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Beyond recovery: toward innovative, inclusive private sector financing

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Despite the extensive use of development finance institutions (DFIs) in recent years, the Covid-19 pandemic has shed a harsh light on the persistence of gender inequalities, particularly in terms of access to finance in emerging markets. It is therefore urgent to break down the systemic barriers that limit the flow of capital to gender-smart funds and diversity entrepreneurs. Only a collective and innovative response can lead to a paradigm shift in development finance.

The 2X Challenge, launched by the DFIs of the G7 countries at the G7 Summit in 2018, was joined by all EDFIs (European Development Finance Institutions), and mobilized USD 11.4 billion by the end of 2020, demonstrating a robust pipeline in times of crisis with a 2X capital pool growth of almost 170% in the Covid-year 2020.

Globally, the pandemic highlighted gender inequality and exacerbated existing inequalities and gaps in capital allocation. Its magnitude led to health, economic and inequality crises, confronting EDFIs with unprecedented challenges.

LESSONS FROM THE COVID-19 RESPONSE

Small and medium-sized enterprises (SMEs), especially small and growing businesses (SGBs), play a pivotal role in job creation, innovation and prosperity. They are the backbone of developed economies and the engine of developing economies. The turbulence and uncertainty brought about by the pandemic significantly impacted the SME sector globally. While liquidity and other Covid-response support was made available to SMEs in developed markets, their peers in developing markets largely navigated the crisis without external support. Women-owned and -led SMEs, already facing a significant funding gap across emerging markets, were disproportionately impacted. A World Bank analysis across 52 countries shows that women-led businesses were less likely to have received public Covid-support, although they were more severely impacted.

Notable gender-lens Covid-19 responses emerged in 2020, with structures based on new data on how SGBs can be effectively and equitably reached. Examples are the *CFF Covid-Response Bridging Facility* (aimed at channeling Covid-response liquidity to SGBs through local gender-smart capital providers) and other pioneer gender-smart investment funds and alternative vehicles led by diverse teams from emerging markets, which came up with fast response mechanisms. Many of these were too innovative for DFIs to support, for the following reasons.

1. DFIs focused on supporting existing clients and portfolio projects during the crisis. These were largely gender-blind, making it hard to shift to supporting new clients with more effective, gender-equitable strategies.
2. The Covid-19 response for SMEs/SGBs was channeled through financial intermediaries with whom DFIs had existing relationships. Hence, female-led funds and other intermediaries with gender-lens investing (GLI) strategies – often headed up by first-time fund managers – that had entered the pipeline of DFIs were now at the back of the queue.
3. As many DFIs themselves were under pressure from regulators and shareholders to control risk during the prevailing uncertainty, there was little flexibility and risk capacity for deal teams to pursue innovative investment approaches based on new data insights.

The legacy of DFIs and other development finance actors backing predominantly male-led fund and facility managers – who invested largely in male-led and gender-blind companies – meant that channeling Covid-19 responses through these relationships perpetuated gender gaps in capital allocation to both fund managers and businesses.

Beyond the few DFIs that intentionally worked with traditionally gender-blind intermediaries to design gender-smart Covid-19 response mechanisms (see box “Spotlight on DFIs’ gender-smart Covid-19 responses”), there was still a misconception that the traditional gender-blind approach was gender-neutral and that the Covid-19 response would reach SMEs and benefit community members equally. However, previous crises and data from investments in normal times indicate that a gender-blind approach perpetuates gender gaps and inequality. Therefore, an important lesson is to apply a gender lens across all investment activities, not only to a few niche projects.

THE NEXT FRONTIER OF GENDER-LENS INVESTING

The success of the 2X Challenge and the strong pipeline in 2020 evidences the success of DFIs in implementing GLI. In early 2021, the 2X Challenge DFIs and Dalberg conducted a detailed study on the key lessons of the 2X Challenge from 2018-2020. It revealed success in working with existing clients to identify gender-smart opportunities.

Thus there have been notable achievements in transforming traditionally gender-blind businesses and financial intermediaries into gender-smart ones across the 2X criteria. Yet the growing interest in GLI has not led to reflection on the investment strategies and criteria of DFIs, such as which investment approaches might have the greatest impact on ensuring access for female entrepreneurs and fund managers. This is important because apparently gender-neutral investment criteria can perpetuate historic inequalities. Transforming non-diverse businesses into diverse ones is thus much needed, but is not sufficient for an inclusive recovery and more resilient and equitable economies. Transformation must also extend to DFIs and their investment strategies.

GENDER-SMART INNOVATION: THE WAY FORWARD

Reflecting on the Covid crisis and the first three years of the 2X Challenge, 2X members identified inequalities and systemic barriers limiting capital from flowing towards gender-smart funds and diverse entrepreneurs, which require collective action.

The gender and diversity bias in capital allocation from private equity (PE), venture capital (VC) and private debt funds to businesses is well documented since before Covid. Women-led companies receive only 7% of PE and VC investments in emerging markets. In Africa, capital allocation is also skewed towards expatriate-run businesses. This gender and diversity gap is largely attributed to the 92% of investment decision-makers in emerging market PE and VC being homogenous and men. Still, fewer than 10% of traditional fund management firms have strategies to increase their numbers of female investment professionals.

GLOSSARY

Gender-blind is defined as "ignores gender norms, roles and relations". It is often constructed as "treating everyone the same" but often reinforces gender-based discrimination. An alternative term would be **gender-unaware**.

The next levels along the spectrum are **gender-sensitive** (considers gender norms, roles and relations), **gender-responsive** (considers gender norms in intentional project design for positive outcomes) and **gender-transformative** (intentionally transforms gender norms by addressing root causes).

Yet there is no lack of female-led PE, VC and debt funds. Over recent years, funds led by women and diverse teams have emerged with the very types of GLI strategies promoted by the 2X Challenge. Still, they have struggled to raise funds from DFIs as they are often first- time fund managers.

Also, in many developing-country markets, due to historic inequalities, women-led businesses are predominantly smaller and at an earlier stage of growth. As a result, DFIs' traditional investment criteria and risk assessment approaches put them at a disadvantage. The same is true for women-led funds and other capital vehicles focusing on the needs of women-led businesses, which tend to have smaller-size funds. If they were to meet DFIs' minimum fund-size requirements, they would lose their focus on underserved gender-smart SGBs.

Ensuring gender equality in allocating capital to fund managers and businesses is not only the right thing to do, but it also has a strong business case: PE and VC funds with gender-balanced leadership teams have a 20% higher net IRR than those with all-male investment managers. Research also reveals that although women-led businesses receive significantly less funding than their male-led counterparts, they make twice as much revenue per dollar invested.

There is also a strong impact case linked to investing in funds with gender-balanced management: female fund partners invest twice as much in female entrepreneurs and businesses that serve women consumers. Ensuring that there are more women investors in the ecosystem helps to fill the capital allocation gap to women entrepreneurs and gender-smart businesses, which can provide more quality jobs and opportunities for women and improve the quality and quantity of goods and services for women consumers.

Leveraging these lessons and insights, 2X members with strong participation from EDFIs spearheaded collective action and convened fund managers and fund investors from across emerging markets to co-create a scalable market-building solution in order to jointly overcome these systemic barriers (see box “2X Ignite: from lessons to action”).

2X Ignite: from lessons to action

Based on key learnings from the Covid-19 response and an evaluation of the first 3 years of the 2X Challenge, 2X member DFIs spearheaded a groundbreaking series of design sprints in 2021 to co-create an innovative solution together with more than 120 investment professionals, including pioneer fund managers, regional PE and VC associations, and LP (limited partners) investors across developing markets. EDFIs played a pivotal role in this endeavor. The design sprint concluded that the smartest way to unlock capital at scale for more resilient, climate-smart and inclusive economies is to invest in female-led/gender-balanced fund managers with gender lens investing strategies.

The outcome is 2X Ignite, a holistic market-building solution to unlock gender-smart capital at scale by accelerating 100 gender-smart fund managers/vehicles reaching 1,000+ gender-smart businesses across emerging markets over the coming years. 2X Ignite is an innovative facility combining capacity building, working capital and warehousing to accelerate the next generation of gender-smart fund managers, providing LPs with an investable pipeline of GLI funds. This highly scalable solution grounded in context-specific innovation aims to unleash the ripple effects of GLI towards the SDGs. Learn more: www.2XIgnite.org

THE WAY FORWARD FOR EDFIS: INNOVATIVE AND INCLUSIVE FINANCE

EDFIs and their peers have played a significant role in spearheading the 2X Challenge, demonstrating a robust pipeline of GLI opportunities during the pandemic. Their signaling role has attracted a broad range of investors to the GLI space, turning the challenges presented by the pandemic into opportunities. The targeted Covid-response by DFIs, on the other hand, has been predominantly gender blind, with notable exceptions.

Spotlight on DFIs' gender-smart Covid-19 responses

Despite the challenges and missed opportunities presented above, there are salient examples of gender-smart response strategies backed by EDFIs and their peers:

1. British International Investment (BII, formerly CDC Group), JICA, and DFC invested in BlueOrchard's *Covid-19 Emerging and Frontier Markets MSME Support Fund*. The fund adopted a gender-lens impact framework and targets 70% women end-borrowers. This example highlights leveraging existing relationships to design gender-smart solutions.
2. DFC and the Small Enterprise Assistance Fund (SEAF) created the SEAF *Global Gender Lens Emergency Loan Finance Facility* to provide emergency funding for SMEs that support women, and gender-smart business support services to mitigate the impact of Covid-19 on SMEs. This is an example of backing a GLI facility with high intentionality.
3. FMO supported the *Women's Enterprise Recovery Fund* to provide funding, TA, mentorship and digital solutions for female entrepreneurs. This example illustrates SDG 17 (partnerships) in action.
4. BII added a gender lens to all three pillars of its Covid-19 response strategy – *Preserve, Strengthen, Rebuild* – representing a good example of mainstreaming a gender lens across the business.
5. FinDev Canada and EIB backed Alitheia IDF, a pioneer female-led GLI fund and prime example of intentionality and innovation.

Going forward, persistent gender gaps and systemic barriers will require more innovative collective action to unleash the ripple effects of gender-lens investing. Lessons from missed opportunities offer a pathway out of the crisis. There is a role for EDFIs to play in unlocking gender-smart capital at scale by backing gender-diverse local capital providers with highly effective GLI strategies to support gender equitable SMEs and SGBs, themselves drivers of employment, innovation and inclusive prosperity.

DFIs can pursue this underserved market opportunity by purposely realigning their weighting of (actual and perceived) financial risk versus the tremendous societal and economic impact of backing more innovative and early-stage gender-smart funds and businesses. Overcoming systematic barriers and building more resilient and equitable economies requires a paradigm shift in development finance.