Investment for Development: the UK’s strategy towards development finance institutions new inquiry

Submission of Written Evidence from Agora Global

About us

Agora Global have been providing training, research, and advisory services in international development for the last five years and in different configurations across two decades. Our work is oriented to sustainable, large-scale impact through changing the systems which constrain development. We have worked with DFID, FCDO, and BII in different capacity across many years and we also work extensively with other donors and DFIs, giving us a perspective on the UK’s relative performance in relation to the subject of this enquiry.

Our mandate to improve development effectiveness leads to substantial investment in funding and carrying out research and advocacy activities with a view to improving development effectiveness, which is the motivation for this submission.

Our evidence

The UK government made a pivot towards aid as enlightened self-interest over the last five years which has been accompanied by a significant cut in aid spending in real terms. Aligned with this pivot, the role of investment in achieving development goals has become increasingly important. Investment can, in theory, achieve goals of sustainability through private sector involvement and is very attractive administratively in that the cost of disbursal (when compared with other development spending) is much lower while capital can be preserved. Money is ‘spent’ on an annual basis even when this capital is returned. All of this can be achieved at the same time as potentially having positive dividends on UK trade which is much more difficult to engineer if looking at problems from the ground up, as would be the case in more traditional ODA focused programming.

The purpose of our submission here is to highlight both the value of development finance in delivering on development objectives but also to highlight the risks in how this is currently being pursued.

To what extent is ‘access to capital’ a problem? If capital is the reason that a market isn’t working, then providing that capital can unlock that market and allow all of the developmental benefits that a more functional market brings. Suppliers of beneficial goods and services can grow and increase access to those goods and services. Employers can grow and create jobs. Firms can become more competitive, increase tax revenues and allow for social and inclusive investments. However, capital isn’t always a problem, is rarely the only problem, and the degree to which it is a problem varies widely.

What is the additionality of the capital? If the UK hopes to improve efficiency in achieving development impact by channelling additional funding to DFIs, then this is only case where access to concessional capital is a key issue. Results are often presented as though any impact from investment is because of the investment. In the majority of cases, the counterfactual is a firm taking investment with different conditions, at a higher rate, in a smaller amount, or in a couple of years' time, rather than no investment at all.

Can capital alone solve the many reasons why a market fails? The economies in which investee firms operate are part of complex systems. In more conventional ODA programmes, interventions can take many forms – financial support, technical assistance, research, advocacy, grants, loans etc. And these forms of support can happen in many different and related areas of an economy. The advantage this brings is that constraints beyond a firm – affecting firms that are similar in nature or even those which only affect one firm but are not within its control – can be addressed to make progress towards achieving ones development objectives more likely. Deploying these instruments can be slower and more expensive. Deploying £20m of ODA across five years in a technical assistance programme is far less attractive than a month or two of due diligence to invest the same money in a single firm with a good chance that you'll get the money back and make a return upon exit. However, the value for money in terms of additional impact is a lot higher when you are able to address constraints affecting multiple firms, taking account of the relationships between them, in a way that leverages the incentives for sustainable behaviour change amongst all stakeholder. In summary, as the proverb goes, with development finance when all you have is a hammer, every problem is a nail.

To make this concrete in some of the questions asked by the enquiry, we will consider using development finance as a mechanism to achieve development impact in areas such as climate or gender.

Why isn't uptake of off-grid solar products higher in Africa? A proposal might be received to supply patient capital to a provider of off-grid solar energy to help them scale more quickly. It may be that there is a risk or perceived risk that drives up the cost of borrowing or lower risk adjusted return beyond the appetite of commercial capital (leaving aside alternative sources of concessional capital). As such, BIIs investment may help their investee to accelerate scaling, increase uptake of off-grid solar, and contribute to climate objectives. However, examining the complexity of that system, one would see that there are many competing technologies and companies providing them introducing significant displacement through the investment. There are constraints way beyond capital which might prevent the impact from being realised – issues with import duty on components, skills deficits among installers, distribution networks, marketing strategies etc. The patient capital may be patiently waiting for nothing to happen. And so lean is the measurement system that underpins development finance that such displacements and lack of impact is often under-reported.

And climate is actually a relatively easy area where careful selection of private investments can positively contribute to a defined impact. When considering gender, the social and sometimes legal drivers of these development challenges can be far harder to address through targeted investment in a sustainable way.

In such cases, what tends to happen is a much less market driven and much more normative way of achieving development targets. A DFI will provide concessional debt finance to a financial institution on condition that a certain number of loan accounts are opened for women. Once the debt is repaid, without addressing the root cause of why women were not receiving equal access to credit in the first place, the financial institution will simply revert to type and the impact will be nullified. This

undermine the sustainability rationale for using investment as a tool and engaging the private sector in the first place.

In some cases, DFIs have made a token gesture towards addressing some of these issues by providing some technical assistance to firms. However, this is typically focused only on the profitability of that firm and does little to address the barriers to impact or the constraints affecting the sectors more broadly.

The Solution?

Investment is an important tool in the development armoury. It can be used to efficiently overcome constraints to risk capital and, due to these efficiencies, can bring to bear an amount of money and influence that can move markets. However, rigorous evaluation of impact finance reveals huge issues with displacement and raises significant doubt about additional impact. Sustainable targeting of different priorities for UK aid is challenging using development finance as the principal if not the only tool.

So how do we reap the benefits of development finance to maximise impact while minimising risk? We need to see development finance as one tool in a suite of options which need to be fully integrated. Sound analysis of the systems into which development finance might be placed seems a reasonable place to start. This helps to gauge where the development problems are and whether additional capital might help to overcome them. It will also help to understand what else needs to change in order for this investment to be truly catalytic. Catalysing that change will likely require the deployment of other tools – technical assistance, research etc – but that shouldn't be an excuse to lose the efficiencies gained in using investment as a tool. It should not make processes or budgets unmanageably cumbersome.

Agora have been employing a *Lean Systems* approach to development finance over the last few years and the results have been strong. We recommend that such a systems based approach is integrated into the UK's processes for development finance investment in order to maximise gains from this strategy.