Helpdesk Research Report: Development Finance Institutions and Development Outcomes
Date: 23.11.2010

Query: Review evidence about the development impacts of development finance institutions investing public funds in private sector development. Where possible, identify outcomes by country, sector, and asset class.

Enquirer: DFID

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1. Overview

Development finance institutions (DFIs) are established and financially supported by governments and private investors to provide access to financial capital to populations and economic sectors under-served by mainstream private capital markets. They lend money under conditions similar to commercial lenders, but may be able to offer longer loan terms, more flexible risk tolerances, or (rarely) subsidised interest rates, and are mandated to lend for development-oriented purposes. They do not aim to compete with private finance; they aim to operate where private capital markets fail to satisfy needs.

Evidence about the development impacts of DFIs is limited. DFIs carry out evaluations of their investments, but these are generally limited to examining direct outputs and economic impacts; comprehensive evaluation of impacts is complicated and expensive, and is very rarely undertaken. DFIs argue that financial performance and development outcomes go hand-in-hand, as financially successful projects contribute to economic growth which in turn naturally results in improved development outcomes.

Critics charge that DFIs are driven by financial returns and tend to lose sight of their development mandates, investing in locations and sectors with the greatest potential for profit rather than the greatest need for development capital. They also accuse DFIs of failing to carry out adequate evaluations of development outcomes, and in some cases engaging in tax avoidance rather than contributing to national tax revenues.

In terms of sectors, as a rule DFIs invest most often in financial services and infrastructure projects, but individual institutions have developed specific areas of expertise. For example, the European Association of DFIs reports that industry and manufacturing is the second-largest area of activity for its members (15 European bilateral DFIs), but the IFC finds manufacturing to be a relatively poorly-performing area in terms of development outcomes. The Inter-American Development Bank places a particularly strong emphasis on social investment, particularly social protection and education. The importance of the investor's sectoral expertise is highlighted by the Dutch institution FMO which experienced a significant decrease in achievement of development objectives when it ventured out of its traditional areas of strength into new sectors.
In terms of geographical engagement, Asia receives the largest share of investment from the global DFIs. Africa receives the smallest share of IFC lending, but the second-largest share (after Asia) of European bilateral DFIs’ lending. In the IFC’s experience, Africa is the worst performing region in terms of development impacts; the African Development Bank reports much higher success rates but these cannot be directly compared because the organisations do not necessarily use the same criteria.

Information about performance by asset class was not reported by the DFIs reviewed. Critics of the Commonwealth Development Corporation have noted a shift from debt to equity investment in pursuit of higher investment returns. DFIs generally prefer larger investments over smaller ones, and report better financial returns and better development impacts for larger projects.

It should be noted that in the time available to compile this report it was not possible to cover the full range of DFIs in detail, so this analysis relies on only a small sampling of reports from global, regional, and bilateral DFIs with some independent analyses.

2. Summaries of selected DFIs’ activities


This report concludes that 63% of the IFC’s programmes that were examined met or exceeded market, financial, economic, environmental, and social performance benchmarks and standards. It also finds that in 85% of projects, development results were strongly correlated with financial returns. The report noted that (p. 1):

- Results continue to be much weaker in smaller projects.
- Less than half of projects in Africa and the Middle East & North Africa and only half in Asia met or exceeded development benchmarks and standards, widening the performance divide between these regions and Europe, Central Asia, Latin America, and the Caribbean.
- Environmental and social effects continued to be weak in Africa
- Performance was strongest in infrastructure and finance, and weakest in general manufacturing, services, and information technology.

Evaluation of development outcomes is based on four areas (Appendix B):

- project business performance, the principal indicator of which is the project’s after-tax financial return
- economic sustainability, considering the project’s effects on the local economy and the associated benefits and costs measured by economic rates of return
- environmental and social effects, including “(i) the project’s environmental performance in meeting IFC’s requirements; and (ii) the project’s actual environmental impacts through its subprojects, including pollution loads, conservation of biodiversity and natural resources, and, in a broader context, social, cultural, and community health aspects, as well as labor and working conditions and workers’ health and safety.”
- private sector development impacts beyond the project, addressing the extent to which the financial intermediary has become a “corporate role model” and “whether the project has contributed to IFC’s purpose by spreading the growth benefits of productive private enterprise beyond the financial intermediary.”
The IFC achieves its best development outcomes in Latin America, the Caribbean, Europe, Central Asia, and Asia, and in the infrastructure and finance sectors. It also experiences better outcomes for large projects than for small ones, with success rates of 78% for projects worth more than $15 million but only 48% for projects under $5 million.
This short briefing note from the IFC argues that financial performance is “is highly correlated with development outcome, as well as with environmental and social performance, private sector development impact, and economic performance” (p. 1) based on an analysis of 469 companies where investments were made between 1998 and 2003 and two other studies. “Over 97% of projects with satisfactory or excellent financial performance also have high development impact ratings.” (p. 1) The report argues that “(i) well managed companies tend to perform well on financial as well as on environmental and social matters; and (ii) companies with financial problems may lack the resources to continue to address environmental concerns adequately” (p. 2), and that “financially troubled businesses usually have difficulty fulfilling their immediate duties, to pay their workers, taxes etc, and are unlikely to have strong positive effects beyond company boundaries.” (p. 3) The study calculates financial rates of return (to investors)
and economic rates of return (to society, including external and qualitative benefits) and argues that economic returns to society as a whole exceed financial returns on investment in 91% of cases.


The African Development Bank invests mostly in infrastructure projects, making up 42% of its portfolio. New infrastructure projects approved in 2008 consisted of transport (45%), power supply (38%) and water supply & sanitation (17%) projects. The Bank is increasing the size of its operations in order to “leverage its limited resources more effectively, and earn a position of leadership at the country level” (p. v) and the average size of operations has increased by 40% in the last two years.

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<table>
<thead>
<tr>
<th>Active Portfolio</th>
<th>UA m</th>
<th>% of active portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure</td>
<td>6,032</td>
<td>42%</td>
</tr>
<tr>
<td>Industry</td>
<td>2,527</td>
<td>18%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>2,434</td>
<td>17%</td>
</tr>
<tr>
<td>Human development</td>
<td>1,869</td>
<td>13%</td>
</tr>
<tr>
<td>Governance/Multi.</td>
<td>1,283</td>
<td>9%</td>
</tr>
<tr>
<td>Finance</td>
<td>180</td>
<td>1%</td>
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</tbody>
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The Bank reports high success rates for its projects, with 91% of projects considered to have achieved their development objectives. Success rates by geographic region range from 83% in the South to 98% in the North. Sectoral success rates are 82% for governance/multi-sectoral projects, and other sectors are rated between 90% and 93% successful. The finance sector contains only one project, which was rated successful giving that sector a 100% success rating.


The IDB describes its priority areas of activity as poverty reduction (social protection, health, labour markets), sustainable energy and climate change, water and sanitation, other infrastructure (including transport, agriculture, tourism), education, and a portfolio called Opportunities for the Majority which addresses the needs of poor and low-income populations. Its investment portfolio is distributed as follows:
This report reviews the effectiveness of IDB projects in six categories. The body of the report contains extensive information about evaluation procedures used by the Bank. The executive summary summarises the findings and concludes that, with the exception of social protection and education, evidence of effectiveness is limited and more needs to be done to monitor and evaluate projects.

- **Social policy for equity and growth:** This included mostly social protection (by far the largest area), education, and health projects, with some work on labour markets and gender issues. These projects show “strong evidence of development effectiveness as well as innovations that will generate new evidence in the near future” and there are robust research and evaluation activities.

- **Infrastructure for Competitiveness and Social Welfare:** these projects focus on transport (the largest area of activity), water and sanitation, energy, and urban development. These are key fields where public investment is justified due to large welfare effects and high potential for
underinvestment by the private sector. However, evaluation studies within the Bank are limited. Evaluations of infrastructure projects tend to consider predicted costs and benefits but not actual results, higher-level outcomes, or comparisons with counterfactuals, and further improvements in evaluation practice are needed.

- Institutions for Growth and Social Welfare: these programmes include work on financial access for small and medium enterprises, citizen security, and anti-corruption. In these areas the Bank has not been able to implement solid evaluation designs and systematically document results, particularly where firms rather than households are the intended beneficiaries of projects.

- Competitive Regional and Global International Integration: this includes work on business environment improvement, clusters and local development promotion, technology adoption and innovation, export and investment promotion, and trade enhancement. Wide theoretical and empirical evidence justifies IDB interventions in these areas. However, the evidence on the effectiveness of these policies is still scarce and somewhat inconclusive, showing positive impacts in some areas (e.g. innovation and export promotion) but failing to show impacts in others.

- Protect the environment, respond to climate change, promote renewable energy, and ensure food security: The rationale for interventions in environmentally sustainable development is strong but “evidence of the actual effectiveness of specific interventions in these areas” is weak; in watershed management, few projects have adopted rigorous impact evaluation techniques, and on climate change, “impact evaluations are almost nonexistent.” The fact that climate change is a cross-sectoral issue “greatly complicates both the design and evaluation of these interventions.”

- Less developed countries: This area includes projects across all themes in the five LDCs in the region, including work in all five of the Bank’s strategic priority areas, with emphasis on transport infrastructure and fiscal sustainability. “Increasing technical support is needed to produce evidence on development effectiveness in LDC.”


This report was commissioned by the Association of European Development Finance Institutions to provide an overview of the activities of its 15 member DFIs. CDC has the highest net profit and highest average return on investment among the 15 European DFIs. (p. 21) Collectively, European DFIs’ investment portfolios are distributed as follows (p.15):

The report acknowledges the need for evidence of contribution to development outcomes. It cites several studies suggesting a positive correlation between financial performance and development outcomes in
most cases: 64% of FMO (Netherlands) projects showed both good development outcome and good investment outcome and 55% for DEG (Germany); but only 42% for PROPARCO (France).

Assessment of development success is limited to “three specific quantitative indicators; jobs, taxes and net currency effect [contribution to balance of payments] generated through the portfolio companies. In addition to these quantitative effects, the investments generate substantial qualitative effects, which are hard to measure and aggregate and rarely captured.” (p. 29) The report argues that European DFIs contribute to the achievement of the MDGs through employment creation, introducing standards and policies for gender equality and environmental sustainability, sector specific investments in education and health, improving the investment climate and supporting the transfer of technologies and know-how. (p. 35)

Aggregated data on impacts are not available but some examples from national DFIs are cited for 2008:

- DEG (Germany) claims contributions of €0.7 billion in government taxes, securing 2,072,000 jobs (49% in SMEs), and producing €13.7 billion in combined net currency effect
- CDC (UK) claims €1.7 billion in government taxes and 676,000 people employed in the portfolio companies which reported employment data


FMO, the Dutch DFI, evaluates projects’ development outcomes “on the basis of their business success, their contribution to economic growth and private sector development and their environmental and social performance.” (p. 5) 81% of projects were deemed to have good development outcomes and 92% to produce good investment outcomes; 78% of projects achieved success on both grounds. The report noted a decline in development performance in the last two years because declining financial margins had encouraged FMO to seek new investments outside its traditional areas of expertise in the financial and infrastructure sectors. FMO also manages riskier projects supported by government funds outside its main investment portfolio, and these projects show worse development and financial outcomes: 67% and 52% success rates respectively, and only 44% successful both financially and developmentally.

FMO’s development effectiveness framework (newly introduced in 2009) considers economic development impact (indicators include employment effects, government revenues, balance of payments effects, and sector-specific indicators), environmental and social development impact (incorporating risk management and environmental sustainability factors that vary depending on the project), and an assessment of FMO’s role as a DFI (including “elements for additionality are derived from the assessment of product risk, client risk and country risk”).
3. Independent assessments


This report notes that most evaluations of DFIs have relied on “traditional accounting profitability measurements” (p. 3) and neglected the subsidies that DFIs receive and their social objectives. Where analyses of social objectives have been done, they have usually consisted of “cross-country analyses of aggregated data with a focus on macroeconomic variables. These analyses have the limitation of ignoring important outcomes due to the heterogeneity across and within countries. Thus, they fail to evaluate whether DFIs or governments achieve their various and diversified social objectives.” (p. 3-4)

Furthermore, “recent studies have corroborated that DFIs have not mitigated market failures but have actually led to inefficient allocation of resources”, “a number of studies found little evidence that state ownership of banks promotes economic growth… or financial depth”, and “distorting effects on the allocation of financial resources were found.” (p. 7) DFIs tend to favour large firms over small firms when lending, and “do not differ from private banks regarding the provision of credit to firms lacking collateral.” (p. 7) While some success stories are found among locally-based DFIs (the Village Bank system of Bank Rayat in Indonesia and the Bank for Agriculture and Agricultural Cooperatives in Thailand were cited), for the most part DFIs have not clearly demonstrated significant social benefits and in terms of purely financial performance have actually tended to perform worse than private banks.
To improve monitoring of social objectives, the authors advocate using an indicator of social performance that they call an Output Index (OI), which would be customised for every situation to take into account the specific policy objectives of the DFI being evaluated. The Output Index relies on quantifiable variables related to the policy objectives. The authors demonstrate the use of this approach in two pilot case studies, in Honduras and Guatemala.


In principle, state-owned development finance institutions (SDFIs) are meant to intervene in situations where there is a market failure in the provision of private capital (which is fairly common), and where the social benefits of intervening outweigh the costs, and where intervention in financial markets compares favourably against other interventions such as social insurance, employment generation, food support, or investments in infrastructure or human development. The need to weigh the social benefits, however, “creates daunting measurement problems.” (p. 6)

Evaluations of the performance of SDFIs have been mixed. Some rigorous econometric studies have found that “access to financial services by the poor generated substantial welfare gains.” (p. 12) However, in most cases, SDFIs experienced poor financial performance including “huge losses, large voluntary and involuntary arrears and non-performing loans, frequent bail-outs accompanied by sloppy, non-professional management…. Inadequate loan pricing, credit risk evaluations, debt forgiveness and lax financial discipline have reflected more the rule rather than the exception. Targeting was also often ill-practiced and consequently led to regressive income distribution” (p. 12)

Evaluating SDFIs’ interventions requires “very demanding, rigorous econometric measurement” (p. 23) which is prohibitively expensive, time-consuming, and demanding of expertise. “In principle, a complete evaluation would use cost-benefit analysis or cost-effectiveness analysis to compare social value (of the intervention) with social cost in general equilibrium. In practice, it is so expensive to measure social value and social cost that almost all evaluations proceed in terms of outreach and sustainability in partial equilibrium.” (p. 23) These criteria assess the degree to which the institution reaches its target clientele, and the institution’s independence from subsidies.

The report concludes, among other points, that (p. 31-32):

- The performance of most of the SDFIs fell short of original expectations
- There is an increase in renewed interest in SDFIs in many developing countries, but their use demands improved performance assessment
- Political intervention can generate misallocation of resources and long-lasting demand for subsidies, and at worst can damage the culture of financial discipline
- Some rigorous economic studies have indicated that a few SDFIs generated social gains that exceed the subsidies they received. These SDFIs, by and large, have adopted “good practices” in financial intermediation and distanced themselves from the “old school” of narrowly directed and heavily subsidized lending rates, inadequate pricing of products rendered, lack of incentives to staff and clients and nonautonomous poorly skilled management.
- While econometric measurement used in evaluating SDFIs’ performance is warranted, it is plausible that only a few SDFIs would be assessed by using such methods, due to the high costs and skill levels required to carry out such studies.
- Donors and states should use the proposed methodology of the Output Index and Subsidy Dependence Index which could provide a relatively inexpensive evaluation of performance.

This report examines the use of subsidies by DFIs in the private infrastructure sector, comprising water and sanitation, transport, telecoms, and energy. Infrastructure is a good candidate for DFI investment because it is a public good which tends to attract less private investment than would be socially optimal, because it involves large sunk costs, and returns on investment are strongly dependent on government policies. Infrastructure also has an important development role.

The authors conclude that DFIs “have the potential to contribute to growth and poverty reduction by supporting the development of a vibrant private sector in developing countries. DFIs operate in sectors such as infrastructure where they help to overcome the considerable risks posed by private sector projects with large sunk costs…. Well-targeted and transparent subsidies have the potential to deliver development. At the same time, however, they can distort competition among DFIs or with private companies, particularly when there is a lack of transparency about how such subsidies are being used.” (p. 29)

The authors also note that DFIs are non-transparent, both in their operations (e.g. the terms of deals) and in their interactions with the rest of the development community, and they comment that “little is known in the development community about the extent of DFI operations.” (p. vii)


This book published by the World Bank discusses the analysis of social costs: the opportunity cost to society of public resources used by a DFI, or the social return that funds would generate in the best alternative to using them in a DFI. The usual method of evaluating DFI performance is by looking at social costs rather than social benefits, because “it is so expensive to measure social benefits that a full-blown social cost-benefit analysis (CBA) cannot be done each time a choice must be made to spend public funds on a DFI.” (p. 1) Social cost is measured by calculating a Subsidy Dependence Index (SDI) or a Net Present Cost to Society (NPCS).

4. Reviews of the Commonwealth Development Corporation


This report notes that CDC has performed well financially, achieving "impressive growth" (para 4) in assets and exceeding market indices. Its assets in mid-2008 included £1.2 invested overseas and £1.4 billion in cash, all of which was committed to future investments.

CDC’s investment portfolio is significantly more focused on the poorest countries than other DFIs, but it invests heavily in India, Nigeria, China and South Africa, which also have good access to private finance. “There is as yet no systematic evidence on the extent to which CDC investment adds to overall investment in poor countries. Assessing this aspect of performance presents technical challenges which all Development Finance Institutions face.” (para 8)
CDC’s financial performance is its principal indicator of development impact, on the premise that “profitable investments are likely to contribute to economic growth, and through growth to poverty reduction.” (para 4.2) However, “there is no academic research examining DFIs’ contributions to economic growth at country level” (para 4.3) and the effects of investment are difficult to disentangle from other factors. CDC’s business principles reflect international best practice but the fact that CDC operates through intermediary fund managers and does not carry out independent evaluation makes evaluation of compliance uncertain. The report argues that “Provided that sound ethical business principles are applied, the prime indicator of development impact can be financial performance, since good financial performance is associated with sustainable economic growth. The extent to which this translates to poverty reduction and social development is harder to demonstrate, particularly since these will be felt over the longer term.” (para 4.9)

Evaluation of development impacts has been very limited: the report notes that DFID “lacked rigorous information on CDC’s contribution to development and poverty reduction, beyond financial performance” (para 4.9), and that “without better evidence, DFID is not well-equipped to consider the benefits of its investment in CDC” (para 4.10).

http://www.publications.parliament.uk/pa/cm200809/cmselect/cmpubacc/94/9402.htm

The Commons Public Accounts Committee reviewed CDC performance in 2009. Its report shows that CDC invests 60% of its portfolio in low income countries, which is a greater proportion than other DFIs. The countries with the largest share of CDC investments are Nigeria, South Africa, India and China, which contain 62% of the world’s poor people but also have well established private investment markets. CDC’s model of using fund managers to invest on its behalf, rather than directly identifying investment opportunities, makes it difficult to direct money to specific regions and sectors. There are plans to alter CDC’s policies to focus on poorer countries, and in the case of China to focus on small and medium-sized enterprises.

CDC has only undertaken limited evaluations of its development impact. The assessments completed up to 2008 “lacked depth, with little performance data apart from financial performance” (para 18) and “there was no arrangement for DFID to receive or review these assessments.” Additional assessments were completed in 2008-09 but the Committee still concluded that “it is hard to assess the contribution CDC’s investments make to development” and that more comprehensive evaluation is necessary. (para 18)

The Committee also noted in its conclusions that:

- CDC has performed well financially, outperforming the market, although there were some questions about financial targets and increasing administrative costs
- DFID should exercise more oversight of CDC
- There were questions about the justification for steep increases in remuneration for CDC executives, and staff incentives place too much emphasis on financial performance and not enough on poverty reduction
- There is no independent verification of fund managers’ compliance with ethical business principles
- CDC has increased the proportion of its portfolio in countries such as China and India which are already successful in attracting foreign investors
- CDC should invest more in low income countries, which may require different financing instruments
- CDC’s model of investing through private sector fund managers has made it more challenging to collect and report non-financial information such as its contribution to reducing poverty.
- There is limited evidence of CDC’s effects on poverty reduction, and a need for improved information on the developmental effects of its investments
This report by the International Development Committee of the House of Commons noted that it had previously called for CDC’s portfolio of investments to be scrutinised and “highlighted that its social and environmental record was patchy” (para 40). It also noted the report of the Public Accounts Committee that “pointed to the lack of clear evidence of the impact of CDC’s work on poverty reduction in the countries in which it operates” (para 41).

The report notes that the publication of CDC’s first annual development report in 2009 was a positive step but the committee was “not convinced that the link between profitability of CDC’s activities and their positive development impact has yet been sufficiently demonstrated. More robust evidence is needed.” (para 44)

This report, written by a researcher with the Jubilee Debt Campaign, argues that CDC has lost sight of its development objectives, and is instead primarily concerned with financial returns. It criticises CDC for investing too often in sectors with high profitability but low development impacts, such as the financial, consumer products, and industrial sectors rather than in agriculture, and investing too often in larger, established, profitable companies rather than smaller businesses. It also charges that CDC “causes developing countries to lose substantial resources through the use of tax avoidance structures” and argues that it has a “social responsibility to contribute fully to the tax revenues of developing countries”.

5. Further resources

ODI has announced that it is undertaking a DFID-funded research project “The role of development finance institutions in addressing global challenges” from September 2010 to March 2011. Limited information is available on the ODI web site and unfortunately we were unable to contact the project leader, Dirk Willem te Velde, in time to obtain his input on this question. For more information, see: http://www.odi.org.uk/work/projects/details.asp?id=2276&title=role-development-finance-institutions-addressing-global-challenges or contact D.teVelde@odi.org.uk.

The House of Commons International Development Committee recently began its inquiry into DFID’s Annual Report and Resource Accounts for 2009-10 and called for written evidence around four questions, one of which is the work of CDC, to be submitted in September. The Committee’s report and the submissions it has received will likely be published next year. (http://www.parliament.uk/business/committees/committees-a-z/commons-select/international-development-committee/inquiries/dfid-annual-report-and-resource-accounts-2009-10/)

The House of Commons International Development Committee announced on 22 October an inquiry into the future of the CDC and has called for written evidence to be submitted by 18 November. (http://www.parliament.uk/business/committees/committees-a-z/commons-select/international-development-committee/news/committee-announces-inquiry-into-the-future-of-cdc/)
6. Additional information

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