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European DFIs in a troubled world: strategic actors of the European financial architecture for development

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In a rapidly changing world threatened by the risk of irreversible climate change, major crises and an increasingly polarised world order, Europe has to articulate its external actions in a more strategic, geopolitical, principled and impactful manner. In this context, European development finance must become an integrated part of this comprehensive European international strategic endeavour. This should be the direction of the reforms of the European financial architecture for development (EFAD).

European development finance institutions (DFIs) are playing an increasingly critical role in European ambitions and the evolving EFAD, supporting private investment for transformative development. Their specificities are at least three-fold. First, their private-sector focus, as part of their DNA, gives them a critical perspective on mobilising private finance and supporting private entities, linking public development objectives to private needs and initiatives.

Second, most European DFIs are relatively small compared with European public development banks, such as the European Investment Bank (EIB), the European Development Bank for Reconstruction and Development (EBRD), the French Agence française de développement (AFD) and the German KfW Development Bank. Yet, they collectively account for about half of the European overall non-sovereign operations outside the EU, matching the combined private sector investment of the EBRD and the EIB[1].

Third, European DFIs are a perfect example of the benefits of collective action, without impeding the autonomy of each DFI. The association of European DFIs (EDFI) has become a very effective club, giving visibility and clout to a large number of DFIs.

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EDFI has enabled the harmonisation of processes, the promotion of greater reliance, the adoption of common standards and principles, and the fostering of mutual reliance and co-investment. Co-investments account for about half of the operations of European DFIs. To ease the process, co-investment facilities have been put in place, as in the cases of the European Financing Partners (EFP) with the EIB, the Interact Climate Change Facility (ICCF) with the EIB and the AFD, and the Friendship Facility between the Dutch, the French and the German DFIs. The EDFI Management Company, a subsidiary set up by EFDI, effectively manages EDFI facilities and other EU blended finance vehicles, such as the ElectriFI and AgriFI facilities, as well as facilitates European DFIs access to EU risk-sharing programmes under the (enhanced) European Fund for Sustainable Development (EFSD/EFSD+).

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RESPONDING TO THE COVID-19 CRISIS

With the Covid-19 crisis, DFIs were asked to step up their efforts in a countercyclical manner, to help address the economic contraction and provide enhanced support for private sector investment, in particular to small and medium-sized enterprises (SMEs), which are the main job providers.

The pandemic and the resulting travel restrictions limited European DFIs' local presence and ability to generate new deals in developing countries, while increasing uncertainty and their risk exposure. Their immediate efforts are focused mainly on supporting their existing clients. This resulted in a drop in their total operations by about one fifth, from €9 billion in 2019, a record year, to €7.5 billion in 2020.

Unlike what happened within Europe, and advanced economies in general, where support measures for the private sector were readily available at scale, the European DFIs were generally not given the strategic impulse and means to immediately boost their operations in the crisis context and more actively stimulate private sector investment in developing countries.

European DFIs could get inspire by the countercyclical crisis response by multilateral development banks (MDBs), whose non-sovereign commitments increased by 11% in 2020 (still a modest increase compared to their 39% increase in sovereign operations), whereas those of European DFIs fell by 18%.[2] This illustrates the fact that private investment in developing countries has overall not been given enough attention in the Covid-19 response, but also that European DFIs were not equipped for an immediate response to the crisis.

Nonetheless, European DFIs managed to adapt to the new situation, adjusting their procedures and reengaging effectively, so as to return in 2021 to their 2019 level of commitments, at €9 billion. This capacity to quickly rebound, which has been much stronger than in the case of the global financial community, demonstrates the willingness and ability of European DFIs to pull their act together, adjust their operational processes, and identify new ways to engage with local partners, even in the face of the successive pandemic waves and their aftermaths. But these efforts will not suffice to address the longer-term recovery and resilience of developing countries, in particular among African private actors.

So far, the African financial sector has shown remarkable resilience during the Covid-19 crisis, partly due to strong reserves and public support measures[3]. Yet, African SMEs have been seriously affected, even more so women-led enterprises[4]. While a liquidity crunch was avoided, the quality of assets of African financial institutions has deteriorated considerably. The divergent recovery paths between advanced and developing economies, the global economic and geopolitical turmoil, combined with the impacts of the Russian war in Ukraine – in particular on food security, energy, commodity prices and development assistance – will increase hardship and uncertainties for many developing nations. European DFIs, as part of a broader set of endeavours by the development community, will have to step up their efforts and revisit their business models.

WAY FORWARD TO UNLEASHING THE POTENTIAL OF EUROPEAN DFIS

Many of the European DFIs have been around for a long time, but never before have so many hopes been pinned on, and demands made of them. Among other things, they are being asked to:

- **Increase inclusivity and engagement in social sectors and human development:** The Covid-19 pandemic has had very negative effects on poorer and vulnerable groups, highlighting the importance of inclusive approaches. It has also exposed the importance of private investments in the health sector[8]. Other social sectors, such as water and sanitation, and education and skills development should also get greater attention from European DFIs. Technological innovation, digitalisation and financial services are some of the areas where private investment and human development also connect.
- **Leverage more private finance, at scale:** The needs and financing gaps are DFIs generally tend to adopt conservative risk-tolerance, to exhibit a preference for senior debt[5]. European DFIs, and in particular their shareholders, should adjust their approaches and instruments to enable them to mobilise significantly more private investment.
- **Seek greater development impact, including in poorer countries and more fragile contexts:** While maintaining their focus on bankable projects, European DFIs should emphasise the additionality and development impact of their operations. This may require greater effort towards transparency and impact monitoring. Given the lack of bankable projects, in particular in poorer and weaker markets, more effort should be dedicated to identifying and preparing projects, mitigating risks and providing accompanying measures. This can be done in cooperation with local actors and development partners.
- **Adopt more transformational strategies and approaches, aligned not only with the Paris Agreement, but also with the SDGs:** This may require adjusting DFI mandates and long-term vision, internal culture, business models and incent It also means seeking more systemic engagement, beyond an opportunistic approach to single deals, toward portfolio approaches enshrined in transformative objectives, with partners promoting the SDG-alignment of private finance, and seeking to influence the ecosystem, together with other partners[6] .

- **Address climate change more forcefully:** As part of an SDG-aligned endeavour and harmonised approaches to the Paris Agreement, European DFIs must contribute more significantly to boosting private investment not only in climate mitigation (already a priority for many of them), but also in climate adaptation and resilience (an area largely neglected by most of them). European DFIs could all join initiatives such as the Coalition for convergence of climate and biodiversity finance, and the DFI+ Adaptation and Resilience Collaborative[7]
- **Be more responsive and resilient to crises:** A more turbulent world, characterised by multiple crises and shocks, and increased international tensions, is likely to become the norm for the medium-term European DFIs should adjust to this new environment, better assess compound risks and enhance their ability to respond more rapidly, effectively and in a countercyclical manner, as well as increase their own and their partners' resilience.
- **Further enhance gender-sensitive approaches:** European DFIs have made important commitments to gender finance and mainstreaming gender approaches, in line with the 2X Challenge. In pursuing this essential endeavour, they should focus on demonstrating the effects of these approaches, and leverage them with their clients. They should also make a greater effort to promote women's leadership, including in their ranks, which remain overwhelmingly dominated by men.

> *European DFIs should ensure greater accountability and transparency of their approaches and operations, towards citizens in Europe and in the developing countries where they operate.*

European DFIs do not need to be jacks of all trades, and can – and generally do – specialise in their respective comparative advantage and core mandate. But the range of demands made of them does reflect the level of expectations of their roles in an evolving European financial architecture for development and troubled world.

To unleash the potential of European DFIs, shareholders must empower them, increasing their financial and human capital when needed, adjusting their incentives and business models, and including them in broader development endeavours. European DFIs should be included more systematically in multi-stakeholder partnerships with other DFIs and PDBs, private sector initiatives, development agencies, and local actors. The reform of the EFAD should empower European DFIs and allow them to innovate, giving them greater access to blended finance instruments and guarantees, including as part of the current operationalisation process of the EFSD+. This is also the essence of the Team Europe approach and the collective and cooperative approach undertaken by European DFIs. Last, but not least, European DFIs should ensure greater accountability and transparency of their approaches and operations, towards citizens in Europe and in the developing countries where they operate.

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