CHAPTER 4. The risk appetite of development finance institutions

DFIs are governed by rules that discourage them from taking risks to provide financing that would otherwise not be available from commercial lenders.

Key recommendation: Donor governments must provide DFIs with dedicated funds that allow them to:

i. offer higher-risk loans, such as first loss and mezzanine debt, that have well-defined targets on sustainable food and agriculture;
ii. provide long-term credit lines, guarantees, transaction advice and technical assistance to domestic financial institutions to build institutional knowledge on sustainable agriculture and food systems;
iii. accompany institutions, funds and projects over the long term.

This section presents the rationale for the above recommendations and discusses why and how DFIs should take more risks. In doing so, DFIs have the potential to mobilize greater amounts of financing from private investors.

DFIs are largely funded by either government guarantees or (inter)national development financing. This strong backing ensures their creditworthiness, allowing them to raise money in international markets and provide financing at very competitive rates (OECD, 2023a, no pagination). Developing finance institutions include bilateral and multilateral institutions. The latter are also referred to as MDBs, are established by more than one country and are subject to international law (OECD, 2023a, no pagination).

DFIs hold investment-grade credit ratings and take a portfolio approach to investment. They can therefore distribute project risks across their balance sheet and thus participate in transactions of varying risk and return levels. They also have distinct mandates. For example, DFC is financed almost entirely through budget allocations and therefore may be able to take on more risks than other development banks, which may need to uphold their credit ratings. DFIs that maintain investment-grade credit ratings can raise cheaper capital and lend to projects in higher-risk countries (Horrocks, n.d.).

Do DFIs crowd out private investors?

Additionality is one of the central questions in increasing efficiency and innovation in development finance. In the case of DFIs, additionality refers to the extent to which they offer financing on favourable terms and conditions that commercial investors will not be able to match. It also refers to the extent that the financing terms and comfort provided by the DFIs result in de-risking and mobilizing commercial investors that would otherwise not have participated in development projects.

The challenge for DFIs is that they are governed by prudential rules and statutes that prevent them from lending to high-risk projects. DFIs hold investment-grade credit ratings (rated AA or AAA by Standard & Poor's and Fitch Ratings) and, to maintain these high ratings, their regulations discourage excessive risk-taking. As the food and agriculture sector is higher risk and tends to offer lower financial returns than other sectors, DFIs tend to hesitate to lend to food and agriculture projects (see Figure 17). When they do, they tend to provide senior debt rather than first-loss financing (see Box 10).

Figure 17 - DFIs deployed less financing to food and agriculture projects than other sectors
Total volume of DFI blended finance projects in millions of United States dollars, 2021

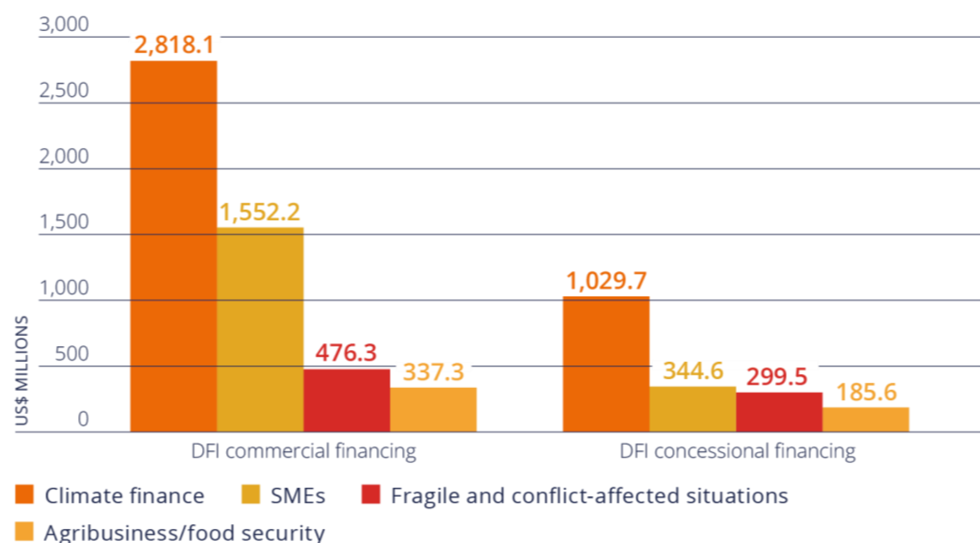


Chart: Kamal El Harty. *Source:* DFI Working Group on Blended Concessional Finance for Private Sector Projects, 2023

Box 10 - What are first loss, senior debt, mezzanine debt and loan guarantees?

First loss is a type of concessional finance where the lender is the first in line to take a loss if the project or fund fails.

Senior debt is a type of loan with commercial interest rates. These loans are the first to be repaid before any other creditors or shareholders if the project or fund fails.

Mezzanine debt can be concessional or commercial finance. It gives the lender the right to convert to an ownership stake (equity) if the borrower does not repay the debt on time and in full.

Loan guarantees are guarantees provided by a third party who agrees to repay the loan if the borrower defaults.

Sources: K4D, 2021; SDC, 2017; USAID, n.d.

As one expert on sustainable finance said:

> *"Development banks are being asked to realize financial returns along with development additionality, and these two objectives are not always compatible. Ministries of economic development and foreign affairs require them to help developing countries, but treasuries and finance ministries, along with credit rating agencies, determine their risk exposure. The incentives they receive therefore promote returns over impacts."*
>
> *(Expert on sustainable finance, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*

This is a lost opportunity for the development finance community. If DFIs take first-loss financing, it will increase the pool of concessional finance that can, in turn, mobilize more commercial finance for development projects. The overall pool of development finance could then be significantly increased.

The debate heightens when considering whether senior debt loans provided by DFIs crowd out commercial lenders. Stakeholders interviewed had different views on this matter.

According to one commercial lender interviewed:

> *"Development banks are almost a competitor to us. They take senior debt, and we ask, 'What is their additionality?'"*
>
> *(Commercial bank investing in agriculture, Shamba Centre enquiry into sustainable finance, 2023)*

Similarly, one fund manager remarked:

> *"Development finance institutions must take on more risk. What is their value when they don't provide first-loss financing?"*
>
> *(Fund manager, Shamba Centre enquiry into sustainable finance, 2023)*

The DFIs that participated in this enquiry were, however, unequivocal in saying that they compete much more among themselves than with private commercial lenders. They also considered their role to be that of an anchor lender, bringing comfort to other commercial lenders so that may then invest alongside them.

According to two DFI representatives:

> *"We do not crowd out private commercial lenders, but we compete between ourselves. When sponsors of projects approach us, there are often several of us [development banks] in the conversation – but no private commercial banks. So, yes, we take senior debt, but we are almost always the only entity willing to lend on the terms we do."*
>
> *(Development finance institution, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*

> *"Our additionality is that we help build institutions and enterprises. The technical assistance, market facilitation and advisory services we provide are also very important – even more important than the money we lend. Businesses and institutions in developing countries do not receive these services from commercial lenders."*
>
> *(Development finance institution, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*

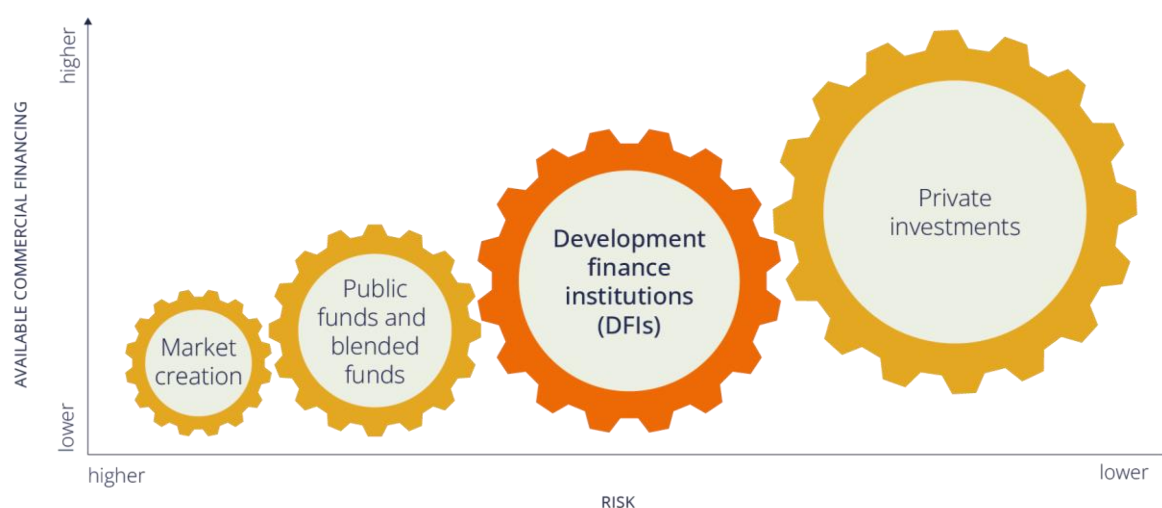
DFIs are driving performance on environmental, social and governance measures

DFIs consider themselves change agents that drive innovation and ESG improvements across value chains. They view their additionality as financiers of early-stage, high-risk ventures such as in agricultural technology and green financial technology in low- and middle-income countries.

When funding such ventures, DFIs predominantly use public funds under their management or finance local financial intermediaries and blended funds. Once these projects reach a certain size and produce a more stable cash flow, DFIs then seek to finance them directly using their own financial resources to the point where commercial investors can take over (FMO, 2022) (see Figure 18).

Figure 18 - How DFIs view their additionality

DFIs view themselves as anchor investors cofinancing along with private investors and supporters of blended funds and public funds in market creation



Source: FMO, 2022

DFIs also work with financial intermediaries and their follow-on beneficiaries to increase their expertise on measuring, managing and reporting on climate risks. The eligibility requirements to borrow from DFIs include the ability to report an organization's exposure to climate risks. Borrowers need to report on their direct emissions for scope 1 (emissions from assets that are owned and controlled by the borrower), scope 2 (indirect emissions from the production of electricity used by the borrower) and scope 3 (indirect emissions that the enterprise triggers across its value chain). Many banks, non-banks and private enterprises in developing countries have not yet developed the skills to manage and report on scope 3 emission and, thus, are finding themselves not eligible to receive loans that originate from DFIs. DFIs are therefore starting to offer loans with tranches that are conditional to improvements in climate risk measurement.

> *"Understanding scope 3 emissions remain[s] particularly problematic in the food and agriculture sectors. It is becoming important for us to have the flexibility to lend to such entities on the conditionality that they will begin scope 3 emission tracking and mitigation during the loan tenure …"*
>
> *(DFI representative, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*

DFIs welcome the opportunity to take more risk and offer more favourable and more longer-term commercial financing

The DFIs that participated in the enquiry unanimously welcomed changes in their mandates that will provide them with the flexibility to:

- consider longer-term loans and provide longer-term technical assistance and transaction advisory services to accompany domestic lenders and businesses through different stages of growth and maturity;
- work with dedicated pools of financing to provide first-loss financing (see Box 16);
- increase the use of guarantees, hedging instruments and liquidity facilities to finance riskier projects and mobilize commercial financing (see Box 11 and Box 12).

Moreover, the MDBs that participated in the enquiry welcomed the option to use their callable capital (i.e. capital that is not yet paid in by shareholders) to take additional risks.

In tandem, the World Bank Evolution Roadmap, published in October 2023, reports on several reforms under way including an equity-to-loan ratio lowered from 20 to 19 per cent and greater use of callable capital and guarantees. This increased lending capacity, together with the reinvigorated priorities on poverty alleviation, shared prosperity on a liveable planet and transnational global challenges, is likely to result in more risk-taking across the World Bank Group and the MDBs systems more widely (Development Committee, 2023).

Box 11 - Proparco and the Food and Agriculture Resilience Mission

The French President, Emmanuel Macron, announced the Food and Agriculture Resilience Mission (FARM) initiative at the EU summit in March 2022. Through FARM's third pillar, which focuses on strengthening local agricultural production in vulnerable countries, the Government of France launched the first pilot phase of the FARM private sector initiative. With an initial budget of EUR 40 million, this initiative will be implemented by Proparco and other French public financing institutions.

Proparco will use this budget to finance African and French agrifood SMEs across the entire food value chain. The starting ticket size will be EUR 100,000 and, working through intermediaries, Proparco aims to reach SMEs with financing needs as low as EUR 1,000. Financing will be designed as loans, guarantees and technical assistance to local and French banks and microfinance institutions that will on-lend to SMEs (Proparco, direct communication). The objective is to provide an incentive for local and French banks to increase lending to SMEs with limited collateral and based in rural environments (Proparco, direct communication, 2023) (see Figure 19).

This pool of off-balance-sheet financing presents new opportunities and challenges for Proparco as it works to put in place due diligence processes to manage smaller, high-risk loans for agriculture and agrifood logistics.
As a representative from Proparco remarked, "The FARM financing is new for us, as we are taking first loss, working with smaller ticket sizes, investing in riskier businesses with the goal of addressing food security and climate change. Our success is critical to the catalytic potential of the FARM initiative" (representative from Proparco, Shamba Centre enquiry into sustainable finance, 2023).

In June 2023, through the FARM initiative, Proparco allocated a grant of EUR 230,000 to Advans Côte d'Ivoire, a microfinance institution, to support a pilot programme of pre-harvest lending and technical assistance to 1,500 corn cooperatives. In the absence of this dedicated financing, Proparco would have not been able to support this high-risk pilot programme (Proparco, 2023).

Figure 19 - Overview of the Food and Agriculture Resilience Mission (FARM) private sector initiative

Beneficiaries	**Start-ups and incubators in Africa**	**SMEs in Africa**	**Agro-industrial enterprises across the food value chain**
Ticket sizes	Between EUR 1,000 and EUR 1 million	Between EUR 1,000 and EUR 5 million	Starting from EUR 5 million
Financing from the AFD Group, including Proparco	Financing for start-ups directly and through investment funds	Financing for SMEs in partnership with domestic banking and microfinance institutions	Financing and technical assistance for agro-industrial enterprises across the food value chain
In partnership with French public financing institutions	Support for the acceleration of start-ups	Financing for SMEs in partnership with French banks	Financing and technical assistance for agro-industrial enterprises seeking to establish themselves in Africa

Source: Proparco, direct communication, 2023

Box 12 - The European Union's InvestEU programme

InvestEU provides an EU budgetary guarantee to the European Bank for Reconstruction and Development (EBRD), enabling it to provide unfunded guarantees to financial intermediaries.

Under the InvestEU guarantee agreement signed between the European Commission and the EBRD in December 2022, the EBRD will extend an EU budgetary guarantee valued at EUR 470 million to eligible partner financial institutions in 12 EU Member States. This guarantee will be partially covered by first-loss cover provided by the European Commission (EBRD, 2023).

With the support of this EU budgetary guarantee, EBRD gains the capacity to take on risk at the first-loss level and have skin in the game in going beyond its typical risk-taking capacity. The budgetary guarantee is significant, as it is a legal confirmation from the EU that it will back EBRD investments under this programme by placing the associated financial obligation on the budget of the EU should a specified event materialize.

It is estimated that EBRD will unlock EUR 2.1 billion of financing by extending these guarantees to financial institutions. This financing will support projects across a wide range of sectors, including sustainable infrastructure, energy, food, the green and blue economies and digitalization (Ahlemeyer, 2022).

Since this guarantee is provided by InvestEU, EBRD does not set aside reserves from its own financial resources to cover potential loan losses in case of default. The freed-up financial resources, traditionally earmarked for guarantees, can be used to increase EBRD's lending capacity to support more beneficiaries.

In addition, under this agreement, financial institutions that benefit from the risk reduction on their portfolios of loans through the EBRD guarantees will be required to improve the conditions of the loan extended to end-borrowers. This improvement may include lower collateral requirements, lower interest rates and long loan terms (Investment Committee of the InvestEU Fund, 2023).

Owing to the additionality of the InvestEU guarantees, EBRD is considering increasing its guarantees to up to EUR 805 million (EBRD, 2023).

CHAPTER 5. The value of data

More research and data on the performance of agrifood SME loans that originate from donors are a prerequisite to make ODA catalytic.

Key recommendation: Donors should create a data repository on the performance of agrifood SME loans, based on the experiences of stakeholders such as the Council on Smallholder Agricultural Finance, IDH Farmfit Fund, AgDevCo, Acumen Capital Partners and MIX Market.

To scale up lending and blending, donors need research and data on the loans they provide to agrifood SMEs. They also need to be able to compare their own portfolios of agrifood SME loans with those of other donors and DFIs. While donors may be collecting this information, there is no public (or private) data repository where data are recorded, cleaned and prepared for investment decisions. The lack of comparable data impedes transparency and the development of market insight that is so critical for building an inclusive market.

The value of collecting and using loan performance data is demonstrated by the work of Acumen Capital Partners and the Council on Smallholder Agricultural Finance (CSAF).

The Acumen Foundation, through grant financing from donors, invests in marginalized SMEs and receives a revenue of US$0.89 cents for each dollar invested. This translates into losses of US$0.11 cents per dollar (Perera, 2023). Acumen continues to support these SMEs, carefully recording their progress on climate resilience, sustainable farming and processing practices, and the management of their assets and cash flow.

Using these data records, the Acumen Foundation, through Acumen Capital Partners, launched the Acumen Resilient Agriculture Fund in 2022. The Acumen Resilient Agriculture Fund takes equity stakes in SMEs to finance, advise and scale up climate resilient farming and processing. Concessional financing for the Acumen Resilient Agriculture Fund was provided by the Acumen Foundation and the Green Climate Fund with commercial financing from FMO, the Soros Economic Development Fund, Proparco, the Children's Investment Fund Foundation, Global Social Impact, the IKEA Foundation and others (ARAF, n.d.).

Similarly, CSAF, a network of impact investors, is a successful example of the value added of sharing and analysing data collectively. CSAF broke new ground in collecting and analysing data on loans that originate from donor funds disbursed by CSAF members to agrifood SMEs in developing countries. Data are collected on loans by region, size, existing versus new borrowers, informal and less developed value chains, and contract duration. CSAF members benefit from comparative analyses and can find solutions to common challenges. Aceli Africa was launched, in part, to address some of these challenges.

Other examples include MIX Market, a data catalogue for financial service providers targeting unbanked communities in developing countries, and SAFIN, which provides resources and designs clinics to help SMEs prepare due diligence for investors.

During the enquiry, several stakeholders voiced support for a wider data repository on agrifood SME loans, based on the experiences of Acumen, IDH, CSAF and MIX Market.

Box 13 - The value of loan-level data: The IDH–Neumann Kaffee Gruppe advance payment programme

The Neumann Kaffee Gruppe (NKG) launched the NKG Bloom advance payment programme with a first-loss guarantee from the IDH Farmfit Fund and a second-loss guarantee from USAID. Implementation began in Uganda in 2017. NKG Bloom operates through farmer services units that are set up within NKG export companies. These units provide coffee farmers with service bundles, including mobile money advances, fertilizer inputs and training, to enable them to run their farms at full potential and maximize their incomes. Farmers are provided with the preferred option to repay the money advances with the harvested coffee.

Assessing the credit risks of smallholder farmers is challenging because of the lack of reliable data on their productivity. NKG Bloom overcame this challenge by assessing the credit risk and the indebtedness level of farmers based on transactional data from the sales of coffee by farmers to NKG export companies. The credit a farmer can obtain is contingent on the volume of coffee they supplied in the prior season (FRP and Rural and Agricultural Finance Learning Lab, n.d.). NKG Bloom aims to expand their risk appetite and additionality by offering longer-term loans to farmers with well-established track records of repaying short-term loans.