A CALL TO ACTION | May 2022

Unlocking investments in fragile states

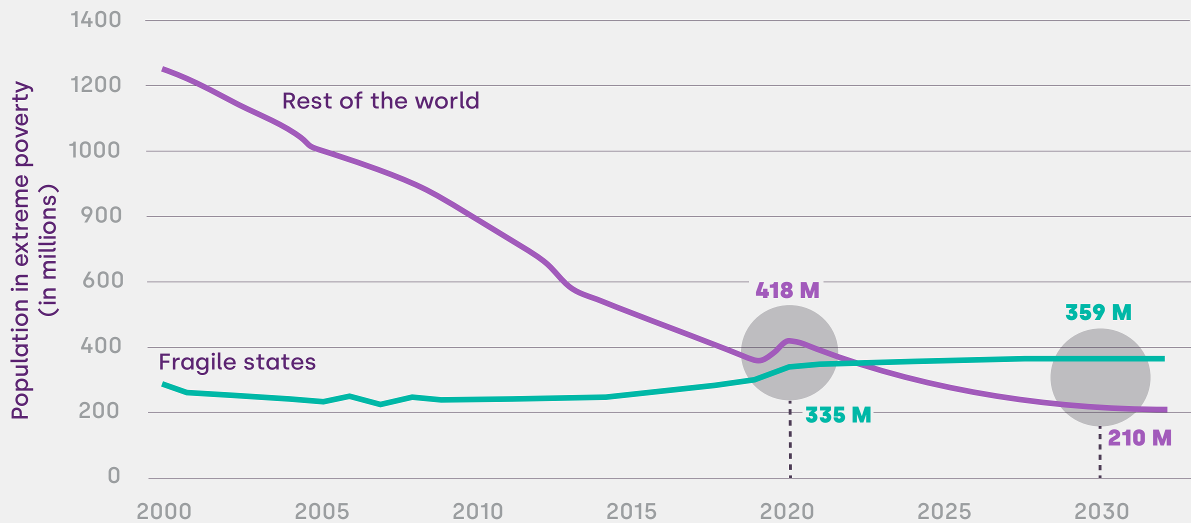
Despite steady gains in global poverty reduction over the last few decades, a growing portion of the world's poor are living in fragile and conflict-affected countries. It is estimated that by 2030, nearly 360 million people will live in extreme poverty in today's fragile states, representing 63 percent of the world's poor.

State fragility contributes to some of the biggest problems in our world today: extreme poverty, mass migration, terrorism, and trafficking.

Escaping fragility and achieving prosperity hinges on igniting economic growth in environments characterised by high risk and low capacity.

Fragile states are chronically short of dynamic, job-creating private sector firms, and are stuck in a low-productivity equilibrium. Development Finance Institutions (DFIs) have a critical role to play in financing and de-risking private investment in fragile contexts.

Council on State Fragility
State Fragility initiative



Why is this important?

In conflict-prone settings, the rapid expansion of decent and productive jobs enables a key peace dividend: ensuring that people benefit visibly from stability strengthens firms' and citizens' determination to resist division and violence and contributes to a more broad-based commitment to peace. Achieving this requires modern firms with dynamic supply chains that create productive jobs at scale, investments that can transform, energy access that is resilient, and digital economies that can link farmers and informal businesses to markets and finance. Investments in improved housing and urbanisation that enable healthy living can also be a stabilising factor.

Although DFIs and their shareholders have stated their desire to scale up their work in fragile contexts in their development policies and strategies, **there is a gap between aspiration and reality. The scope and vigour of DFI engagement and impact in fragile states remains limited and broadly unsatisfactory.** While official development assistance for fragile settings has grown over the past decade, transformative investments by DFIs in private sector firms with the potential to enable economic growth and create jobs in key sectors have been largely lacking, especially in the most fragile contexts.

To truly make a difference, DFIs need to invest more in fragile states, accept more risk, better target their investments, and do far more on the ground to help grow the private sector.

What are the key challenges?

Socio-economic, political, policy, and institutional challenges in fragile states have led to a chronically underdeveloped private sector and a limited supply of investable projects. There are obstacles and deterrents "upstream" of investments including armed conflict, corruption, widespread poverty, weak institutions, and absent regulatory frameworks. Combined with a lack of project preparation and development capacity in both the public and private sectors, this leads to smaller project sizes with higher overhead costs which current DFI structures and processes are not well-suited to address. This is further complicated by DFI Environmental, Social and Governance (ESG) standards that do not differentiate and accommodate the contextual challenges of investing in fragile contexts.

In addition to these external factors, however, **internal frameworks and constraints within DFIs limit their ability and willingness to deploy high risk-taking finance and mobilise critical resources** such as capital commitments, on-the-ground staff, and external resources for upstream activities and blended finance in fragile states. Incentives for DFI investment teams continue to emphasise the volume of deals signed rather than their development or peacebuilding potential, creating a strong individual bias towards engaging in countries with larger and easier markets. In addition, while shareholders and donors have been publicly calling for greater DFI investment in fragile contexts, they have often not backed these demands with adequate resources and unambiguous support for operational and financial risk-taking. Indeed, shareholders largely continue to require unrealistic risk-return thresholds and to place significant constraints on the use of concessional finance.

How can DFIs and their stakeholders make an impact?

Business as usual is no longer an option. To achieve the full potential of DFIs in unlocking economic growth in fragile states, the **Council on State Fragility urgently calls on**:

1. **DFIs** to significantly scale-up their resources and staff in fragile states, take higher risks, accept longer time horizons and lower returns for their investments, sharpen their peace and conflict lens, engage in upstream activities with other development partners, and collaborate better with other DFIs.

2. **DFI shareholders** to match their stated prioritisation of fragile states with the targets and risk thresholds they set for the DFIs, allow DFIs to adapt operational policies to fit fragile contexts, and stand behind the DFIs when challenges arise, as they inevitably will when operating in these environments with high risk and uncertainty.

3. **Governments in fragile states** to prioritise engagement with private investors, and implement effective regulation practices to create a conducive business environment and facilitate the flow of DFI and private investments.

4. **Private sector investors and operators** to scale-up their direct investments in fragile states and lend their expertise and business models to help DFIs and governments in fragile settings address high risks and operate in situations of radical uncertainty.

5. **NGOs and civil society groups** to play an active supporting role to ensure that investments can be scaled sustainably in fragile contexts, enabling more job creation, and increased standards of living.

What follows are measures that DFIs and their shareholding governments, private investors and firms, governments in fragile contexts, and civil society actors should take to make a real difference.

None of this is easy. We understand that it is always simpler for DFIs to invest in large projects rather than small ones, low risk areas rather than high risk ones, stable countries rather than fragile ones – but if we want to achieve any of the global sustainable development goals, it is essential that we turn this around.

DFIs

DFIs should acknowledge the significant mismatch between the rhetorical focus on fragile contexts in their strategies and the reality of their investment portfolios and act to close the gap. DFIs need to adjust their risk appetite to better match the requirements of working in fragile contexts by allocating more investment resources to these countries and accepting much higher risk thresholds as well as longer time horizons for the returns on their investments.

DFIs should introduce internal incentives that enable rather than penalise risk-taking and reward staff for bringing projects with development and stabilisation potential to fruition. Importantly, they need to radically increase their on-the-ground presence, strengthen their contextual understanding (including through conflict sensitivity and peacebuilding lenses), and introduce innovative structures to support diversified portfolios – such as first-loss buffers, funding pools with higher loss tolerance, streamlined instruments for political risk insurance and currency risk management, and innovative development and investment platforms.

Instead of pursuing investment opportunities on an *ad hoc* basis, DFIs need to consider strategic approaches and transformative investments in key sectors of the countries they work in. Transformative investments catalyse the whole system to re-arrange itself and thrive through imitation, knowledge transfer, capacity building, reduction in the price of intermediate inputs, and establishment of forward and backward linkages. Such investments enable the creation of clusters and webs of production. Examples include investments in the IT backbone that improve connectivity across the economy, energy investments that unlock inclusive energy access, or pioneering investments that have the potential to seed the knowledge and revolutionise an entire industry in the country.

Leveraging the collective strength of DFIs requires closer collaboration, especially at the country level. Establishing DFI country platforms to collaborate in fragile contexts can help DFIs in sharing knowledge, seeking advice, achieving strategic alignment, drawing on collective resources to raise in-country capacity, and agreeing on joint messaging to national governments, civil society, and the rest of the development community. In addition, country platforms can facilitate joint work on upstream activities and sharing of investment overhead costs – a key factor undermining profitability in fragile contexts.

Shareholding governments

To have more impact in fragile settings, **shareholders may need to increase capital allocations to DFIs, including through more concessional finance, that are predicated on stepped-up investments in these countries.**

Shareholders should calibrate risk-return thresholds, operational policies, and Key Performance Indicators (KPIs) to reflect the realities of investing in fragile contexts, particularly around returns, ESG compliance, and the need for resource-intensive and time-consuming engagement upstream to develop higher risk project pipelines.

Shareholders also need to reach a common understanding of how DFIs should collectively finance and implement upstream activities and project preparation, which are critical to generating investable opportunities. So far, DFI shareholders have almost exclusively authorised upstream resources for Multilateral Development Banks (MDBs) including the IFC and virtually none for smaller, bilateral DFIs. This has led to misalignments where some DFIs and MDBs can feel they are unfairly carrying a bigger share of the investment in a public good that all other DFIs benefit from, without necessarily being rewarded for it.

Governments in fragile settings

Governments in fragile settings have a key role to play in strengthening the business environment for private firms, both foreign and local, to operate and grow. Given the scale of policy and regulatory reforms often needed, governments in fragile settings are advised to prioritise simplicity and speed by replicating regulatory models, contract designs, and risk-sharing arrangements that have proven successful elsewhere. While minor adjustments can be made to reflect country-specific factors, building individual regulatory frameworks and project models for each country makes it more difficult for DFIs and private investors to engage effectively with investment opportunities in that country.

Private sector

DFIs and governments cannot achieve the impact they aspire for in fragile states without active private sector partners as investors and operators. Beyond direct co-investment with DFIs in fragile states, private equity and venture capital funds can lend their expertise and business models to help DFIs and governments in fragile settings address high risks and operate in situations of radical uncertainty which is an area these funds are accustomed to. International firms could identify opportunities for operations and knowledge transfer in fragile states but should ensure the adoption of a conflict-sensitive approach to avoid further destabilising the local economy, doing harm, or exacerbating conflict.

NGOs and civil society

Civil society groups should be partners in ensuring that investments can be scaled in fragile contexts, enabling more job creation and higher standards of living. Strengthening ties and developing collaborative relationships between DFIs and civil society groups is important for shared learning and better understanding of each other's aims and challenges, especially around ESG standards. NGOs and civil society groups can provide guidance to help ensure that private sector development does not aggravate tensions or conflict through skewed benefit distribution. They can also help DFIs and investors mitigate risks by highlighting social and political developments that may impact investments.

The **Council on State Fragility** brings together global leaders who are passionate about addressing the challenges of state fragility and supporting governments of fragile and conflict-affected states as they transition out of fragility. Eradicating extreme poverty and achieving global peace, stability, and prosperity is not feasible without realistic approaches to address the interlocking characteristics that define state fragility, and the Council aims to advance new ideas and evidence-based thinking to forge new approaches in this space.

The **State Fragility initiative (SFi)** serves as the Secretariat for the Council on State Fragility and is an International Growth Centre (IGC) initiative that aims to work with national, regional, and international actors to catalyse new thinking, develop more effective approaches to addressing state fragility, and support collaborative efforts to take emerging consensus into practice. SFi brings together robust evidence and practical insight to produce and promote actionable, policy-focused guidance in the following areas: state legitimacy, state effectiveness, private sector development, and conflict and security. SFi has financial support from the UK Foreign, Commonwealth, and Development Office (FCDO) and The Rockefeller Foundation.

www.theigc.org
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