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# **Financing fragile contexts: WHAT CAN DEVELOPMENT FINANCE INSTITUTIONS DO BETTER?**

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Fragility and conflicts prevent countries from achieving sustainable development goals. They cause a loss of lives and livelihoods, displacement of people, poverty and hunger, poor health and education services, and gender and income inequalities. Although official development assistance is the most critical source of external assistance used to support the economic recovery of fragile and conflict-affected countries (FCACs), development finance institutions (DFIs) are also increasingly committed to investing in fragile contexts. However, DFI operations are still more concentrated in politically stable middle-income countries, with minimal investments directed towards FCACs.

This paper looks at how development finance institutions engage in fragile and conflict-affected countries. It gives an overview of the structural features of FCACs and DFIs, zooms in on the main DFIs investing in FCACs and discusses the challenges DFIs face. We make a number of recommendations for development finance institutions on how to increase their investments in fragile and conflict-affected countries. For instance, they could take on specific mandates in FCACs, adopt conflict-sensitivity strategies, strengthen the use of blended finance approaches, exploit the potential of financial intermediaries, embrace the first-mover advantage, and support the building and rebuilding of markets.

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## Acronyms

AAAA	Addis Ababa Action Agenda
ACLED	Armed Conflict Location and Event Data
ACP	Africa, Caribbean and Pacific
ADB	Asian Development Bank
AfD	Action for Development
AFD	Agence Française de Développement
AfDB	African Development Bank
ARIA	Africa Resilience Investment Accelerator
BCG	Boston Consulting Group
BDB	Bilateral Development Bank
BIO	Belgian Investment Bank
BII	British Investment International
BMI-SBI	Belgian Corporation for International Investment
CASF	Central Africa SME Fund
CDC	Commonwealth Development Corporation
CDP/SIMEST	Cassa Depositi e Prestiti
COFIDES	Compañía Española de Financiación del Desarrollo
CPIA	Country Policy and Institutional Assessment
CSO	Civil society organisation
DFC	US International Development Finance Corporation
DFI	Development Finance Institution
DFID	British Department for International Development
DRC	Democratic Republic of Congo
EBRD	European Bank for Reconstruction and Development
ECA	European court of auditors
ECDPM	European Centre for Development Policy Management
EDFI	European Development Finance Institution
ESG	Environmental, Social and Governance
EFSD+	European Fund for Sustainable Development Plus
EIB	European Investment Bank
EU	European Union
FCAC	Fragile and conflict affected country
FDI	Foreign direct investment
FMO	Dutch entrepreneurial Development Bank
FSI	Fragile States Index
IBP	International business publications
G7	Group of Seven

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ICAI	Independent Commission for Aid Impact
IFC	International Financial Corporation
IGC	International Growth Centre
KfW/DEG	Kreditanstalt für Wiederaufbau/German Investment and Development Company
LIC	Low-income country
MDB	Multilateral development bank
MENA	Middle East and North Africa
MIC	Middle-income country
MSME	Micro, small and medium-sized enterprises
NDB	National development bank
NGO	Non-governmental organisation
ODA	Overseas Development Assistance
OECD	Development Assistance Committee
OPIC	Overseas Private Investment Corporation
<b>OOF</b>	Other official flows
<b>SDC</b>	Swiss Development Cooperation
SDG	Sustainable development goal
SME	Small and medium enterprises
Swedfund	Swedish Development Finance Institution
TDB	Trade and Development Bank
TSF	Transition Support Facility
UCDP	Uppsala Conflict Data Programme
UK	United Kingdom
UN	United Nations
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
US	United States
WB	World Bank
WHO	World Health Organisation

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## 1. Introduction

The Russian war in Ukraine and its international repercussions have put conflicts at the forefront of the global agenda. Its effects are far too familiar to many fragile and conflict-affected countries (FCACs), encompassing nearly one billion people. The negative ramifications of fragility and conflicts on the attainment of the Sustainable Development Goals (SDGs) are broadly well-recognised. Conflicts and fragility lead to the displacement of people, loss of lives and livelihoods, increase in poverty and hunger rates, poor health and education services, and widen gender and income inequalities. FCACs suffer from unstable macroeconomic conditions, weak institutions and governance, and a lack of infrastructure, with limited resources and capacities, hindering their ability to address their numerous challenges. Existing challenges such as climate change, food insecurity, pandemics like the recent COVID-19, and global inflation exacerbate fragility.

Currently, official development assistance (ODA) is the most critical source of external financing for FCACs. In 2018, ODA volume to extreme FCACs was 11.5 times that of foreign direct investment (FDI) and 2.5 times that of remittances (OECD 2020a). However, addressing the development needs of FCACs requires more than foreign aid. It also entails working with the private sector, whose potential in supporting the sustainable economic transformation of developing countries is spelt out clearly in the Addis Ababa Action Agenda (AAAA).

The private sector and private financial flows play a significant role in rebuilding and supporting the development of FCACs. While higher political instability and perceived risks deter international investors, the international community can complement domestic economic policy reforms. It can influence the adoption of macroeconomic policies that facilitate sustainable and inclusive socio-economic recovery, economic growth and job creation through a long-term and transformative engagement with FCACs (IMF 2022). Development finance institutions (DFIs) focus on supporting the development of the private sector in the poorest and most vulnerable countries, including FCACs. While their engagements are concentrated mainly in emerging capital markets of middle-income and lower-middle-income countries, the potential for their increased activities in low-income countries and FCACs has been stressed over and over in recent months and years.

The UN 2030 Agenda for Sustainable Development has emphasised the role of the private sector and economic actors in achieving the SDGs, including in poorer and more fragile and vulnerable countries. The development actors have also called on financial players (including DFIs) to pay greater attention to innovative finance by blending public development finance with private finance for increased development impact. Heeding this call, the European Union (EU) has engaged in reforms of its financial development architecture and put a greater focus on development finance, increasing blended finance and making a system of EU guarantees open to accredited (mainly European) DFIs through the European Fund for Sustainable Development Plus (EFSD+). In its conclusions on 10 June 2021, the Council of the EU stressed once more “the relevance of mobilising both the public and private sectors and of targeting investments where the needs are greatest and to the most vulnerable regions, notably the Least Developed Countries and countries in situation of fragility or affected by conflict”. This requires DFIs to mobilise additional finance to support projects in FCACs.

Multilateral development banks (MDBs) such as the World Bank Group – International Finance Corporation (IFC), European Investment Bank (EIB) and African Development Bank (AfDB) have led the way to deploy development finance approaches tailored to fragile and conflict-affected situations. Conflict-specific financial models are vital in Africa due to increasing insecurities. As Akinwumi Adesina, the President of the African Development Bank, put it: “insecurity situations and insurgencies now pose the biggest risks to Africa’s development. Yet, countries lack

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adequate resources to effectively tackle these challenges. If unaddressed quickly, insecurity will become a huge risk to our dream of an African Continental Free Trade Area. It is time to adapt our approach. [...] we must now link security to investment, growth and development.” (Adesina 2021).

This paper looks at the underlying factors that make investing in FCACs difficult. It analyses why DFIs invest less in FCACs despite their mandates and commitments to invest more in FCACs. More specifically, the paper sets out to answer the following questions:

1. What are FCACs, and what development challenges do they face?
2. What are DFIs, and how do they engage (their mandates and presence) in FCACs?
3. What are the challenges faced by FCACs in accessing development finance?
4. What are the challenges faced by DFIs in trying to invest in FCACs?
5. What recommendations can DFIs take to better support FCACs?

By answering these questions, the study aims to advise policy makers in the development finance arena on how to best support private sector development in FCACs.

The following section (Section 2) presents the definition of state fragility and what is meant by conflict-affected countries. Section 3 focuses on the financial landscape, discussing what DFIs are, their mandates, and how their operations align with their owner’s wishes. Section 4 identifies the main challenges of investing in FCACs, while Section 5 presents the recommendations that DFIs can adopt to address these challenges and boost their financing of FCACs.

## 2. Fragile and conflict-affected countries: common political and economic features

### 2.1. State fragility

**Although commonly used, 'state fragility' does not have a clear definition. It is often associated with the state's capacity (or incapability) to deliver core functions such as security and essential public services.** Indeed, different organisations describe state fragility differently. However, the conceptualisations of the World Bank and the OECD are leading in describing state fragility. The OECD characterises fragility "as the combination of exposure to risk and insufficient coping capacity of the state, systems and/or communities to manage, absorb or mitigate those risks" (OECD 2020a). The OECD assesses fragility along five dimensions: political fragility, environmental, social, economic, and human capital. Human capital will be added as a sixth dimension in the next State of Fragility report which will come out later in 2022 (OECD 2020a). The World Bank on the other hand, defines fragile countries as those that have weak institutions and policy environments or the presence of a UN peacekeeping operation, forced displacement of people across borders at a rate of 2000 or more per 100,000 (WB 2021b).

This concept is, however, not without critique. Western or Weberian definitions of statehood and how states ought to perform shape these assessments of state performance (McCloughlin and Idris 2016). Further, institutional and policy weakness assessment by the World Bank, for example, is based on its Country Policy and Institutional Assessment (CPIA), which relies on the views and perceptions of country experts, in the absence of data. It was never set up for this purpose but has become a proxy indicator of fragility (Woolcock 2014). Given the difficulty of defining state fragility, different agencies and organisations have tried to develop the concept of fragility further by adding other factors, such as the state's willingness (not just ability) to deliver on development and the needs of citizens or the state's political legitimacy fragility (Torres and Anderson 2004).

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There is also debate on the binary categorisation of states as fragile and not fragile, as state fragility is not static. Conditions of fragility can occur even in stable and functioning states. For example, the US had a yearly worsening score in the Fragile States Index in 2021 due to police brutality, protests and the pandemic that contributed to the steepest economic contraction in the last 60 years of its economic history (FFP 2021). **In due recognition of the fact that state fragility occurs in a spectrum, there is now a growing reference to ‘conditions of fragility’ among donors and development agencies** (McCloughlin and Idris 2016). The OECD has already abandoned referring to states in binary as fragile or non-fragile by introducing the concept of ‘fragility to resilience.’

## 2.2. Conflict-affected countries

**The definition of conflict-affected countries is also not straightforward. However, the concept revolves around the intensity of violence a country experiences, as may be measured by battle deaths** based on, for instance, data collected by the Armed Conflict Location and Event Data Project (ACLED) and the Uppsala Conflict Data Programme (UCDP).

The World Bank (N.d.) also assesses conflict in two categories. **Firstly, there is a high-intensity conflict state with:**

1. an absolute number of conflict deaths above 250 according to ACLED<sup>1</sup> and 150 according to UCDP<sup>2</sup> and
2. a number of conflict deaths relative to the population above 10 per 100,000 according to both ACLED and UCDP, which reflects how widespread intense violence is across a country.

**Secondly, there is a medium-intensity conflict state with:**

1. an absolute number of conflict deaths above 250 according to ACLED and 150 according to UCDP;<sup>3</sup> and between 2 and 10 per 100,000 population according to ACLED and between 1 and 10 according to UCDP; and
2. countries with a rapid deterioration of the security situation, as measured by (a) an absolute number of conflict deaths above 250 according to ACLED and 150 according to UCDP; (b) a lower number of conflict deaths relative to the population between 1 and 2 (ACLED) and 0.5 and 1 (UCDP); and (c) more than a doubling of the number of casualties in the last year.

**The nature of conflict and its causes and impact varies across countries. Beyond the exact measure of battle deaths, a country can be at different phases of the conflict cycle. It can have an ongoing conflict, be emerging from conflict, be on the path to recovery or with a history of conflict. The intensity and phase of a conflict are vital because they determine what economic and peacebuilding interventions are needed.** For example, a country undergoing a full-scale armed conflict – widespread or localised, will need a ceasefire or a level of stabilisation before it pursues an economic recovery programme. On the other hand, a country emerging from such conflict or war and has achieved a level of political settlement would need finance for reform and reconstruction, while disarmament, reconciliation and trust-building interventions are conducted in parallel to mend the social fabric.

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<sup>1</sup> See Acled.

<sup>2</sup> See Armed Conflict Location and Event Data project, and also Uppsala Conflict Data programme

<sup>3</sup> Uppsala Conflict Data programme.

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## 2.3. The relationship between fragility and conflict

**There is a very close connection between state fragility and conflict in that intense and pervasive conflict could undermine the state's ability to perform its duties, which is a key aspect of assessing a state's capacity or fragility.** Medium intensity conflict sustained over a long period takes away from a state's ability to deliver on economic goals at the local (in areas closely affected by conflict) and national levels. Populations that are particularly affected by these conflicts are more disenfranchised as the state is unable or unwilling to deliver services. This further compounds popular grievances against the state, opens the ground for challenging the state's authority and can compound drivers of violent conflict. This sets in motion a vicious cycle in which state fragility or the state's inability to govern can trigger violent conflict while violent conflict further undermines the state's ability to perform its core mandates. The insecurity in northern Nigeria is a case in point, where years of state neglect coupled with violent repression have contributed to the emergence of the Boko Haram movement and the growing level of insecurity in the north-eastern part of Nigeria. This has in turn undermined the public's trust in the state.

**But the relationship between conflict and state fragility is not direct. A country can be conflict-affected while continuing to perform its core function and maintaining strong state capacity to govern.** This is the case with Morocco and its conflict with the Sahrawi People's Liberation Army over the independence of the Sahrawi republic, which Morocco considers part of its sovereign territory (Stewart and Brown 2010).

**Therefore, to analyse a country's vulnerabilities – and hence its investment potential - one needs to go beyond the binary categorisation of 'conflict-affected state' or 'non-conflict-affected state'.** The kind of conflict, its geographic scope, its intensity, the state's (in)ability to manage conflict as well as its presence and (in)ability to perform its core functions should inform the assessment of the support both the state and the private sector need to overcome challenges. DFIs willing to support investment in fragile and conflict-affected countries should therefore perform or rely on specific assessments that characterise the state of fragility and conflict situation in the environment where they will undertake investments.

## 2.4. The private sector in conflict affected countries

The nature of conflict and its causes and impact varies across countries, but FCACs share some key characteristics: **businesses are usually smaller in size, the informal economy is big particularly in the agricultural and service sectors, and the manufacturing sector suffers the most in times of insecurity and crisis (IFC 2019).**

This is because, when state fragility and conflict are intertwined, **regulatory frameworks could be inexistent, broken or cumbersome disincentivising large scale and formal business investments.** For some businesses, lack of hard or soft infrastructure (financial markets, skills, innovation etc) in FCAC are barriers for larger investments. If physical security and property rights cannot be guaranteed, and the whole of the economy (consumption, government spending and FDI) are all hampered by conflict, then large investments become risky.

**In the absence of legal enforcement and other incentives, the informal economy expands as it offers fewer barriers to entry for the self-employed and micro level businesses.** While this is valuable and even necessary for the continuation of people's day to day life under conflict, it has implications on the role of the government in post conflict settings. Most countries that are emerging out of conflict and re-establishing state presence struggle to formalise the economy to generate state revenue. They also cannot easily reclaim traditional state functions such as security and service provision (e.g. health care, education, financial services (regulation), rule of law etc.) from the private sector which had stepped in to provide these services in their absence. A good example of this is Somalia where private security agencies have been providing security services to NGOs and businesses during the two



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decades of war. The political economy dynamics of this market is one of the challenges behind the slow progress in national security sector reform in the country (Menkhaus 2016).

**The other side of the post conflict phase is the recalibration of the economy – the service and construction sectors in particular – due to aid and diaspora engagement. To achieve sustainable economic progress, however, countries need to boost their productive sectors such as agriculture and manufacturing.** And that is where targeted support to the private sector becomes an important contribution to not only a country's recovery and resilience but also the durability of peace. Poor economic prospects, large scale unemployment and severe socio-economic crises undermine political settlements and peace deals that were struck to end violent conflict. This explains for example why in the aftermath of a negotiated deal between the Sudanese civilian and military leadership in 2019, financial pledges (grants and loans) and reintegration of Sudan into the international market through the suspension of US sanctions were seen as necessary conditions to nurture the fragile peace achieved through political negotiations (Crisis Group 2020).

In due recognition of the economics behind political settlements, the international community has increased its focus on engaging the private sector in the economic recovery, poverty reduction and peacebuilding programmes of FCACs. This is reflected in key global policy frameworks such as the New Deal for Engagement in the Fragile States (International Dialogue on Peacebuilding and Statebuilding 2011) and the seminal UN – World Bank study Pathways for Peace (WB 2018).

The private sector, including micro-, small- and medium-sized enterprises, provides the majority of the employment opportunities in FCACs. Jobs are a source of livelihood and help create a sense of belongingness in one's community. The private sector can also be instrumental in targeted stabilisation efforts such as the employment of former combatants. In addition, formal private sector businesses contribute to domestic resource mobilisation through taxation, which further enhances the state's ability to invest in public goods. Governments of FCACs can use such revenues effectively to improve state-society relations by providing the essential services (e.g. security, education and health services) that is expected of them

**The call for greater involvement of the private sector in poverty alleviation, post-conflict reconstruction and sustaining peace however, has normative underpinnings.** There are critical debates on retaining the role of the state as the primary duty bearer for security and essential social services. The state and elected governments should thus not absolve themselves of this responsibility in favour of business and profit-seeking entities, which are not directly accountable to citizens (Abshagen et al. 2018). Moreover, while a state's ability to deliver security and public services is key to its popular legitimacy which strengthens the state's ability to govern, it should not lead to the assumption that good economic performance – brought about by private sector engagement or government interventions – leads to state legitimacy. Research shows that 'legitimacy of process' – *how* the state delivers on its core functions, the quality and type of service it delivers, the state's political representativeness and its ability to uphold societal values influence people's view of the state's legitimacy (McCloughlin 2014; McCullough 2014; Cummings and Paude 2019).

**Moreover, while it can be a substantial positive contributor, the private sector should not be assumed to be an always-positive actor in FCACs.** It can also be part of the conflict system, supporting one conflict actor or another and directly benefiting from the conflict. There are ample examples of businesses profiteering from violent conflict or acting as barriers to change to defend business interests. Such is true of private sector businesses engaged in combat-related sectors, such as arms sales. It is also the case with private sector businesses in other sectors where status quo or one conflicting party highly influences political and economic interests. Some of the globally exposed scandals here, include the complicity of Shell in government repression of resistance in the oil-producing region of

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Ogoniland in Nigeria in the 1990s. De Beers also sourced diamonds from rebel-held areas in Sierra Leone, Angola, and the Democratic Republic of Congo (Nelson 2000; Amnesty International 2017). Therefore, if not understood on a case-by-case basis, some private sector actors could exacerbate existing power imbalances and violent conflict dynamics (Collier et al. 2021; Shiferaw 2020).

For this reason, donors and DFIs should be well aware of the domestic political economy of conflicts and the vested interests at stake. While donors are developing various due diligence frameworks – such as OECD Due Diligence Guidance for Responsible Business Conduct adopted in 2018 – the need for conflict analysis and (sectoral) political economy analyses cannot be overstated.

## 2.5. COVID-19 and fragile and conflict-affected countries

The COVID-19 pandemic has threatened global stability, including in the Global North, particularly the US and European countries, which had otherwise enjoyed the benefits of sound economies and governments. The pandemic has further deepened economic and political fragility of countries in the Global South, some of which were already operating on shaky grounds. The consequences of COVID-19 in FCACs are dire. **The OECD estimates that the pandemic pushed 60 million people into extreme poverty in 2020 alone, 43% (26 million) of whom live in FCACs (OECD 2020a).** In addition, the World Bank estimates that by 2030, 85% (342 million people) of the World's extreme poor will be from fragile contexts (World Bank 2019).

**While the pandemic has had a compounded effect on an already grim picture of poverty and fragility, it is not yet clear if there is a causal relationship between COVID-19 and conflict trends** (Desmidt and Neat 2020; Neat and Desmidt 2021). But there are anecdotal instances where COVID-19 related measures have contributed to existing fragilities. For example, in Ethiopia, the postponement of elections due to COVID-19 led to a constitutional crisis, which compounded long standing political tensions and contributed to violent conflict. In other countries such as South Africa, Nigeria, Canada, US, Netherlands, France, Germany, protests and violent confrontations with security forces arose due to strict COVID-19 health and security measures and resulting socio-economic grievances.<sup>4</sup>

Most developed countries have managed to invest in rebooting their economies through significant public investment (e.g. the European Recovery plan and its Recovery and Resilience Facility). **However, the public sector of FCACs has limited fiscal space to solve the existing health and socio-economic challenges resulting from the COVID-19 pandemic while also supporting the private sector.** At the same time, the private sector in FCACs, which could bridge this gap, has also been more adversely affected by the pandemic. Both sectors would need to be more effectively supported by development partners, including DFIs, to help expedite COVID-19 recovery in FCACs and prevent sharper regression on the SDGs.

## 3. Development finance and fragile and conflict-affected countries

Broadly, low-income countries (LICs) have higher credit availability gaps than any other country-income group. In limited cases where credit is available, individuals and businesses struggle to access it, and this is worse in LICs that double as FCACs – 51% of FCACs are also LICs (WHO 2017). This is mainly because of the political fragility in these countries, characterised by insecurities, weak governance, poor administrative capacity, underperforming private institutions, greater unemployment levels, tenacious social tensions, and humanitarian crises. FCACs equally have

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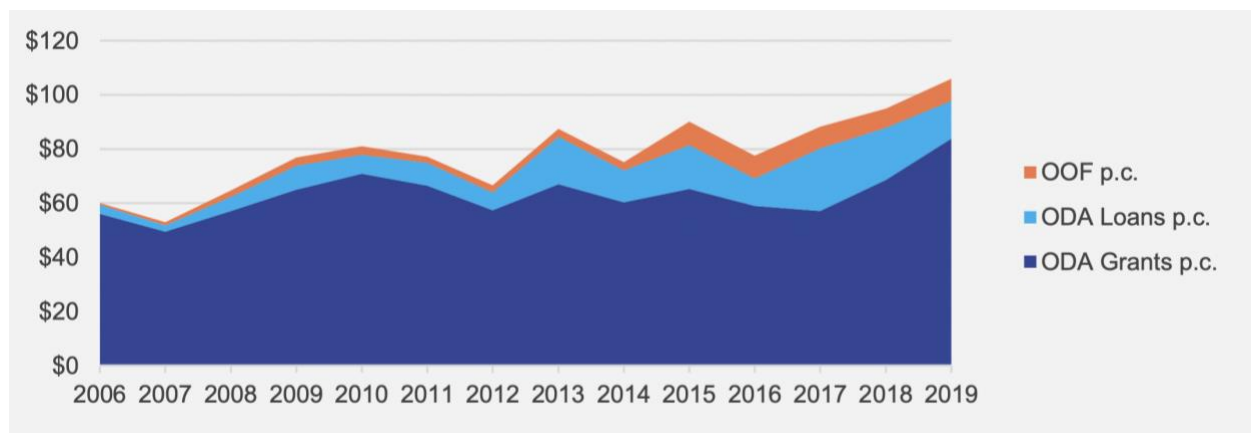
<sup>4</sup> See <https://www.euronews.com/tag/protest>.

weak fiscal regimes that undermine the business environment, increase economic uncertainty, discourage domestic financing of the private sector, and expose individuals or households to poverty (Hameed and Mixon 2013).

Roughly 76.5% of the extremely poor in the world dwell in fragile environments, and this proportion was projected to increase to 85% by 2020 (WB 2019; Collier et al. 2021). The actual number could be higher following the COVID-19 pandemic that has intensified conflict and fragility. Legacies of poor governance, as demonstrated by poor quality infrastructure, arbitrary regulatory frameworks and feeble economic conditions, continue to limit the growth of the private sector that could partially address the poverty problem. Governments of FCACs usually and highly rely on external financial assistance to address socio-economic challenges affecting the private and public sectors.

Foreign aid has, for so long, been deemed as the most crucial source of financing that befits the investment climate and nature of FCACs. **Unlike other official flows (OOFs) like blended finance and export credits, FCACs highly depend on grants and concessional loans (ODA loans), as presented in Figure 1.** Figure 1 also illustrates that although OOFs are slowly becoming an additional source of external finance, their potential remains arguably largely untapped.

Figure 1: Official financial flows commitments per capita to FCACs (US\$ at 2019 prices)



Source: WB (2021).

**There is a recent notable paradigm shift in the international development practice field with a realisation that poverty reduction and economic transformation, even in fragile situations, cannot be achieved through ODA alone.** Despite this paradigm shift, ODA remains the largest source of external financing for FCACs (US\$76 billion in 2018). In extreme FCACs, ODA far surpasses Foreign Direct Investments (FDIs) – by 11.5 times and remittance flows – by 2.5 times. In moderate conflict situations, ODA is 2.3 times the level of FDI and two-thirds of the remittance's flows (OECD 2020a).

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A large share of ODA goes to the public sector, yet surmountable challenges that LICs and FCACs face cannot be tackled solely by the public sector. About 95% of the jobs created in fragile contexts tend to come from the private sector (WB 2014). More public development actors acknowledge the role of financial and technical assistance in spearheading private sector development and facilitating economic recovery and transformation of FCACs. **Yet, this increasing recognition of the importance of development finance as either a sustainable alternative or complement to ODA needs to translate into practical investments on the ground**, with increased development engagement of all the necessary development actors.

**Investing in FCACS generally requires a dedicated approach and focus. It necessitates an understanding of existing investment risks and the conflict trends and dynamics to ensure that DFIs do not cause any harm or exacerbate conflicts.** Development actors and investors do generally conduct a risk assessment, focusing on the feasibility and viability of their investments within the given physical, environmental, social, and financial context of FCACs. But they need to complement this assessment with a conflict sensitivity analysis, to understand how their investments and the actors they work with affect conflict dynamics. Conflict sensitivity analysis and mitigation strategies also include reflections on what should be done: to avoid doing any harm – at the minimum; or to promote investment that can optimise peacebuilding objectives. Although the need to consider how their operations interact with conflict has become more explicit now, only a few DFIs have adopted conflict sensitivity approaches, as this paper will discuss later.

### 3.1. Development finance institutions and fragile and conflict-affected situations

Current evidence suggests that extreme FCACs countries are lagging far behind in achieving SDGs. Their progress towards reducing poverty, hunger and gender inequality, and improving the quality of education, health, innovation, sustainable cities, and justice, among others, had reduced even before the COVID-19 pandemic hit (OECD 2020a). With only eight years left to achieve the SDGs, the role of DFIs in supporting fragile contexts is more important than ever.

**Development finance institutions (DFIs), as specialised development banks or subsidiaries, are dedicated to supporting private sector development in developing countries.** Over the years, they have invested more and more in building the private sector of the Global South. Globally, their annual financing increased from US\$12 billion in 2000 to about US\$90 billion in 2020 (BCG 2020; Runde and Milner 2019). DFIs can be national (bilateral) or international (multilateral). Whether multilateral development banks (MDBs) or national/bilateral development banks (NDBs), DFIs are increasingly focusing on addressing the policy concerns of the fragile situations, supporting the development of their underdeveloped financial markets, and promoting access to credit by the private sector (IFC 2019).

**The development mandates of most, if not all DFIs, have some degree of focus on fostering private sector development in FCACs.** Such a common objective has provided a foundation for several DFIs to collaborate<sup>5</sup>, for example, under the Africa Resilience Investment Accelerator (ARIA) for the African region. DFIs can, at times, also partner with other players (e.g. domestic financial institutions, diaspora investors, foreign direct investors, and impact funders) to leverage additional finance for FCACs. **Partnerships allow DFIs to share risks, knowledge and expertise; and use blended finance facilities to reach the most extreme FCACs** (AfDB 2020; BII 2021). Collaborations with the right intentions indeed exist. The big challenge is making such partnerships functional to have tangible value addition on the ground.

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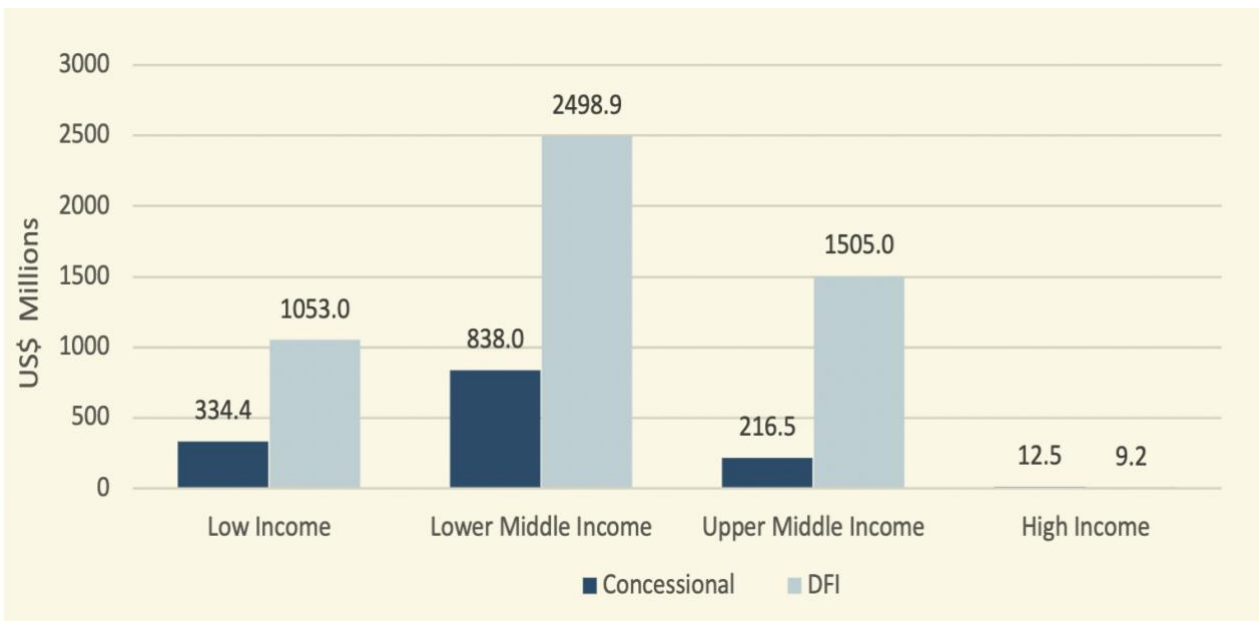
<sup>5</sup> See DFI Fragility Forum (ICG).

Regarding the individual operations of each DFI, only a few are explicitly committing to mobilising private finance in fragile situations (OECD 2020b). Investors, and at times, DFIs, commonly perceive that the FCACs have no private sector. The political instability and a weakened rule of law negatively affect the quality of institutions in FCACs and the proper functioning of the private sector, making it hard for DFIs to find bankable projects. Nonetheless, the private sector still plays a crucial role in meeting the everyday needs of residents in FCACs. It is true that the effects of fragility make the private sector in FCACs fluid and ineffectively formalised, but a lack of the necessary financial resources worsens their already weak status.

In FCACs, where DFIs acknowledge the presence of the private sector, they assess it as highly risky. This discourages them from prioritising it, leaving it underfunded and increasing its financing gap. While complete data on the financing gap in FCACs is missing, BCG (2020) estimates that the humanitarian and resilience investing gap alone (including from a private sector context) is US\$27.8 billion. The COVID-19 pandemic, which has undermined development in stable and unstable countries alike, could have increased this gap and pushed many people into poverty.

**The other irony is that DFIs tend to aim at supporting low-income countries (about 20 of which double as FCACs countries)<sup>6</sup>. Yet a large percentage of their concessional blended finance and own account commitments are invested in more promising emerging markets, usually politically stable middle-income countries (MICs), as presented in Figure 2.** Among the fragile country recipients, DFIs also invest highly in MICs, especially in Kenya and Nigeria (Kenny et al. 2018). MICs are generally attractive for DFIs to invest in as they have relatively more developed financial markets and better governance (even amid fragility). They also have more diverse bankable projects which can attract long-term investments. However, biased investments in these countries are contrary to the objective of DFIs, which aims at supporting the most in-need countries and groups of people.

Figure 2: Concessional and DFI new commitment by country income in 2019



Source: DFI Working Group 2021

<sup>6</sup> See FY22 List of Fragile and Conflict-affected Situations.

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There is a general need to ensure that DFIs do not divert from their financing objectives of supporting the most vulnerable states with high poverty rates and underdeveloped financial markets, which cannot meet private capital needs. In scenarios like these, DFIs complement domestic financial operations and ensure that they avoid crowding out the private sector financial institutions. DFIs usually provide concessional loans with low or no interest rates and, at times, they provide grants. **Maintaining this business model requires DFIs to receive incentives such as debt and equity financing subsidies, sovereign guarantees, tax exemptions, and technical assistance.** Such incentives, which can be from international and local actors, empower DFIs to invest in high-risk projects and high-risk regions, fragile situations inclusive, enabling them to bridge the financing gap that local financial institutions often leave (Giordano and Ruiters 2016).

### 3.2. Main development finance institutions in fragile and conflict-affected countries

The development designs of most DFIs require them to invest in the private sector of FCACs. However, their levels of prioritisation of FCACs vary greatly. Determining which DFIs invest more than others in FCACs depends on the variables (dollar value units or share of the total portfolio) under consideration. **While some DFIs (especially multilaterals) invest more by dollar amount, others (especially bilaterals) invest more by the proportion of their portfolio. However, these assessments come with an overall challenge of limited transparency on the aggregated amounts by financial instrument type and sector.** Therefore, getting a precise overview of the operations of DFIs in FCACs is difficult. The outlook below relies on desk review to cite some examples of DFIs, which actively engage in FCACs regardless of the financial instruments used and the sectors.

#### 3.2.1. Main multilateral development banks in fragile contexts

**The International Finance Corporation (IFC)** – a member of the World Bank Group, strategically prioritises investing in FCACs, and its investments in these situations have more than doubled in the last ten years (IFC 2019).

**IFC leads as the largest financier of the private sector of FCACs, investing more than all the European DFIs combined (Kenny et al. 2018).** In 2016, 15 largest DFIs invested US\$1.3 billion in the private sector of FCACs, about a third of which was from the IFC (IFC 2019). From 2019 to 2021, IFC invested US\$ 7.8 billion in FCACs, US\$2.8 billion of which is from its own – account (IFC N.d.). The IFC has further committed to increasing its share of financing dedicated to LICs and FCACs from 10% to about 15 – 20% by 2030 (WB 2019). However, it is important to note that, although the investments of IFC are high by US\$, other DFIs (e.g. CDC Group, now the British Investment International (BII)) invest a large proportion of their portfolio in LICs and FCACs.

IFC has also been able to use its position as one of the largest investors to build strategic partnerships with other multilateral (e.g. the European Investment Bank (EIB) and African Development Bank (AfDB)) and bilateral DFIs (e.g. Proparco – an affiliate of the Agence Française de Développement, the Dutch Development Bank (FMO) and Belgian Investment Company (BIO)). These partnerships have helped IFC to mobilise additional finance and share risks via the different co-financing instruments while exploiting the expertise of various DFIs. To promote its cooperation with financial institutions within the FCACs, the IFC has, for instance, also established the Small Loan Guarantee scheme, which provides a risk-sharing platform for local financial intermediaries to invest in small businesses (DFI Working Group 2019).

IFC is able to assess how its investments influence conflict. It has developed a conflict-sensitive approach (IFC N.d.b.), which it uses to “identify and navigate the complex working of FCACs with their associated commonplace risks and dangers which are rarely obvious.” In this ex-ante analysis, IFC uses its own-unique methodology to conduct a

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conflict sensitivity analysis to know where to invest and how. However, not all DFIs have the capacity to carry this out. Others rely on either outsourced external short-term consultants or conflict-prevention NGOs to assess the dynamics of conflicts in fragile states in which their operations take place.

**The European Investment Bank (EIB)**, the European Union (EU) bank, delivers on the EU external development policies, providing financial support to countries that need it the most but have the most difficulties accessing it.

**The EIB intends to use its activities in FCACs to lower investment risks, prevent conflict aggravation, and support the prevention of and recovery from conflict.** It has invested €6.8 billion in fragile regions across 116 operations since 2012 (EIB 2018b). Following the pandemic in 2020, the EIB also took more decisive steps, increasing the share of its smaller, higher-impact and riskier investments in developing countries to 76% of its financing, investing about €1.7 billion in FCACs (EIB 2021). The EU bank also supports micro-, small- and medium-sized enterprises (MSMEs) in fragile contexts within Africa. It signed a 12-year €81.5 million initiative in 2021 with the Eastern and Southern African Trade and Development Bank (TDB) to support entrepreneurs and businesses operating in fragile situations and expects this to leverage €163 million in investment (EIB 2021a).

**The EIB has further pledged to provide climate finance to FCACs to support their resilience to climate change and protect individuals from the risks of displacement (e.g. through building disaster preparedness and early warning systems) and future shocks (Ahairwe 2021).** EIB's commitment to supporting climate change and energy infrastructure projects in FCACs aligns well with its new transition to becoming a 'Climate Bank.' It also positions the bank to help FCACs that greatly need energy infrastructure. Eight out of ten individuals without access to electricity dwell in fragile states (IGC 2021). Investing in the necessary energy infrastructure projects can help spur entrepreneurship and business development in FCACs and address the compounding poverty problems, which go hand in hand with worsening conflicts and fragility.

Like IFC, the EIB has developed a conflict sensitivity approach, defining conflict sensitivity as an “explicit awareness of the operational, institutional and contextual risks related to violent conflict” (EIB 2020). EIB employs its conflict sensitivity approach to (1) reduce the risk of the conflict and fragility derailing the project, (2) avoid the risk of conflict exacerbation by the project, and (3) contribute to conflict prevention and peacebuilding efforts through its investments (EIB 2018a, 2020). Generally, the EIB aspires to flag and understand risks in fragile contexts while taking appropriate measures to mitigate them through suitable project designs and implementation measures. It has also set up a conflict sensitivity help desk to better understand the conflict and fragility issues that may arise concerning its investments and take the necessary steps to address them while promoting sustainable peace in developing countries.

**The Africa Development Bank (AfDB)** has a long history of supporting FCACs. It was one of the first multilateral organisations<sup>7</sup> to promote and institutionalise the fragility agenda in its business model in 2001. The AfDB established a Transition Support Facility (TSF)<sup>8</sup> in 2008 to provide: (1) supplementary resources for national, regional and private sector operations, (2) resources for arrears-clearance to support FCACs to access debt relief and improve their international community relations, and (3) critical capacity building interventions and technical assistance.

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<sup>7</sup> See AfDB Fragility & Resilience.

<sup>8</sup> See About the Facility.



Through its TSF, the AfDB has mobilised so far a total of UA 3.7 billion (equivalent to US\$ 2.74 billion) of additional finance<sup>9</sup> to address fragility and transition in low-income countries. In its 2022-2026 strategy for addressing fragility and building resilience, the AfDB plans to, inter alia, support the strengthening of private sector development in fragile situations and increase the use of lending and non-lending tools (AfDB 2022).

### 3.2.2. Main bilateral development banks in fragile contexts

Bilateral Development Banks (BDBs) also invest in FCACs. They mostly deliver on foreign development and cooperation policies, as mandated by their national governments, and aim at supporting in the most challenging and risky environments where other investors may not. Their target usually includes countries with weaker governance, enforcement mechanisms, and few private-sector jobs (Attridge et al. 2019). Within the EU, for example, members of the European Development Finance Institutions (EDFI) – such as Dutch entrepreneurial development bank (FMO), British International Investment (BII), DEG -Kreditanstalt für Wiederaufbau (KfW), Proparco – Agence Française de Développement (AFD) and SwedFund are active within FCACs.

Even though it is no small challenge, the European DFIs are committed to investing more in fragile, conflict-affected and vulnerable countries, and this is no small challenge (Wenn 2021; Fleury 2020). **EDFI has just launched a new EDFI MSME Guarantee programme of €80 million under the newly adopted EU EFSD+ Guarantee and hopes to mobilise €200 million in private finance for MSMEs within LDCs and fragile countries (EDFI 2022).** However, EDFI is yet to take a dedicated approach to ensure that MSMEs in FCACs will not remain marginalised in this scheme.

**Members of EDFI are also independently investing in FCACs. Under the MASSIF fund, FMO has supported various countries experiencing fragility and conflict.**<sup>10</sup> Together with IFC (US\$12.5million) and Lundin Foundation (US\$ 1.5million), FMO has contributed US\$5 million to the Central Africa SME Fund (CASF) (FMO N.d.) private equity fund to support SMEs and job growth in the conflict-affected Democratic Republic of Congo. Under MASSIF, FMO has partnered with the United Nations Capital Development Fund (UNCDF)(FMO 2020) to provide technical assistance and financial support to SMEs in the Democratic Republic of Congo and Sierra Leone; supported women and young entrepreneurs in Jordan (FMO 2017); and improved food security in Yemen (FMO 2021).

**Additionally, KfW has established a peace, conflict and fragility portfolio of about €19.0 billion (KfW N.d.). It invests in the private sector development of FCACs through a resilience-strengthening approach to build the capacity of individuals and institutions that can encourage peaceful living (KfW 2020).** The BII also prioritises fragile countries, as highlighted in its Strategic framework for 2017–2021, where it contributed 41% as the share of its post-2012 portfolio by 2016 (CDC 2016). Compared to other leading DFIs, **BII seems to be investing a much higher proportion of its investment – 43% in FCACs, with Proparco featuring as second best – 28% (ICAI 2019).**

AFD also invests highly in fragile states, focusing mainly on the recovery and development in the private sector. **AFD, together with Overseas Private Investment Corporation (OPIC), contributed approximately 30% of the total development finance that was mobilised for fragile countries for over six years, from 2012 to 2017** (Basile and Neunuebel 2019). The Swedfund is also pledging to take on more risks and invest in fragile contexts (SwedFund 2020).

<sup>9</sup> See AfDB Fragility & Resilience.

<sup>10</sup> MASSIF is a financial inclusion fund that FMO manages on behalf of the Dutch government.



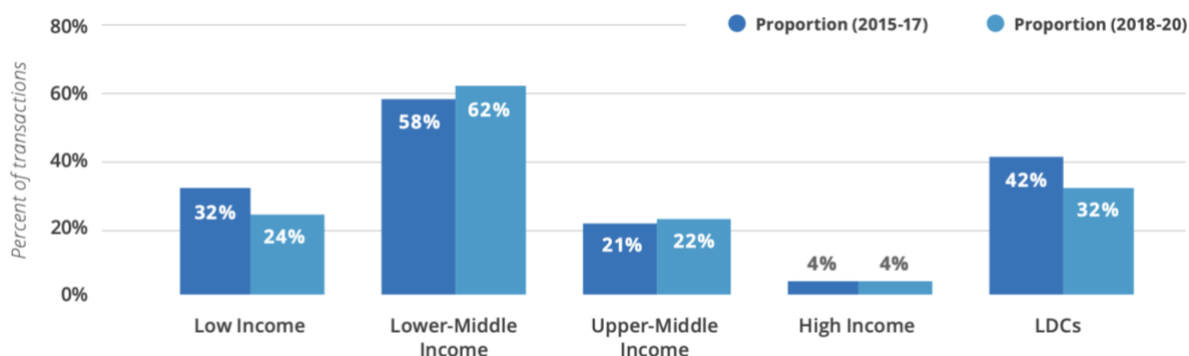
### 3.2.3. Development finance banks and the financing gaps in fragile contexts

DFIs broadly continue to invest more and more in FCACs through mobilising additional financial resources and providing the necessary technical support. Most have created partnership platforms to enable them to take on more risks through risk-sharing schemes. Even in situations where opportunities to support and invest in the private sector of FCACs are limited or quasi absent, some DFIs are making efforts to penetrate the markets through a series of initiatives. Researchers and economists argue that based on the comparative advantage of various FCACs, possibilities for business development in especially the agricultural and natural resource sectors. DFIs can venture into these opportunities to create a social development impact.

**Despite all these contributions from DFIs, FCACs remain underfunded.** Public discourses propose a need to focus far beyond the numbers when assessing the financing of DFIs in FCACs. These stress that even lower amounts of investments can positively impact FCACs given their low-income status, which is often associated with lower prices of factors of production. This debate would partly shift the discussion to the number of transactions (no matter the ticket size) that DFIs conduct in LICs. However, evidence from closed blended finance transactions also shows that when compared to MICs, LICs (mainly including FCACs) still receive a smaller share of the total number of transactions, as presented in Figure 3.

The blended finance scheme promotes risk-sharing and can allow DFIs to invest in more risky countries, especially FCACs. However, in the absence of an explicit focus on FCACs, **DFIs find politically stable emerging economies a more attractive investment option. These economies entail lower political and commercial risks, have more easily identifiable bankable projects that require larger ticket sizes and provide DFIs with an opportunity to invest at a large scale with sustainable development impact.** DFIs that invest in FCACs, regardless of the attractive markets in politically stable countries, are associated with the problem of short-termism. While operating in fragile contexts, they invest in projects for a relatively shorter tenure to deal with long term political uncertainty.

Figure 3: Proportion of closed blended finance transactions by recipient country income group



Source: Convergence (2021).

**For DFIs and overall development finance actors to provide long-term credit to FCACs, they need, among others, safety nets.** Guarantees can play a critical role but do not suffice. Where possible, DFIs can collaborate with their owners to engage in policy dialogues that can spur peacebuilding processes in FCACs and promote the political certainty which can attract medium to long term private sector investments. Indeed, compared to countries currently experiencing conflict, those emerging from conflict appear to be attracting more investments from the DFIs, partly due to the decreased political uncertainty (IFC 2019).

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### 3.3. Operations of development finance institutions and the mandates of their owners

DFIs are majorly owned and controlled by governments, which provide them with capital from specific national and international guarantees or development funds. Some DFIs also have private shareholders. Owners, at times, mandate their DFIs to support FCACs. However, DFIs have stressed that they do not have enough risk-free funds to invest highly in these countries. Others do not have the required expertise to oversee their operations in these countries, leaving a wider financing gap. Owners of DFIs also face difficulties in identifying the best approaches to support DFIs in ways that make them countercyclical and empower them to support the build back better programmes to meet the expectations of the stakeholders and beneficiaries in FCACs.<sup>11</sup>

**Based on the mandates of most DFIs, especially within the EU, it is evident that owners would like the DFIs to take on a more active role in FCACs. Despite these good intentions, owners do not usually share with DFIs the risks associated with operating in such realities.** These risks are not only of financial and political nature; they are also reputational risks related to mismanagement, diversion of invested funds, corruption, bribery and overall failure of DFIs supported projects. Indeed, DFIs have expressed that as much as they can mitigate financial risks through risk-sharing and guarantee schemes, addressing political risks can be beyond their control yet within their owners capacities. Owners can support DFIs deal with reputation damages that come with investing in politically sensitive areas through tapping into their regulatory potentials and connections.

Regarding the financial-related risks, owners can foster the effective engagement of DFIs, allowing them to adopt financial instruments that enable them to invest in FCACs at the risk of their owners. Providing additional risk-tolerant capital will balance the interests of the financing power of the DFIs and the investment power of the owners. Some donors and third parties also support DFIs to address risks that damage their balance sheets by h providing them with concessional capital. DFIs can blend this financial support with their own-account resources, allowing them to, in part, mitigate the financial risk on their balance sheets. However, this approach has not been sufficient in influencing the risk appetite of DFIs (Attridge and Lengen 2019). **Too often, DFIs tend to shy away from investing in FCACs to maintain their AAA rating.** The AAA rating could weaken with DFIs' increased investments in risky situations that might lower their financial risk profile, liquidity, and capital adequacy grading.

**Another likely example is a case of the Global Europe development funds under the current EU budget and its financial instruments, the EFSD+ with the External Action Guarantee combined with blended finance, which aims to help DFIs invest in poorer, more fragile and vulnerable contexts.** Nevertheless, in the absence of an explicit EFSD+ investment window dedicated to stimulating investments in FCACs, most DFIs will likely integrate their approach to fragility and conflict-affected situations in their broader proposed investment programmes, running the risk of a diluted the fragility focus.

DFIs also operate within the financial regulations that their owners have the capacity and political clout to influence for better or for worse. **The financial rules and regulations within developed countries or the home countries of DFIs seem to overburden the operations of especially bilateral DFIs in developing countries (including FCACs). For instance, at times, financial regulators classify financial intermediaries in the beneficiary developing countries as shadow banks, limiting the extent to which DFIs can engage with them.** Banking regulations also lead to the assessments of the investments of DFIs in developing countries as liabilities whose risks increase with the increase in political instability, sometimes without nuance to the nature of conflict and the ability of the state to manage it. Such misalignment limits incentives for DFIs to invest in FCACs.

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<sup>11</sup> See THK Roadmap for Blended Finance.

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In situations like this, owners can align their actions with the operations of DFIs. **Within the home countries of DFIs, owners, who also act as regulators and policymakers, have the potential to influence the adoption of special regulations for DFIs, which can smoothen; rather than impede DFIs investments in FCACs.** Supportive regulations have worked well for MDBs (e.g. the EIB) and can also work for bilateral DFIs. They can enable multilateral and bilateral DFIs to complement each other rather than compete for projects in FCACs. Owners can also support the shaping of the general government policies that promote political stability in developed and developing communities.

Additionally, private investors (e.g. trade unions, large (multilateral) commercial banks, employer's associations, and individual investors) as shareholders are usually reluctant to invest in DFIs, which have a high-risk exposure of their portfolio in uncertain and politically volatile environments. This behaviour of shareholders discourages DFIs from investing in the most fragile situations where they are more likely to incur higher losses. It is indubitable that DFIs barely get bankable projects in FCACs as most businesses in these contexts are not financially viable and feasible. Nonetheless, the owners and shareholders of DFIs should be willing to align their wishes with the development mandate of such financial institutions. **They could also consider a segmented balance sheet or earmarked portfolios, allowing for lower risk-return ratios in dedicated DFIs approaches to FCACs and other poorer and more vulnerable contexts.**

**Owners of different DFIs can coordinate to create a pool of resources (financial and technical) for FCACs. Increased scale mobilisation promotes risk-sharing and lowers the losses of each owner. It can also facilitate market or project development.** Besides, owners can also make additional contributions to the partnership platforms of DFIs that aim at enhancing the financing of fragile contexts. An example of these platforms is the recent development by the Commission for State Fragility, Growth and Development,<sup>12</sup> which has attracted about 27 participating multilateral and bilateral financial institutions. These have committed to 'prepare' to incur higher operating costs, risks and capacity demands in FCACs. Tying the support of owners to such programmes is an ideal addition to the efforts of DFIs in closing the financing gap in FCACs.

Under the Commission for State Fragility, Growth and Development, the DFIs have pledged to work together in complementarity. They will enhance active dialogues with shareholders, governments and other stakeholders to identify private-sector financial and non-financial risks at the country level and address them to create a better business environment. This collaboration also creates an opportunity for owners by encouraging them to align their wishes and actions with the respective mandates of DFIs in FCACs. Collaborative efforts such as these are not new. DFIs have a history of working together to achieve common agendas. However, most of their collaborations always fall short of mobilising the needed financial resources to meet their commitments within set deadlines.

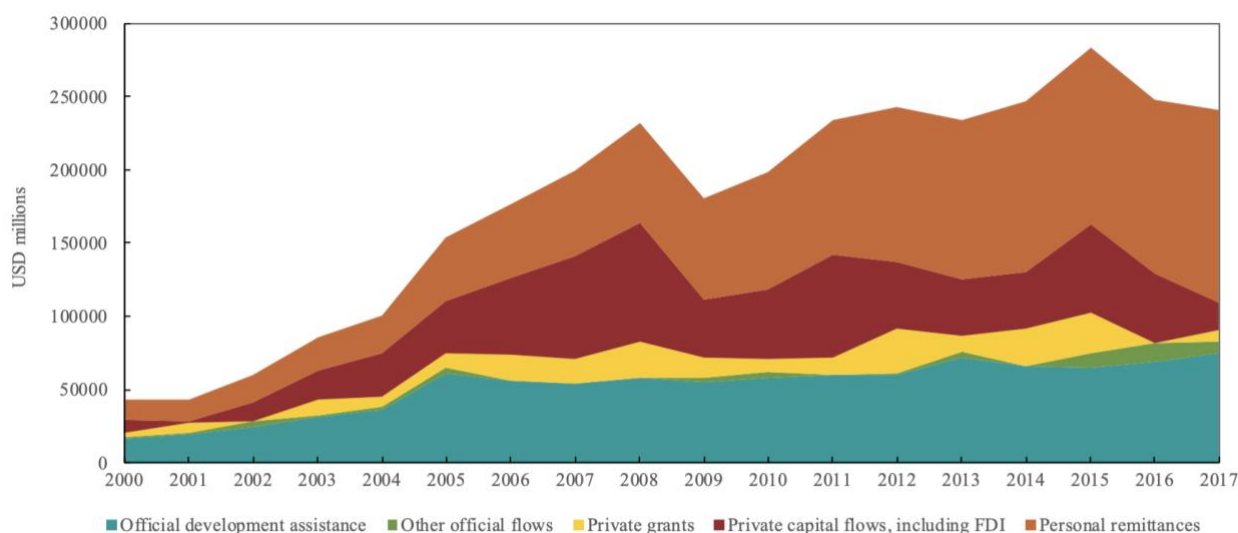
There are many instances where DFIs have joined hands, although not necessary to invest in FCACs. A case example is the International Development Finance Club and 'Finance in Common' that bring together worldwide DFIs and public development banks. In Europe, EDFI has become a key player in an enhanced European financial architecture for the development and has built partnerships with other DFIs worldwide, for instance, DFI Alliance (EDFI 2020; Bilal 2021, 2022). Collaborations have provided DFIs with structures to adopt guarantee and blended finance schemes that enable financial institutions to provide concessional loans and grants to developing countries. European DFIs, for example, can exploit the EFSD+ framework under Global Europe to enhance their support of FCACs, leveraging additional financing for development from beyond multilateral DFIs and bilateral country donors, especially the United States and France, as is currently the case (Basile and Neunuebel 2019).

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<sup>12</sup> See IGC Commission on State Fragility, Growth and Development.

**More owners of bilateral DFIs need to utilise the risk-sharing opportunities that blended finance offers to complement other sources of development finance (personal remittances, ODA, private capital flows and private grants) in fragile contexts, as presented in Figure 4.** As FCACs currently receive less than a fifth (MICs receive 73% of the total investments) of the total blended finance, owners might have to endorse their DFIs to direct the packages of blended finance towards FCACs (Basile and Neunuebel 2019).

Figure 4: Other major sources of external finance to fragile contexts over the period 2000 to 2017



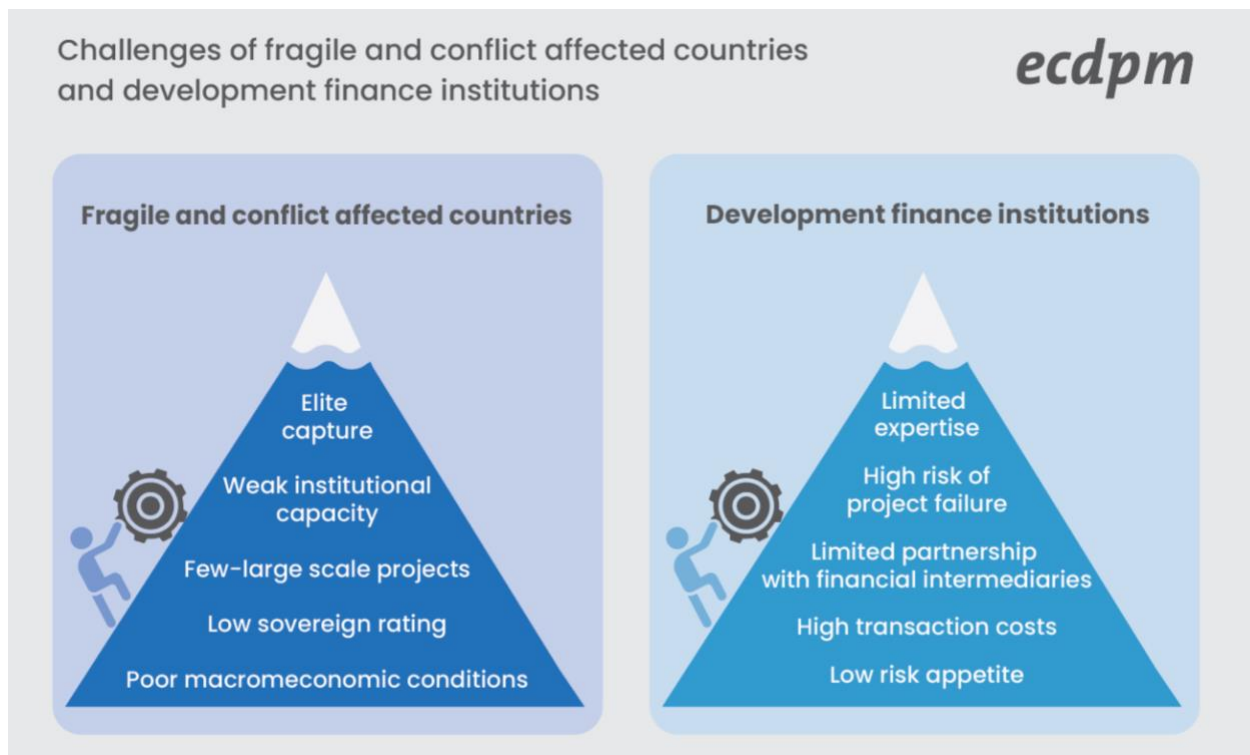
Source: OECD (2019).

**The owners of DFIs can also help mitigate risks that DFIs face by leveraging their institutional networks within FCACs to call for the implementation of development interventions that strengthen institutional capacity and promote the rule of law.** Improved political stability can espouse the development of a relatively more improved investment environment. As donors and policy actors, owners can influence, impact and promote political stability and sustainable recovery, and improve the quality of life of people, especially women and children living in fragile situations. Moreover, they have representative governmental bodies and organs with local knowledge and expertise on the ground. Owners can utilise these networks to advocate for peacebuilding strategies. Efforts like these can address or mitigate the unpredictability of markets, for example, when unforeseen conflicts suddenly occur and increase the risk exposure of DFIs' investments. Such is the current case of Ethiopia, a country that has moved swiftly from being one of the fastest-growing African economies to a nation at war, driving away investors.

## 4. Challenges encountered while financing fragile and conflict-affected countries

Promoting development finance flows to FCACs is both a role of DFIs, their owners and FCACs themselves. Several factors can affect the magnitude of the operations of DFIs in fragile contexts. Inherent factors within FCACs can also influence how international financial institutions are willing to invest in projects and businesses in fragile contexts. Figure 5 summarises the challenges the DFIs encounter both in their financing models and in the FCACs.

Figure 5: Challenges of fragile and conflict affected countries and development finance institutions



### 4.1. Challenges faced by fragile and conflict-affected states

Fragility and conflict cause many challenges that negatively affect the competitiveness of the private sector in the development finance markets. As discussed in sections 2 and 3, they create periods of heightened insecurity and political turbulence that weaken institutional capacity, governance, and the rule of law. In most FCACs, the current and future path of government economic development and governance policies are unknown. Uncertainty generates high security, political and economic risks that discourage local and international financiers from investing in such contexts. This combined series of events are associated with low levels of economic activity. In some cases, they also lead to economic inactivity due to business failure and other associated mishappenings.

Although all are fragile states, severe and less severe FCACs face different challenges, and investors perceive them differently while providing them with financing. These perceptions affect the attractiveness of different fragile contexts in the market. Relative to other FCACs, extremely fragile countries experience several acute challenges, for example, limited access to loans, failure of financial services to meet market needs and poorly developed equity markets (IFC 2019). This severe phase of the conflict also negatively affects the extent to which their economic markets can have the right kind of factors of production (labour, capital, land and technology) to boost their

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productivity and achieve economic growth and development. Below, this paper discusses the general challenges that FCACs are likely to face irrespective of the severity of their situation.

#### **Challenge 1: Weak regulatory systems limit the extent to which DFIs are willing to invest in FCACs**

Compared to other developing countries, FCACs countries have low scores on perceptions of regulatory quality (19th percentile) and government effectiveness (16th percentile) (OECD 2020a). These levels of ineffectiveness usually correlate with high levels of corruption and low levels of accountability and transparency. In the case of a fragile state such as Libya, corruption is a severe constraint to the growth of 46% of companies in the private sector (Rahman and Maio 2022). Business owners in Libya have to pay bribes to obtain loans plus letters of credit and transport inputs and outputs. Weak regulatory systems and institutions, arbitrary or lack of enforcement, high levels of corruption and bribery continue to affect the quality of public service delivery within many FCACs and make many private sector operations difficult. Such a highly uncertain environment makes it difficult for DFIs to meet the due diligence standards of their owners. All of this reduces the trust of international investors and financiers while increasing investment political, financial, and reputational risks of investing in these countries.

#### **Challenge 2: The elite capture leaves fragile contexts with a few private sector actors**

The private sector of most FCACs is often dominated by the few economic and political elites who control government functions. In the case of the Libyan war economy, the weak regulatory environment and the absence of the rule of law have subjected the Libyan private sector to elite capture (Rahman and Maio 2022). The elites do not only control the state resources and institutions; they also have favourable access to foreign currency and lines of credit.

The political elite exploits the frail regulatory and legal framework to divert national revenues meant to support social-economic development (e.g. the construction of the necessary infrastructure and provision of human development services – health and education) to personal use. The lack of the required infrastructure and service delivery channels leaves a decrypted business environment, which cannot facilitate the growth of MSMEs. Such local behaviour creates a vicious cycle in which domestic and foreign investors cannot readily find bankable projects and hence are unable to support the emergence of a sustainable and inclusive growing economy. Additionally, the private sector cannot grow and flourish to produce projects that can absorb the finance from DFIs. Stagnant private sector businesses also have a lower ability to pay taxes, leading to limited domestic resource mobilisation.

#### **Challenge 3: Poor macroeconomic conditions limit the funding competitiveness of FCACs**

Poor macroeconomic conditions limit the competitiveness of FCACs in accessing development finance from DFIs and other investors. To determine the pricing margin for their investments, DFIs assess the fiscal, trade and monetary policies in all countries of their operations. They evaluate the current exchange rate policies to project the likely currency mismatches between the currency used by DFIs to invest and that of the FCACs. DFIs that provide local currency lending also use months of imports to determine the variations in the local currency and thus the premium.

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Furthermore, setting macroeconomic policies in fragile contexts is difficult due to the political legitimacy questions and how fragility affects the impact of financial flows on macroeconomic outcomes (Chami et al. 2021). A typical example of this is Somalia, whose Central Bank<sup>13</sup> collapsed in 1991 due to long periods of insecurity, fragility and continued economic decline, leaving the country with no central monetary authority from 1991 to 2009 (IBP 2016).

Fragility also affects the economic growth and development outcomes that DFIs care to achieve. Unlike in non-fragile contexts, ODA seems not to be leading to growth accelerations in FCACs, and findings show no impact of ODA, FDI and remittances on employment outcomes (Chami et al. 2021). Available evidence creates doubts about the likely impact of development finance on socio-economic development, discouraging result-oriented financiers from investing in FCACs.

#### **Challenge 4: Large-scale projects, attractive for DFIs, are missing in fragile states**

FCACs have a shortage of large firms that meet the integrity due diligence requirements of DFIs. The few that exist are often under the capture of the political elite. Mostly, FCACs have MSMEs which operate informally and require small-size loans that DFIs do not directly offer. In most politically stable countries, DFIs invest indirectly in small scale projects via local financial intermediaries. However, this is more difficult in fragile states due to the improper functioning of domestic financial institutions that might not mediate well between DFIs and MSMEs. Such a challenge raises questions on the potential role of DFIs in helping establish and grow local formal firms in a fragile setting. They need to adopt special adjustments to make them fit for purpose in fragile contexts.

#### **Challenge 5: Sovereign credit rating score of FCACs is low, which makes them more of a liability**

The Sovereign credit rating score of FCACs is low. This makes them a less attractive choice to invest in. Developing countries in general receive a low credit score from the big three crediting rating agencies (Moody's, Fitch and Standard & Poor) and this challenge was compounded by the COVID-19 pandemic. Indeed, 56% of countries in Africa were downgraded following the pandemic, compared to 9.2% in Europe and 28% in Asia (Fofack 2021). Developing countries that were experiencing fragility and conflict were also downgraded. Ethiopia was downgraded twice to Caa2 (Ghosh 2021) due to debt restructuring and civil war while Mali was downgraded to Caa2 (Moody's 2022) following the extension of the military rule for extra five years and its failure to meet its commercial debt obligations. Burkina Faso has also been downgraded from B to CCC+ following the coup d'état by the Patriotic Movement for Safeguard and Restoration (Mercados Africanos 2022). Such sovereign credit ratings affect the attractiveness of projects in these countries as they are perceived as risky. Where DFIs provide credit, they do so at high premiums and for short grace periods.

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<sup>13</sup> See About Central Bank of Somalia (CBS).



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**In general, risk assessments of developing countries (FCACs inclusive) may be influenced by lack of data and inherent biased perceptions towards developing countries** (Ozturk 2014; Olabisi 2015; Giordano and Ruiters 2016). Much as downgrading developing countries is correlated with fundamental changes, it is also associated with self-fulfilling consequences (Tennant et al. 2020). Developing countries are categorically perceived as unstable and unreliable (Fofack 2021; Timo 2020; Tran et al. 2021). In the absence of adequate data, such risk perceptions and matrices can be used to assess investment risk of developing countries, making the outcomes biased and not well informed.

In some FCACs, violent conflicts are usually geographically contained and limited to conflict hotspots (e.g. Eastern Democratic Republic of Congo or North-Eastern Nigeria). Yet, credit ratings at times provide a nationwide assessment without making the necessary distinctions between local regions (Giordano and Ruiters 2016). The not-so-well-informed risk analyses deter DFIs from assisting these countries with the much-needed financial support.

## 4.2. Challenges faced by development finance institutions

### Challenge 1: DFIs face high transaction costs in trying to support MSMEs in fragile contexts

DFIs find it expensive (in terms of time and money) to develop a pipeline of bankable projects in FCACs. In Africa, the Caribbean and the Pacific (ACP), the processing of small transactions for FCACs by the ACP Investment Facility of the EIB took longer to be administered due to high economic risks and low levels of financial development (ADE 2020). Fragile contexts rarely have projects that can absorb the preferred volume of the DFIs' funding, usually in the marks of \$20 to \$30 million (Collier et al. 2021). FCACs may have a limited supply of large-scale projects, but they have some formal and several informal MSMEs that fulfil market needs in fragile contexts despite the political uncertainty. Informal SMEs, which are also not financially included, often fail to benefit from local and international financial services and products.

### Challenge 2: Risk appetite of DFIs deters them from investing in FCACs

While trying to support FCACs, DFIs face several risks: financial risks, political risks, security risks, and reputational risks. These risks can affect the AAA credit rating of DFIs. At the same time, the AAA rating is one of the building blocks behind business models of DFIs as it gives confidence to their investors, allowing DFIs to access cheap finance from the capital markets. Additionally, current innovations are integrating climate risks within their credit rating methodologies that assess the Environmental, Social and Governance (ESG); albeit, these assessments currently rely on the standards of developed countries (Nguyen 2022). Consequently, it becomes difficult for DFIs to find projects in FCACs that meet the minimum ESG standards. DFIs are, therefore, faced with a challenge of abiding by the principle of common but differentiated responsibilities and still providing climate finance to fragile contexts and empowering them to adapt and stay resilient (Ahairwe 2021).



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### Challenge 3: High risk of project failure in FCACs discourages DFIs from investing in FCACs

Most DFIs struggle to find projects worth investing in within fragile contexts. The future of those that prove to be bankable is uncertain due to underlying political events, which can weaken the economic and business environment at any time. As a result, DFIs tend to shy away from taking a risk on several MSMEs enterprises in fragile contexts. In extremely fragile contexts, political uncertainty makes it difficult for DFIs to clearly assess what may happen to the projects invested in medium-term and long-term periods. Such dynamics cause DFIs to concentrate their investments in a few FCACs, which might align with their financing conditions (bankability of the project). An example of this is the case of CDC – now BII. Although BII has the potential to invest in about 33 FCACs in 2017, it invested 80% of its total investments to FCACs in five countries of Nigeria, Kenya, Pakistan, Côte d'Ivoire and Cameroon (ICAI 2019).

### Challenge 4: Limited partnerships with financial intermediaries within fragile contexts

DFIs work limitedly with financial intermediaries, including microfinance institutions in FCACs. This is because extreme state fragility and conflicts adversely affect financial intermediaries in these counties, sometimes making them dysfunctional. Moreover, the financial sector in FCACs, especially in countries that have experienced fragility for a long time, is characterised by limited skilled workforce due to brain drain and people fleeing the country for safety. The financial sector also tends to have high levels of non-performing loans and lower deposit collection capacity. These inefficiencies translate into an ineffective credit system which cannot provide the required financial support to local markets. Besides, local financial institutions operate within weak regulatory and supervisory monetary systems and sometimes are also under elite capture.

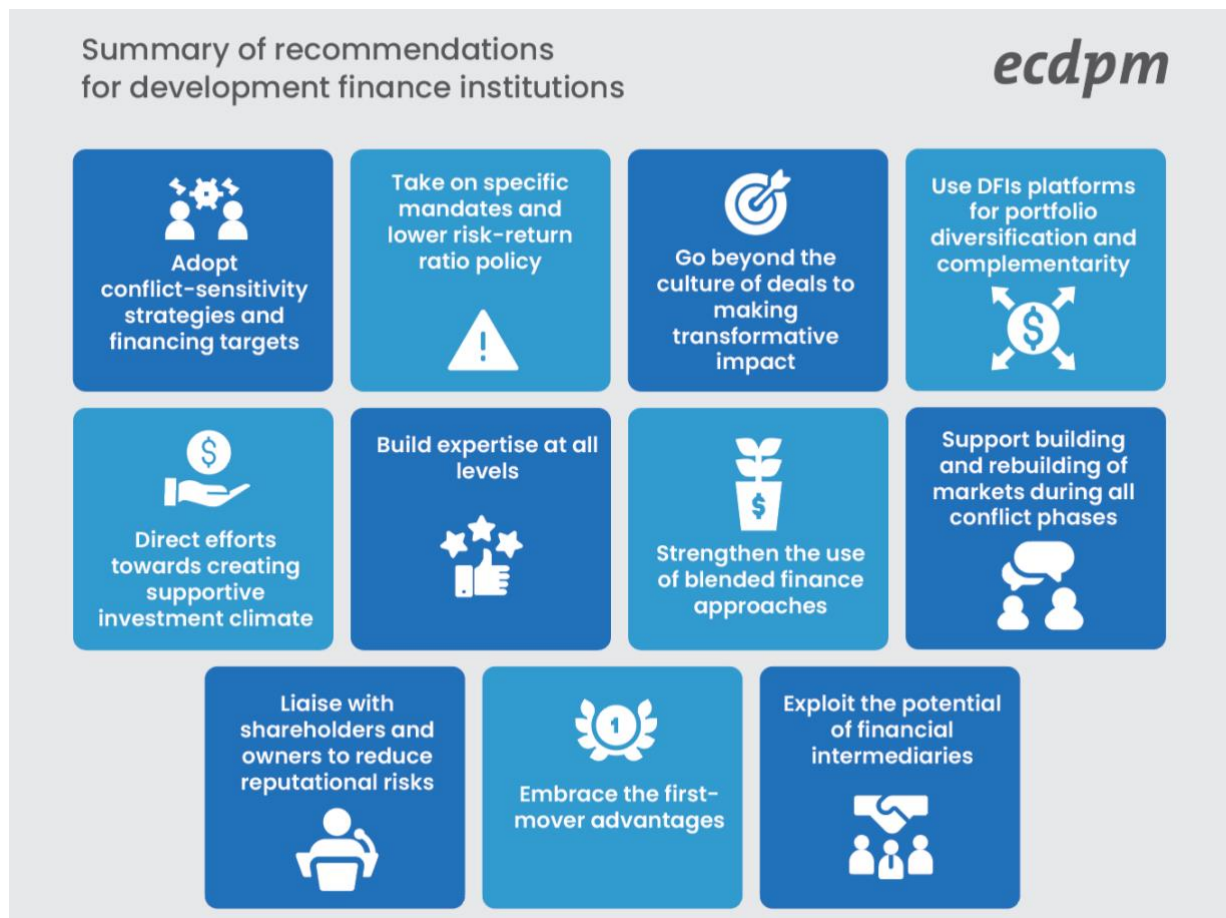
Political uncertainty also deters new financial institutions from entering the banking market and discourages the development of innovations that would foster access to affordable finance. Limited new market entrants leave the private sector (especially MSMEs) with very few financial options, such as utilising credit programmes by government, non-government organisations (NGOs), DFIs, impact funders, diaspora funds, and development grants by country donors.

### Challenge 5: Limited funding and expertise of DFIs deters FCACs financing

In addition to limited financial packages for fragile contexts, most DFIs have often limited expertise to effectively and efficiently take on investments in fragile contexts. DFIs largely operate from their host countries – primarily developed countries, with limited or no presence in FCACs. In some instances, they lack the necessary expertise to conduct an *ex ante* and *ex post* conflict-sensitive assessment of projects they support. DFIs also tend to carry out the required due diligence but in line with developed country standards while paying no or limited attention to the prevailing conditions in FCACs. The current ESG requirements, for example, necessitate that DFIs measure associated transitional and physical climate risks of projects, yet DFIs lack the required data and information to measure these aspects in FCACs.

## 5. Recommendations for development finance institutions

Figure 6: Summary of recommendations for development finance institutions



### Recommendation 1: Adopt conflict-sensitivity strategies and financing targets for FCACs

Investing in FCACS is no business as usual. To boost the amount, quality and impact of their investments in FCACs, DFIs need to adopt dedicated approaches and set targets that solely focus on these contexts without running the risk of being out shadowed by their overall ambitions in developing countries. At the moment, only a few DFIs (e.g. the IFC and EIB) have publicly accessible conflict-sensitivity strategies. All DFIs should adopt a conflict-sensitivity analysis depending on their investment models in FCACs. DFIs can also join and contribute actively to conflict-related DFIs platforms, such as the DFI Fragility Forum on Private Investment in Fragile Environments and the DFIs G7-led ARIA to inform their strategies better. DFIs can further rely on and team up with donors and relevant international and in-country expertise for conflict and fragility assessments and guidance in their approach.

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Rather than take conflict into consideration only at the beginning of the project, DFIs need to continuously assess the nature and phase of conflict throughout their investment cycle. Such a continuous process, which is *cognisant of the conflict cycle*, should go beyond being just a *box-ticking exercise*. It should include an analysis of the interplay between investments of DFIs and their contribution to inclusive job creation, sustainable growth recovery and peace rebuilding in conflict-affected and fragile countries. It should also provide advice on the different kinds of projects that can be effective throughout several stages of the conflict.

However, conflict-sensitivity analysis demands that DFIs develop deep contextual knowledge of regions where they operate. It also requires DFIs to invest in expertise on the interconnectivity between finance and fragility. DFIs should also assess the local ownership of the projects and their contributions to the local political economy and market building dynamics. These evaluations will help DFIs understand how their projects affect local businesses and communities in relation to conflict. For instance, historical finds show that some projects sponsored by DFIs promote displacement of people without clear resettlement and compensation strategies, which further intensifies the conflict situation. Being conflict aware and using local expertise to assess and evaluate the benefits and harm that engagements of DFIs can cause in fragile contexts can help them take appropriate steps to address such challenges.

#### **Recommendation 2: Take on specific mandates in FCACs and lower risk-return ratio policy**

DFIs are called upon to provide more private investments at scale and achieve a substantial impact. In fragile and conflict situations, DFIs can attain this through more risky and costly investments that involve supporting project development and implementation. By doing so, DFIs can achieve a lower risk-return ratio. They can also leverage lower volumes of private finance than in more mature and stable emerging markets.

Taking on this differentiated strategy by DFIs in FCACs should be explicitly encouraged and supported by owners and all other shareholders. However, DFIs should be transparent and account for investments made through the necessary social and development impact evaluations. Furthermore, DFIs and their shareholders should adopt appropriate internal incentives to encourage more investments in FCACs. These may include conflict-related earmarked portfolios, a segmented balance sheet, and a dedicated internal reward and capacity building structure devoted to the staff of DFIs undertaking more costly and risky activities in FCACs. Achieving this will require DFIs and their shareholders to change their business culture.

#### **Recommendation 3: Go beyond the culture of deals to make transformative and measurable impact**

DFIs currently pay too much attention to the volume of investments made or the number of deals sealed in FCACs. They focus on investing in large projects with a promise of higher financial returns and insufficiently consider the overall transformative impact that they are making. Focusing on such deals has left many DFIs with bias, highly investing in politically stable MICs. It is crucial to have such large-single investments. However, DFIs should move beyond the 'just investing strategy' and aim at creating a significant impact that can be measured *ex post* (as opposed to the current *ex ante* impact measurements) in terms of the jobs created, sectoral competitiveness and productivity, market development, infrastructure development and overall economic transformation.

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To make a transformative impact, DFIs need to ensure that every dollar invested adds value on the ground in FCACs. They can adopt transformative investment analyses to evaluate the impact of one-time large transactions – single deals (e.g. infrastructure projects) and several small transactions via financial intermediaries (e.g. for MSMEs). Single-large deals (e.g. investment in infrastructure) have a ripple effect on the rest of the economy, but so do several small transactions (Collier et al. 2021). Additional financial and technical support directed to MSMEs and women-owned or employing enterprises helps promote job creation, business growth and economic development. Impact measurements should thus evaluate how the investments of DFIs can create transition effects and their ability to rebuild a socio-ecosystem.

#### **Recommendation 4: Direct efforts towards creating a supportive investment climate**

DFIs should take a holistic approach, which involves influencing the relevant policies and regulatory frameworks to create a supportive investment climate in fragile contexts. IFC, particularly, recommends development actors to “commit more than money” within FCACs by accompanying their investments with advice, regulatory reforms, capacity building, and on-ground presence (IFC 2019). In turn, improved regulatory frameworks have the potential to attract additional investments and investors in FCACs. Through hands-on experience, DFIs can exert the right political influence over government priorities while respecting national sovereignty and ownership (UNDP 2019).

With their hands-on experience, DFIs have valuable insights and, to some extent, expertise on critical dimensions that can help promote recovery processes in FCACs. They can engage in policy dialogues and influence the FCACs government in adopting enabling rules and regulations that build and strengthen markets while ensuring business growth. DFIs can achieve so by partly working with humanitarian organisations (e.g. the United Nations and the International Committee of the Red Cross) that have built expertise over time and have a depth of country presence in supporting recovery from conflict. DFIs, working closely with the private sector and donors, can contribute to exerting the right political influence over government priorities while respecting national sovereignty and ownership (UNDP 2019).

Influencing institutional development calls on the DFIs to utilise the strong position of their owners, who are also regulators and can work together with governments of FCACs to promote the functioning of institutions. An improved investment climate will boost business capacity, attract more investors, and improve market performance, financial markets inclusive.

#### **Recommendation 5: Build expertise at all levels**

DFIs need to build their capability and improve their expertise in investing in FCACs. They can achieve this through familiarising themselves with local country experience and cooperating with local experts to understand the financing contexts of fragile contexts.

For DFIs that have already built their capacity, there is a need to invest in capacity building programmes to empower financial intermediaries that provide credit to MSMEs. Investing in MSMEs via financial intermediaries helps DFIs leverage additional finance that can be invested back into such societies. DFIs can also provide technical assistance to MSMEs in fragile contexts to train them in managing their investment portfolios throughout various phases of conflict. Investing in capacity and talent development has positive externalities. It helps improve project success and bankability, attracting DFIs to invest more.

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### Recommendation 6: Strengthen the use of blended finance approaches

DFIs should strengthen their use of blended finance approaches in FCACs, where there is a high need for risk mitigation and development impact. FCACs continue to receive a small share of the total blended finance globally. For example, of the \$157 billion mobilised in private finance from 2012 to 2017, only 28.8 billion was invested in fragile contexts (Basile and Neunuebel 2019). The low-risk appetite of DFIs continues to limit their investments in fragile contexts. However, blended finance can be a segmented approach that DFIs can use to reduce or take risks off their balance sheets, sometimes isolating themselves from their risk exposure in poorer and fragile countries. The blended finance approaches provide a chance for financial innovation and experimentation, allowing DFIs and private actors to partner on local currency solutions and other performance instruments (e.g. social impact bonds) and other risk-tolerant solutions (e.g. seed capital).

DFIs mostly face two possible explicitly recognised trade-offs. They can either increase their operations in fragile contexts (this is inherently more costly) or mobilise private capital at scale to support more projects in stable MICs (these are readily available). Striking a balance between the two without compromising either's support requires DFIs to get more specialised financial packages from their donors. The specific financial packages should empower DFIs to take on more risks, especially in FCACs. Processes for leveraging additional financial support for FCAs should also engage the international and national private sector players through well-established public-private partnership systems.

### Recommendation 7: Use DFI platforms for portfolio diversification and complementarity

Examples discussed in section 3 show that DFIs have the potential to use their platforms for portfolio diversification. The investments of DFIs in FCACs could drastically increase if they created a specific investment window to invest in fragile contexts. This model is already proven to be a successful policy option in supporting the economic transformation in the EU neighbourhood. For many years, donors (e.g. European Commission, the Council of Europe Development Bank, European donor countries) and DFIs (e.g. EIB, EBRD, World Bank, KfW and AFD) have worked together under the Western Balkans Investment Framework (WBIF),<sup>14</sup> a regional blending facility to support the Western Balkan countries. DFIs have many platforms for FCACs. However, these have not developed to the degree of the Western Balkan Investment Framework. The ACP Investment Facility – a risk-bearing fund, helped the EIB take on more risky projects and provide low-cost medium and long-term finance to foster sustainable economic development in developing countries, including FCACs (ECA 2015). Yet its survival was tied to the Cotonou Agreement

Investments in FCACs could also increase if DFIs exploit their existing networks and build an investment window or a risk-sharing facility for FCACs. DFIs can equally use the platform to exchange information and share better practices. They can also use it for portfolio diversification, allowing them to administer various forms of innovative financing (e.g. concessional lending, impact investments through equity, venture, and seed capital). Joint approaches and co-investment strategies reduce the risks and costs of engaging in FCACs, drawing on more experienced DFIs in specific fragile situations. DFIs can, at the moment, support FCACs via their existing regional platforms like the ACP Endowment and Trust Fund, which have the same objectives of supporting private sector development (ACP Group 2017).

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<sup>14</sup> See WBIF.

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### Recommendation 8: Liaise with shareholders and owners to reduce reputational risks

When engaging in fragile and conflict situations, DFIs expose themselves to high reputational risks in case of failed operations, losses through materialised risks, and non-compliance with due diligence requirements. Reputational risks associated with project failures usually affect how future projects and programmes of DFIs will be perceived (OECD 2014). These influence their decision to engage or continue to engage in FCACs. In such scenarios, shareholders and owners can support DFIs, by adopting contingency plans and tailored approaches to help mitigate such reputational risks.

Owners also share reputational risks with DFIs by supporting awareness and building trust and good communication networks that may eliminate the negative perceptions about DFIs in the markets. They can also help reduce the political risks DFIs face by providing political and legitimacy backup. Most owners of DFIs are experts in governance and regulatory issues. Such a skills package puts owners in a better position to take on a collaborative approach in bilateral relationships that can foster good governance in FCACs. Owners may equally support DFIs to advance good leadership and promote the reforming and rebuilding of the necessary institutions to facilitate the transition of a fragile context to a more secure and politically stable state.

### Recommendation 9: Embrace the first-mover advantages

DFIs should also embrace the first-mover advantages in fragile and conflict-affected situations. First movers are pioneer firms that produce new products, introduce new processes and enter new markets regardless of the sector in which they operate (Collier, Gregory and Ragoussis 2019). DFIs that provide finance and non-financial support to such pioneer firms make foundational investments (e.g. knowledge transfers, capacity building, and subsidised price of intermediate inputs) whose ripple effects can benefit other businesses and DFIs (Collier et al. 2021). Despite these advantages, DFIs are usually hesitant to invest in fragile contexts due to existing *perceptions* of risk rather than their *experience* of it (Giordano and Ruiters 2016).

On the one hand, loose regulatory systems come with advantages (e.g. reduced bureaucratic tendencies) for entrepreneurs undertaking initiative projects in fragile contexts. However, they also come with risks associated with business integrity (e.g. corruption, bribery and mismanagement). It is important to note that, although there are high-risk perceptions on investments, these are intensified by pessimism towards FCACs and aggravated by the negative press on the business environment. In such instances, having an on-the-ground presence helps DFIs take on a realistic assessment of the investment climate, risks and opportunities, supporting first-movers despite conflicts and fragility. Where markets are missing, first-movers are crucial, and with the support of DFIs, they can support the development of the private sector and improve the overall business climate.

On the other hand, pioneering investments such as infrastructure development come with additional high costs (e.g. overhead and start-up costs), which most DFIs may fund (Collier et al. 2021). DFIs can support these projects in fragile contexts while mobilising additional resources to invest in market development. They can also continuously identify real business opportunities that complement the newly established infrastructure projects. DFIs also ought to pay greater attention to project origination and focus on developing a pipeline of impactful bankable projects, which tend to be too rare in poorer and fragile countries. These projects can help provide a market for the

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investments of DFIs in the near future. DFIs also need to pay greater attention to the local political economy dynamics to avoid rent-seeking and rent-capture behaviour by local economic and political elites who may pre-empt or jeopardise the first-mover advantage.

#### **Recommendation 10: Exploit the potential of financial intermediaries**

DFIs can exploit the potential of the financial intermediaries, particularly microcredit institutions, to promote investments in MSMEs that exist within FCACs. Although DFIs want to support MSMEs, they cannot do so directly due to the high administrative and transactional costs that come with it. Financial intermediaries in fragile contexts have the expertise and local knowledge concerning dealing with MSMEs. They can also administer small-size loans, which DFIs find too expensive to provide.

However, operating in fragile contexts puts the investments of financial intermediaries at very high risk. Even when their clients might not be a flight risk, socio-economic effects from fragility and conflict lead to a relatively high risk of business failure and inactivity. DFIs can partly take on that risk through grants and long-term concessional lending to financial intermediaries, supporting them to support local MSMEs. Through this strategy, DFIs support the rebuilding and making of financial and business markets resilient.

Supporting MSMEs in fragile contexts requires development-focused financing (e.g. grants and concessional loans). However, DFIs sustain their business model by leveraging additional financial resources. They may, therefore, need to partner with other development actors (e.g. impact funders) to mobilise more capital for social impact. For post-conflict countries, relative political certainty increases the success profile of MSMEs, giving DFIs a chance to partner with the private sector (e.g. large international commercial banks) to provide subsidised lending to local businesses. An example of such a partnership is the 2015 partnership between BII and Standard Chartered to create a US\$50 million risk-sharing facility to support MSMEs in Sierra Leone and promote recovery from the economic downturn induced by the Ebola outbreak (African Business Communities 2015).

Given the critical role of women in peacebuilding and recovery, DFIs should also emphasise their gender-sensitive approach in fragile situations, building on the 2X Challenge principles and action plan, including when engaging with financial intermediaries (Ahairwe and Bilal 2020, Desmidt 2021).

#### **Recommendation 11: Support the building and rebuilding of markets during and in post conflict periods**

DFIs can also help build and rebuild markets during and post conflict periods. Rather than look for bankable, DFIs can start supporting the development of bankable projects through unique financial services and products (e.g. seed capital, equity, and grants) that can cover first-time losses. Most MDBs (e.g. the WB, EIB, AfDB, and ADB) have the necessary financial portfolio to invest in high-risk fragile contexts. They can take on an integrated market development approach and engage in market building and rebuilding processes through technical support and policy dialogue with the public sector in FCACs. Progress from a 'one-off deals mentality' to a market strengthening approach can increase productivity and wages while diversifying markets and growth (Papoulidis 2020). While supporting market developments, DFIs should also pay particular attention to the missing middle by partnering with microcredit institutions to ensure that MSMEs, especially women-led businesses, are supported.



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