**DFIs/MDBs help support the development of well functioning, micro finance providers and commercial banks.** The types of interventions they undertake are:

- I. They work on the setting up and institutional strengthening of micro finance institutions. They make investments in, provide advisory services to build capacity in such institutions and serve as providers of wholesale finance to such institutions with the aim of increasing access to financial services, especially for disadvantaged groups such as women. The IFC and FMO are particularly active in this area.
- II. They fulfil a similar function for commercial banks with the aim of financial deepening and expansion of financial services to underserved segments, such as SMEs. In India, IFC focuses on strengthening private sector banks through equity investments in second-tier banks and Upper Tier II capital for stronger private banks. This helps to prepare the banks for the eventual opening

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<sup>19</sup>These parameters are included in DEG-GPR for financial sector and private equity funds.

up of the sector to increased competition and supports the banks as they strive to meet Basel II capital adequacy standards. In Bangladesh, Bhutan, Nepal and Sri Lanka, IFC Advisory Services is working with partner banks to increase SME financing, and also to provide trade finance.

- III. EBRD has used similar means to IFCs to support financial sector development with its equity and debt operations. It is notable that EBRD also combines its investments with technical assistance for institution building in investee banks. For example, the EBRD investee banks initially receive regular technical assistance in basic credit technologies (including for SME finance) and at later stages more advisory services to develop more sophisticated risk management systems, audit functions etc. Ex- post evaluations of operations involving banks regularly come up with the best development outcome ratings when investments are backed up by technical assistance.

**The institutions help to diversify the financial sector, covering gaps in product coverage, and mechanisms to hedge against risk.** For instance, the IFC and FMO have worked to develop housing finance and the IFC supports the development of insurance. They have shown interest in supporting e-banking and micro insurance, leasing, factoring and trade finance.

**They provide innovative mechanisms to help mitigate risk.** For example, they have helped investors cope with currency fluctuations. The Currency Exchange Fund N.V (TCX) was set up to promote lending in local currencies in some 30 countries by offering protection for currency fluctuations. As described in the case study appended, TCX is a collaboration between over twenty DFIs and development banks. The IFC has been particularly active in offering partial credit guarantees to the commercial banks to help them overcome the perceived risk of the lending to SMEs. These instruments help to deepen the financial sector.

**They strengthen the effectiveness of stock exchanges.** The institutions report their activities to strengthen the effectiveness of the capital markets including:

- Providing guarantees to facilitate resource mobilisation in local currencies by private borrowers and enabling banks to develop loans with longer maturities. This guarantee may take several forms: Bond guarantees or guarantees for other products (securitisation for example). DFIs offers a guarantee to savers (institutional or private investors) that lend to a bank or a corporate that issues a bond on the market in order to finance itself
- Selling their shares while exiting investment to increase the number of quoted stocks. For example IFC takes equity stakes in private sector companies and other entities such as financial institutions, and portfolio and investment funds in developing countries. When the time comes to sell, IFC prefers to exit by selling its shares through the domestic stock market in a way that will benefit the enterprise, often in a public offering. To ensure the participation of other private investors, the Corporation generally subscribes to between 5 %-15% of a project's equity will normally not hold more than a 35 % stake, thus encouraging other investors to take invest on the markets.
- Facilitating the access to capital markets for smaller firms
- Transfer know-how and expertise in flotation . An example is the transformation of state-owned enterprises to private firms or public firms whose shares will be sold on a stock exchange. In this process a DFI can help by giving advice during the privatization process on changes that management needs to make, valuation methods and the placement of shares.

**Question 10: What evaluation methods are best-adapted to assess the development impact (including, but not limited to, the financial success) of DFI and MDB operations?**

Answering this question needs to take account of the practical difficulties that the institutions face. As noted under question 1, the two practical constraints are time and cost of monitoring and evaluation and difficulties in arriving at a common unit of account between the different types of projects that they invest in. In view of these constraints, what we have attempted is to set out below why the evaluation methods of the institutions have evolved in the way they have and what might be done to improve them without huge additional costs.

**10.1 Rigorous Cost Benefit Analysis and Evaluation of social impacts**

Cost benefit analysis (CBA) remains the most theoretically valid method for economic evaluation of projects. However, the institutions recognize that calculating an economic rate of return may not be comprehensive enough in capturing wider development impacts such as improving the quality of policies and institutions and setting of new standards in governance or ESHS the impacts of which are difficult to quantify, may be a long time coming and are difficult to attribute.

Even where it is theoretically possible to quantify wider development impacts such as increased competition, technology transfer, know-how gained through training and wider demonstration effects of private sector investment operations, the exercise can be hugely time consuming and the numbers produced may be based on heroic assumptions. Again, attribution remains a challenge.

For these reasons, institutions following the ECG guidelines do evaluate Economic Rates of Return but do so by adjusting the financial rate of return for obvious market distortions and transfer payments and taking on-board obvious externalities such as producer surplus when they are known. They do not attempt a rigorous quantification of wider development impacts.

Attempts at enabling CBA to capture distributional benefits, for instance, by taking on board whether the project benefits the poor, have long been abandoned because of their complexity and the fact that they proved difficult to compare projects<sup>20</sup>. So, in measuring distributional benefits, the institutions have developed indicators that measure social performance in terms of benefits to communities and social groups (ECG) or the effects on gender and social development (GPR).

More rigorous measurement of before and after, with and without (control groups) or randomized control trials to measure the economic and social benefits for project beneficiaries are attempted in the ECG approach but these are limited because of the cost and time of developing baselines and evaluations and conducting RCT. For example, with-and-without project assessments of impact beyond the investee enterprise require detailed counterfactual information. Carrying out rigorous impact evaluation with robust counterfactuals is costly and time-intensive.

If the cost is less of an issue and the main purpose is development outcome, then it is possible to develop approaches such as that used by the small (US\$ 7 million) Grassroot Business Fund (GBF) set up by IFC. GBF uses a Social Return on Investment (SROI) calculation to estimate the quantifiable social-economic impact that a high-impact social enterprise will generate and the projected number of

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<sup>20</sup>Methodologies for undertaking social costs benefit analysis include the UNIDO Guidelines for Project Evaluation, 1972.

beneficiaries it will reach. But this is not appropriate for larger institutions. Given the average cost, it would be impossible to obtain an accurate assessment of the poverty reduction impact of the private sector investment operations of the MDBs and bilateral DFIs using such an approach.

In addition, the institutions need to monitor the progress of their investments in as close to real time as possible. Full scale evaluations are not helpful in this respect because of the time and cost involved. The institutions need to monitor progress on wider development impacts by using indicators that can be tracked easily. They set targets in terms of these indicators and the evaluations then assess how far the targets were achieved.

These limitation explain why the institutions have resorted to “proxy” indicators at project level for the kind of wider development impacts they are likely to have, despite the fact that this approach has methodological limitations.

## **10.2 Comparing the IFC/ECG Model with the EDFI models**

As noted under question 1,two basic approaches to measurement and evaluation have developed based on the use of proxy indicators for development impact. The way that they are used for monitoring and evaluation purposes is set out below.

**Monitoring:** A key strength of IFC’s DOTS tracking approach is the perspective it provides with combined quantitative and qualitative development indicators with both tailored to the specific industry and sector in which the investment takes place. This allows IFC and other MDBs that follow its approach to assess the development outcomes on a more detailed level and set more detailed objectives of their investments. (Dalberg Global Development Advisors, 2010). However, demanding systems for regular monitoring, such as the IFC’s DOTS or the EBRD’s TIMS system seem most realistic for big institutions with quite large volumes of private sector operations. Smaller institutions with lesser volume would not have the scale advantages of IFC and EBRD, and lack realistic capacity to manage similar scope, reporting and review frequencies. This seems to be the main reason why the bilateral DFIs tend to apply simpler, more standardized and less demanding systems such as the GPR.

**Evaluation:** Although DOTS offers continuous outcome tracking through the project cycle, it alone does not provide for in-depth evaluation and attribution of development impacts to the IFC operations. This must be assessed upon completion by the independent joint evaluation function of the World Bank and IFC. The ECG emphasis is more akin to classic economic cost-benefit analysis. This is supplemented by quantitative and qualitative assessments in the specific project context. The ECG evaluation standards exclude arithmetic indicator scoring and any standard weights in aggregation of any overall arithmetic score, resorting instead to verbal ratings of operations. This approach typically needs more time and resources than standardized checklist and scoring systems.

The bilateral DFIs commonly put less emphasis on economic rate of return calculations than IFC, and tend to apply numeric scoring and standard weights, as in the GPR system of DEG. This approach is clearly less demanding than that of ECG but has its own challenges in assigning aggregated overall scores on annual basis to portfolios (as by DEG) or to the year’s new approved investments (as practiced by FMO). The scoring systems used, nevertheless, seek to address similar development dimensions as those using the ECG guidelines derived from DOTS. (Grettve, 2007).

The cost factor thus encourages discipline in choosing appropriate case studies and impact evaluations with thematic focus or at the country level.

### 10.3 Improving the current system

Before considering how the methods of evaluation may be improved, it is worth considering what can be done to improve the current system.

All the institutions have introduced regular monitoring and self-evaluation. IFC, for instance, monitors all portfolio companies at least annually as part of its regular supervision cycle. Monitoring of development impacts is undertaken with less frequency. DEG, for instance, monitors development results for all active portfolio projects every second year, starting three years after the investment.

As reflected in the ECG standards, ensuring the quality of monitoring and evaluation is important, not only from a management perspective but also as an input to well-informed independent, ex-post evaluation. Quality control and validation of monitoring and evaluation is usually performed by internal policy, planning or evaluation units. Several of the bilateral DFIs lack fully independent internal evaluation units with resulting limitations in terms of any independent validation of their evaluation of development outcomes and impact. This is an area on which they can improve.

Ex-post evaluation by the institutions applies longer perspectives and more in depth assessments, and is usually undertaken a few years after the investment has been completed. The latter is typically performed on a representative sample of individual operations along various thematic lines. Very few institutions have opted for independent ex-post evaluations of their investment by using, for instance, independent auditors or academic expertise, and where they have, it is limited in coverage: 20% of AfDB projects are expected to be evaluated independently. The proportion evaluated independently, using third parties can be increased. This will require early involvement of independent evaluators in the project cycle so that base lines and counterfactual considerations can be planned in advance.

As entities, the institutions have been subjected to external reviews and evaluations to varying degrees. For example, EIB has its projects and programs reviewed at intervals by the EU Commission. Similarly, bilateral DFIs (DEG, FMO) are reviewed periodically by government entities such as national audit offices. These reviews appear, generally, to not to have attempted systematic measurement of development impact, typically taking more thematic approaches. One institution, FMO, has introduced regular but limited external audit of its own administration and the environmental performance of projects, which are presented in its annual sustainability report. IFC is a pioneer among the institutions in undertaking external validation by auditors of its development effectiveness system, DOTS, and its annual findings. There is considerable scope to increase the systematic measurement of development impacts by independent evaluators.

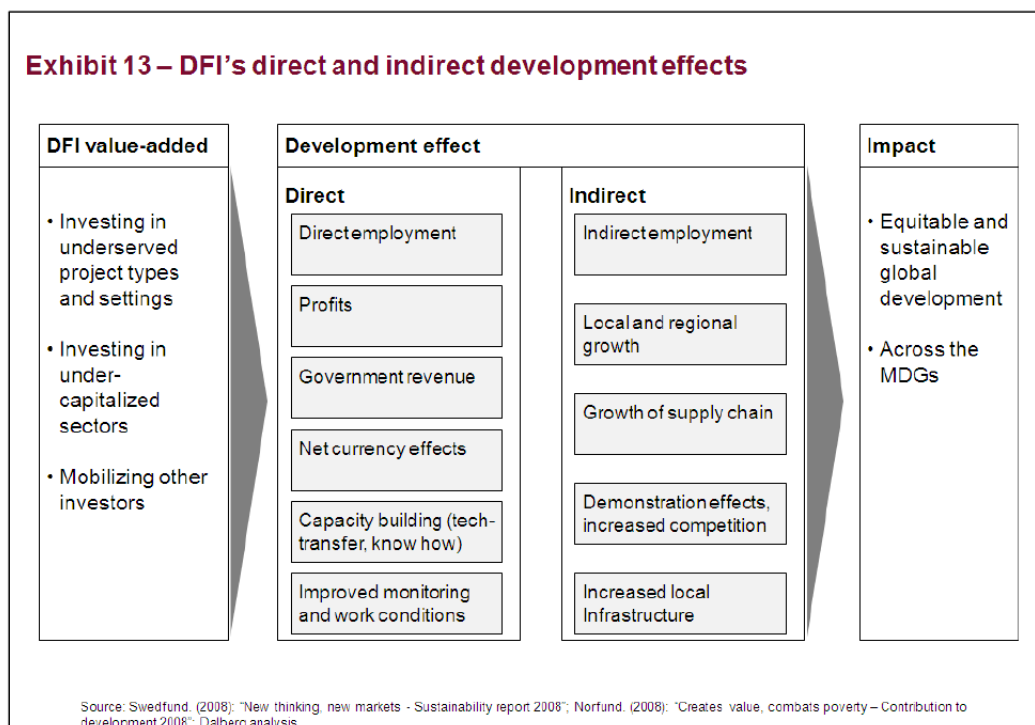
External reports typically address aggregated post-evaluation ratings or scores of development outcomes and impact. However, a few institutions, including IFC, have begun to publish results of monitoring. The six institutions that undertake formal, independent ex-post evaluation in accordance with the ECG standards (AfDB, AsDB, EBRD, IADB, IIC, and IFC) publish thematic evaluation reports without identifying specific investees. EIB applies the same principle. AsDB posts client-approved individual evaluation abstracts on its web-site. DEG has also published client- approved post evaluation results on individual investments on a selective basis.

To date, these external reports have been motivated mainly by the objective of communicating the achievements of the institutions. There is much reliance on selected case studies and thematic evaluations that show the institutions positive impacts. There is a need to be more rigorous and transparent in their external communication publishing more independent reviews including those that are critical. This will only occur if the shareholders in these institutions demand it.

#### 10.4 Better Capture of Development Outcomes and Impacts

Subject to the limitations of time and cost, there is still much that can be done to improve the monitoring and evaluation of development impacts. The key is to set up better logic models that track the causal links between the project's outputs, their need to combine with other changes to deliver outcomes and build to impacts. Finding appropriate indicators and proxy indicators that can then track progress at outcomes and impacts at a reasonably low cost can then help to set up appropriate monitoring and evaluation. Such logic models would be of utility also to independent ex-post evaluators.

To illustrate what this requires, we use the example of a recent evaluation of Swedfund. This uses as its evaluation frame direct and indirect effects. The direct development effect listed include: jobs, project profit, government revenue, net currency effects, as well as capacity building through technology and know-how transfer and improved working conditions. Indirect effects include greater indirect employment, local and regional growth, growth of supply chains, demonstration effects and greater competition and increased supply of infrastructure. Together these direct and indirect effects are expected to cause wider development impacts.



This can be improved readily by developing causing logical chains between direct and indirect effects. For example, the purchases of the project, say an agribusiness, can be shown to have an effect on the supply chains of the agricultural commodities it purchases. Further, if the project then also provides knowledge and inputs to farmers, then it may be shown to have a causal impact on their incomes or, as a proxy, the

yields they obtain. With an appropriate baseline, it should be possible to track progress on yields. For more rigorous evaluation, counterfactuals may be established or RCT undertaken.

Similar causal logic chains may be established for taxes paid and how they result in improved local infrastructure, for employment and net currency affects discussed under question 4. The general principle observed there was that it is important to not stop at project level outputs but to see them through to outcomes if not impacts tracking who is benefitting.

In addition, some of the largest development impacts of projects (public or private) come from the measurement of consumer or producer surplus. Some MDBs, such as IFC already register and report number of farmers reached, purchases from national suppliers, purchases from national suppliers, numbers of MSMEs reached etc. though not for projects in all sectors. The regional development banks have commenced similar practices. It appears, however, from the published annual aggregations that none of the MDBs has used these data as yet for more in-depth assessment of pro-poor impacts. This would not be too costly an exercise if the right baselines and evaluation methods were added on to track who benefits and by how much.

The DFIs/MDBs do assess their investments from the point of view of their social and environmental impact and some look at governance standards as well. However, most of the above are qualitative effects that are hard to measure and aggregate. For this reason they are rarely reflected in the monitoring and evaluation practices of the DFIs and MDBs beyond the various proxy indicators at project level and qualitative judgmental assessment of wider beyond-project impact. If the institutions wish to claim that their projects are having wider beyond the project impacts, they should be able to set up arrangements for demonstration and dissemination and influencing and then track their outputs.

All the above observations point to the need for the institutions to collaborate far more closely with their public sector development agency counterparts (national and international) in bringing about wider development impacts and in monitoring and evaluating their own private sector operations. A recurrent theme in the findings of the external evaluations of institutions that have taken place is the desire to see greater focus on development impact in the selection and design of operations, more akin to the approach of bilateral development cooperation agencies.<sup>21</sup>

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<sup>21</sup> See for example the Swedish National Audit Office report of 2009 on Swedfund.

**Question 11: What evidence exists in relation to whether DFIs and MDBs crowd out (i.e. are not financially additional), and what to show that aid agencies bring private investors into markets otherwise deemed too risky (i.e. crowd in or catalyse private investors).**

### **11.1 Crowding out**

There are three main ways in which the DFIs/MDBs can crowd out other investors:

- By providing cheaper finance as they can raise finance cheaper on the international markets than say, the local investors. This is why the DFIs and MDBs have been very careful that they do not crowd out local financial institutions and most adopted the policy to provide the market rate for their loans. However, anecdotal comments by private investors indicate that in some instances DFIs continue to offer capital at below-market pricing, effectively “crowding out” private investment (Intellectap, IAMFI, 2009). (Abrams, 2007) also concluded that the IFIs are crowding out the small private institutions from lending to the “best MFIs,” in contrast to their public claim of taking the risks the private sector is unwilling to take.
- By exacerbating the problems in the financial sector. This can happen if the DFIs/MDBs give credit lines to banks or provide subsidized credit in countries where the banking sector is liquid.
- By offering free technical assistance with the loans. Because these lower-cost options are beneficiary to the MFIs that have access to them, there is often little room left in the market for private lenders. (Abrams, 2007)

The consensus view is that: DFIs should only make investments that private investors are unwilling or unable to make; DFIs should focus on catalytic investments that entice private investment, especially in the current economic downturn; and DFIs should exit investments once they have achieved the demonstration effect and private investors are ready to supply substitute funds (Intellectap, IAMFI, 2009).

### **11.2 DFIs and MDBs definition of additionality**

All DFIs and MDBs have additionality as one of their screening and evaluation criteria. However, the way they define additionality varies. Most define it in terms of whether the DFI/MDB provides financing that could not be mobilized on the same terms by markets and/or whether the DFI/MDB Bank can influence the design and functioning of a project to secure desirable developmental or transition impact. Some MDBs (e.g. AsDB) add a subsidiary component: the extent to which the MDB/DFI finance was a necessary condition for the timely realization of the project, directly through mobilization of funds and/or indirectly by providing comfort to other financiers. The definitions used by the MDBs subscribing to the ECG standards and by DEG are included in Appendix 5.

### **11.2 Measuring additionality and catalytic effects**

#### 11.2.1 Measuring additionality

There are many reports measuring financial additionality of most DFIs/MDBs programmes. IFC for example, has its internal Independent Evaluation Group (IEG) that annually reviews IFC’s additionality (this feature was introduced in 2008) and effectiveness in supporting private sector development and its contributions to economic growth and poverty reduction. However, evidence is lacking that MDBs/DFIs consistently and thoroughly measure additionality beyond inclusion of this factor in their approval, monitoring and evaluation reports on individual operations..

The DFIs that are partly market-funded appear generally to be stricter than e.g. the regional development banks in their additionality requirements, seemingly reflecting that the former can be more sensitive to any “crowding-out” criticism from market financiers. FMO has reported that additionality had been an issue in 2003 when a few cases were identified with insufficiently established additionality. Examples given included a credit line to a bank in a Central European country about to join the EU, and



another case that effectively amounted to a corporate credit to a multinational operating in Southern Africa. (FMO, 2008/2009)

The external evaluation of Swedfund in 2008, concluded that the level of additionality of the fund in its investments has been difficult to establish. Of the 12 companies who answered the evaluators' questionnaire, 8 stated that the investment would have gone ahead without Swedfund.<sup>22</sup> Of all the cases the evaluators looked at, Swedfund's additionality was assessed as high in 12, medium in 4 and low in 13 of the investments. In 18 of the cases the evaluators did not feel that they had enough information to form an opinion. There were less numbers of clear cut cases where a majority owner stated that the project would not have gone ahead without the Swedfund type of financing. Because of the involvement of other DFIs, the evaluators were also less certain in certain cases of the importance of the role played by Swedfund. This discussion points to the difficulty that is inherent DFIs/MDBs business. If they only accept investment proposals after all other possible financiers have declined, they run a risk of getting a portfolio which does not generate any or very low returns. (Bo Sjö et al, 2008).

#### 11.2.2 Measuring catalytic effects

Both MDBs and DFIs can act as catalysts of participation from other investors both directly and indirectly - directly through the mobilization of other investor capital and indirectly through helping local markets to build strong foundations for commercial activity, making them attractive to other investors by proving that profitable investments are possible in these markets.

In considering the extent of crowding out, the most common measure used is whether the project had been able to raise funds from other sources. Most DFIs claim catalytic effect by supporting investments, often via several successive private equity funds raised by lead partners and fund management teams that become experienced and well-established. These can consequently catalyse sizeable public and private investments (especially for SMEs) and promote market deepening. Similar reasoning in other sectors appear in case studies on pioneering operations presented in annual reports by the institutions. Examples include Norfund acting as a first mover, along with Banco Africano de Investimentos (BAI) in Angola's first private equity fund, DEG's role as co-founder of the Kyrgyz Investment and Credit Bank when no other local banks offered long-term finance to private companies, as well as the catalytic role of SIFEM and FMO in building Ghana's financial sector.

CDC measures and publishes the extent to which it has helped to catalyse private investment into funds operating in countries where the investors might not have gone otherwise. A CDC report states that during 2004-2008 it committed €4.8 (US\$ 7.1) billion to funds that attracted about three times the amount from commercial investors. In their 2008 Report, the AsDB reported an even higher mobilization factor, of over US\$8 for every US\$ that AsDB invested in the respective private equity funds. In general, the institutions tend to regard all other private investor contributions to the fund capital as mobilized funds, at times even including the contributions from other DFIs.

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<sup>22</sup> Companies may have an interest in not fronting that they have been short of funds or have had difficulty in obtaining credit on commercial terms, these answers should therefore be regarded with some caution

## Appendix 1: Development Return Assessment models in use by DFIs/MDBs for private sector investment operations

Systems/Approaches/Models <sup>23</sup>	Coverage	IFC- influenced ECG Model	DEG pioneered GPR Model	HYBRIDS. Variants	Tailored to specific needs
<b>Developed/Adopted by</b>		AfDB, AsDB, EBRD, IFC, IIC and other multilaterals	DEG, COFIDES, Proparco	FMO EIB, , Swedfund and others	Grassroots Business Fund
<b>INTERNAL SYSTEMS</b>					
- regular investments assessment, monitoring	Ex-ante assessment + monitoring of outputs, outcome	IFC DOTS ratings	DEG GPR scoring, standard weights	IIC (DIAS), EBRD (TIMS), AfDB (DOA), EDIS (FMO)	iPal, SROI
- post-evaluation, self-evaluation or by independent internal units	At-completion evaluation of outcome and impact (partial)	ECG standard verbal ratings, no standard weights	Post-evaluation scoring, standard. weights	ECG standards for MDBs and Swedfund; EDIS/ERR analysis (FMO)	iPal, SROI
<b>EXTERNAL EVALUATION AND REVIEWS</b>	Government/owner reviews, periodic. (typically at about five year intervals)  Research-based impact evaluation of projects, programs				

### Notes on institutions subscribing to each of the two main approaches:

#### *The sustainable development approach*

All MDBs reviewed (EBRD, IFC, IIC, EIB and AfDB and AsDB)<sup>24</sup> assess private sector operations from appraisal to post-evaluation with use of the ECG approach throughout with some variations:

**EBRD** introduced its Transition Impact Monitoring System (TIMS) in the early 2000's. The system is applied over the project cycle, and has largely compatible indicators with those in use continuously in EBRD's independent post-evaluation. The latter applies the ECG evaluation standards in most respects. The TIMS monitoring frequency is tailored to project character. TIMS outcomes are not published. By

<sup>23</sup> Development Bank of Zambia has yet to design assessment tools for evaluating the economic development impact of their investment operations (expected to be done during 2011-2015). No public information could be found on the development return assessment models used by SIMEST, Industrial Development Corporation of South Africa and Development Bank of Kenya and the contacts within organisations did not respond in time for this report.

<sup>24</sup> In contrast to IFC and EBRD, the regional development banks, AfDB, AsDB and IADB, have comparatively small private sector operations along dominating public sector activities of these institutions.

contrast the EBRD Annual Reports include aggregation of the Annual Evaluation Overview Reports to the Board of the institution.

**IFC** created its Development Outcome Tracking System, DOTS, in the mid 2000's. DOTS is consistent with the basic approach in IFC's independent post-evaluation, which influenced the ECG approach and standards for private sector evaluations. DOTS tracks and publishes on aggregate level monitored outcomes at least annually as part as its regular supervision cycle. Aggregated post-evaluation results from project and thematic evaluations are published in the IFC Annual Reports.

Post-evaluation of **IIC** operations is performed by the independent valuation unit in **IADB**, the bigger "sister" MDB of IIC, which institution also applies the ECG standards for private sector operations post-evaluation. IIC, however, has its own hybrid approach. This includes scoring at-entry and at regular monitoring with use of the IIC Development Impact and Additionality Scoring System (DIAS). **AfDB** has likewise developed an Additionality and Development Outcome Assessment system (ADOA) to score and monitor private sector operations along more numerous standard indicators. However, independent post-evaluation in AfDB continuously subscribes to the ECG approach and standards. **AsDB** also subscribes to the ECG standards in its independent post-evaluation work, and has largely consistent approaches to at-entry and regular "development effectiveness" monitoring of the private sector operations. **EIB** likewise subscribes to the ECG standards in its evaluation unit's post-evaluation of private sector operations. However, the Impact Assessment Framework of EIB focuses on seven areas: the financial, economic, social and environmental performance, governance, and contribution to the Investment Facility strategy and to the Millennium Development Goals.

Although the above MDBs institutions subscribe to the same good practice standards (GPS)<sup>25</sup> of ECG for post-evaluation, their success ratings are not comparable across the institutions. Moreover, as regards regular monitoring under the described TIMS, DOTSDIAS and ADOA systems, only IFC/DOTS is fully consistent with standards and indicators in ECG compliant independent post-evaluation of the institution. Another important factor is that not all institutions have fully independent internal evaluation units for post-evaluation and validation of self-evaluation and monitoring reports by operations teams. This difference and the several judgmental and qualitative elements in the ECG standards makes cross-comparison of reported development outcome and impact even more difficult. The matrix in Appendix II summarises the differences and similarities of these systems.

#### *The contribution to development approach*

As mentioned, **DEG** has the most elaborate and consistent scoring system. Its GPR scoring influenced the practice of several other bilateral DFIs, as **Cofides** and **Proparco**, as well as that of **FMO**. Among the reviewed MDBs, **IIC** and **AfDB** introduced numerical scoring and weights in similar fashion for their at-approval and monitoring assessments of development outcome and impact. However, both IIC and AfDB subscribe for post-evaluation of their private sector operations to the ECG standards.

#### **Appendix 2: DEG-GPR scoring system**

See attached file.

#### **Appendix 3: IFC's sector specific indicators**

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<sup>25</sup>A recent joint benchmarking review concluded that the ECG standards compliance rates were: IADB (90%), EBRD (83%), AfDB (46%) AsDB (64%), and IFC 93%. The outcome reflects in part that AfDB and AsDB have smaller significantly smaller volume and overall capacities for private sector operations than for example EBRD and IFC.

See attached file

#### **Appendix 4: Case study-FMO and partners Currency Exchange Fund (TCX)**

##### **Case study – FMO and partners Currency Exchange Fund N.V (TCX)**

Due to high currency volatility in developing nations, investing and lending in local currencies carries significant risks. FMO and over twenty partners (including Norfund, IFU and 5 other EDFI members, multilaterals and commercial banks in Africa and Europe), have invested in a fund which allows investors to cover their local currency risks – called the Currency Exchange Fund N.V (TCX). TCX is a special purpose fund providing market risk management products to investors active in emerging markets. The fund focuses on currencies and maturities which are not covered by regular market providers<sup>68</sup>. Its service offers are extremely valuable to investment partners in developing nations and serve to catalyze long-term lending in local currencies despite the inherent risks in these non-liquid emerging market currencies.

TCX manages its risk through portfolio diversification across some 30 currencies, such as Bangladesh Taka, Zambia Kwacha, and Dominican Peso. This large and innovative fund started up with a transaction capacity of US \$1.2 billion.

The results so far suggest drastically reduced default probability, improved business sustainability, and a major contribution to the development of local capital markets<sup>69</sup>. The importance of such a service offering is underscored by increased currency volatility related to the financial crisis. However, the ongoing crisis also creates a challenging business environment for TCX. Still, TCX's performance indicates that it is well positioned to absorb currency shocks in a global crisis. TCX's biannual figures in June 2009 indicate a profit of US \$42.2 million for the first half of 2009; making up for portfolio losses in 2008 associated with the financial crisis and the sharp appreciation in the US dollar against the majority of emerging market currencies. This rapid recovery appears to validate the TCX business model developed in collaboration with a number of financial institution partners.

Sources: TCX and Norfund

#### **Appendix 5: MDBs and DFIs definition of additionality**

The DFIs and MDBs typically require meeting additionality requirements in their charters. The MDBs subscribing to the ECG standards use the following indicators

- Would the client have been able to obtain sufficient financing from private sources on appropriate terms?

- Was the MDB needed to reduce risks or provide comfort (i.e., improve the investors' perceptions of the risks involved)?
- Was the MDB needed to bring about a fair, efficient allocation of risks and responsibilities e.g., between public and private sectors?"
- Did the MBD improve the venture's design or functioning?

DEG, besides using the subsidiarity principle by only providing capital where others do not, is also analyzing DEG's strategic role, by looking at the following:

- Attainment of the shareholder's strategic goals (Risk capital, SME, Climate protection, Africa, German Business, Strategic partnerships, i.e. if DEG co-finances projects together with other strategic partners (as a rule, DFIs).
- Mobilization of third-party capital (Mobilization of private capital, Mobilization of public capital. Mobilization of other funds
- Consulting by DEG (Initial project development, Promoter of E+S, CSR and CG, Consulting/Board seat)
- Umbrella function, e.g. if DEG accompanies a German or European partner to a politically difficult country (umbrella function), where the partner might be exposed to the risk of arbitrary, politically motivated action of local authorities (e.g. privatisation or so-called silent nationalisation); Lender in times of crisis
- Additionality in a more narrow sense (Low-income and/or high-risk country, Project and/or partner risk, Long-term financing, Risk capital and/or (guarantee for) local currency loans).

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