

# STRUCTURED FUNDS IN DEVELOPMENT COOPERATION – A BALANCING ACT BETWEEN DEVELOPMENT IMPACT AND FINANCIAL SUSTAINABILITY

## Summary

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Whether in consumption, mobility or housing construction – sustainability is gaining in importance in more and more areas of life. It is also playing an increasingly important role when deciding how to invest capital. More and more investors are for instance seeking investments that combine an attractive return with measurable social and environmental impact. The market for such products is growing rapidly. Among private investors, demand for these impact investments is rising by around eight per cent every year (FNG, 2020).

This trend also holds major potential for development cooperation. Whether it be (structured) funds, bonds or guarantees, German development cooperation is increasingly using innovative financial investments to mobilise additional capital for development. This is because the existing official capital will not be sufficient for achieving the Sustainable Development Goals (SDGs). Moreover, the coronavirus pandemic is exacerbating existing liquidity shortages in the Global South. In March 2020 alone, private investors withdrew 83 billion US dollars from developing and emerging countries (Institute of International Finance, 2020).

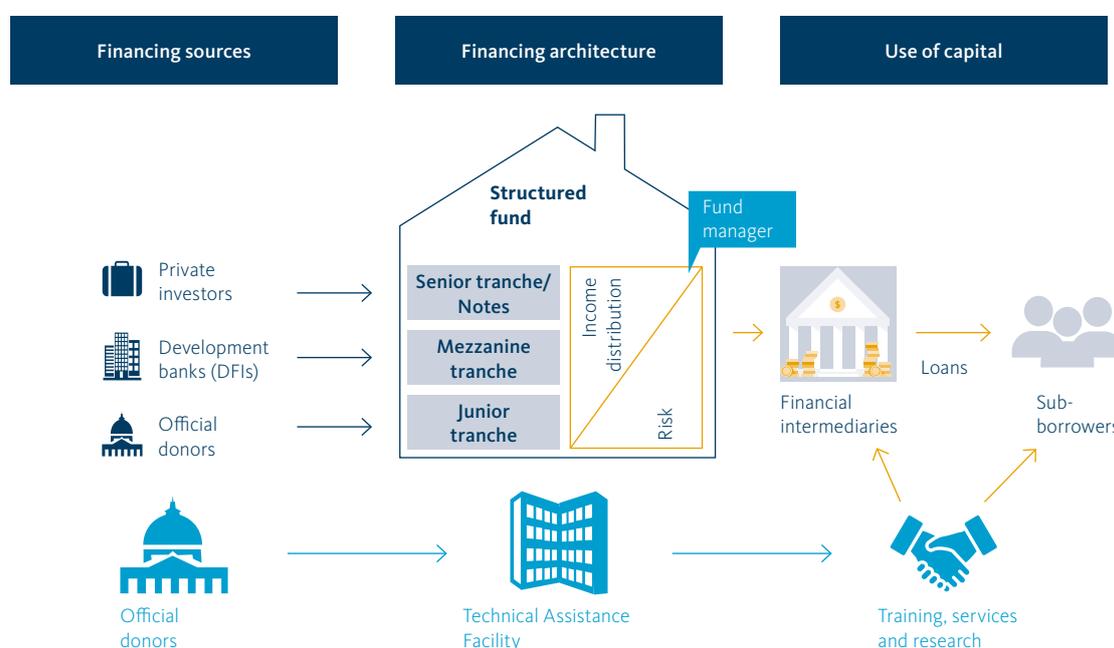
By using the financial products outlined, private investors gain an opportunity to invest in projects in developing countries that deliver measurable effects for various development objectives. However, many investors perceive the investment risks in developing and emerging countries as very high. As a result, official and private capital often have to be combined. The official

capital provides a risk buffer that reduces the investment risks for private investors. This combination of official and private capital to finance development is also termed 'blended finance'. So far, however, little is known about the impact of this financing approach. Against this background, the German Institute for Development Evaluation (DEval) conducted an evaluation on the impact of a blended finance approach that is being used increasingly in German development cooperation – structured funds.

The evaluation shows that the financing approach involves a trade-off between financial sustainability and development impact. This is because financing groups that are particularly relevant for achieving development objectives (such as micro-entrepreneurs) entails a higher risk of default and thus possible losses for the fund. Since structured funds issue loans on market terms, a focus on financial sustainability can currently be observed. The funds finance primarily financially successful financial intermediaries (FIs) in middle income countries. This has clear advantages for attracting private investors. However, target groups that are very important in development terms, but riskier, such as borrowers without collateral, have so far barely been reached by the approach.

The evaluation concludes that structured funds can meet the financial and development demands placed on them. However, it recommends that as well as ensuring the financial sustainability of funds, efforts should also be made to strengthen and further develop them in terms of their development potential (see page 4).

## What are structured funds?



### Structured funds in German development cooperation

German development cooperation uses structured funds to mobilise additional private capital for financing sustainable development in developing and emerging countries. Through legally independent investment funds, private investors are able to invest in development projects. The funds usually combine budgetary resources of the German Federal Government and capital market funds of the KfW Development Bank and/or other financial institutions with investments of private investors. To reduce the investment risks, which private investors often perceive as being too high, the fund capital (liabilities side) is usually split into three tranches and notes. The riskier tranches then serve as a risk buffer for investors in less risky tranches. Official donors typically invest in the riskiest tranche, thus assuming a major part of the investment risk.

### Objectives of structured funds

Structured funds can be used in various regional and sectoral contexts. The direct target group are financial intermediaries (FIs) in developing and emerging countries, which use the funding to provide financial services to their own end clients – the indirect target group of the funds. German development

cooperation uses structured funds in pursuit of three development objectives:

- provide FIs with reliable access to financing opportunities,
- promote a stable financial system in the partner country,
- simplify access to financing for sub-borrowers.

To achieve these objectives many funds supplement their financing with Technical Assistance (TA) interventions for the FIs and sub-borrowers.

### Evaluation design

The evaluation examined ten structured funds, half of which provide financing for micro, small and medium-sized enterprises (MSMEs) in their target countries. A theory-based evaluation design was selected. This involved a mixed-method approach that integrates qualitative analytical methods such as desk study and qualitative comparative analysis, and quantitative analytical methods such as logistic regression, as well as a quasi-experimental design. Some of the data were collected through case studies in Cambodia, Nigeria, Serbia and Tunisia. The volume of the ten funds evaluated is equal to a combined total of more than three billion euros, some 700 million euros of which are accounted for by German Federal Government resources and some 400 million by KfW's own resources.

## Structured funds are financially sustainable

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The evaluation shows that most of the funds studied now operate on a financially sustainable basis. They are largely able to cover their costs, and to maintain the official capital in the fund and use it for continuous lending, i. e. on a revolving basis. For this it is crucial that they possess a sufficiently high financing volume and are able to invest in a sufficient number of countries and institutions, so that they can diversify the risks associated with these investments.

The risk structure of the funds enables them to finance local currency loans and smaller ticket sizes that are no longer financially viable for other approaches such as credit lines. The funds are thus able to deliver considerable additional development benefits. So far, in many cases the official capital has been paid into the funds with unlimited maturity. With few exceptions, no exit strategy for this capital exists that would define the timing and nature of the exit. Nor are there any mechanisms to support a regular review of the continued need for the official capital within the funds.

## Political management made more difficult by lack of capacity and positioning within the BMZ

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On the German side the Federal Ministry for Economic Cooperation and Development (BMZ) and the KfW Development Bank together play a key role in shaping a fund's strategic and development orientation. As the BMZ's trustee, the KfW Development Bank is responsible for operational decision-making regarding the funds' business. The BMZ is able to exercise political management when financial resources are increased, and when it comments on the reports. So far, however, the organisational positioning of the funds and the lack of capacities within the BMZ have made it more difficult for the BMZ to exercise this political management appropriately.

## Potential for mobilising private capital not fully utilised

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The evaluation concludes that structured funds are in principle a suitable approach for mobilising private capital. In the period up to 2018, the evaluated structured funds mobilised around 700 million US dollars in private capital. To achieve this, roughly similar amounts of budgetary resources were invested in the funds over the same period. However, significantly less private

capital is mobilised in regions and sectors where the investment risk is higher and where the financing needs of MSMEs often cannot be met.

Despite the appetite of some private investors to bear a higher risk, the evaluation shows that the risk buffer provided is of major importance for mobilising private capital. The fund' existing track record also crucially determines how much confidence private investors have in them, and thus whether they will invest in the funds.

So far the funds have not made full use of their potential for mobilising private capital. Due to a predefined risk buffer for private investors, for example, some of the funds have reached a natural limit to their capacity for mobilisation. Once this defined risk buffer is used up, it is no longer possible to increase the share of private investment without increasing the financing volume of the fund.

## The balancing act between financial sustainability and development impact

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Structured funds provide the supported FIs with improved access to finance. They also provide – even in times of crisis – long-term financing, sometimes in local currency, and thus promote the stability and financial sustainability of the FIs and the financial system in the partner country.

The funds' investments also provide more sub-borrowers with access to capital, and enable the delivery of TA. However, the findings of the evaluation also show that borrowing terms and access for sub-borrowers that previously had no access to financing have so far only rarely been improved.

This is due among other things to the selection of the FIs to be financed. The funds do select FIs that reach the sub-borrowers targeted by development policy. Of these FIs, however, the ones supported are those that represent a low risk for the funds and their financial sustainability. In some cases these are FIs that are already market leaders in the country concerned and are financed by a large number of international investors. Only few funds define a minimum share of less mature FIs that often have barely any other financing options. In the balancing act between financial sustainability and development impact, there is thus an imbalance in favour of financial sustainability.

## Conclusions and recommendations

The evaluation concludes that structured funds can meet the financial and development demands placed on them. However, the funds should make more exhaustive use of their development potential:

- The evaluation recommends more effective management of the development impact of the funds. This should be enabled through long-term capacity development within the BMZ and through the use of synergy effects between fund and bilateral portfolio in the financial market development sector.
- The key actors should work towards using and monitoring the selection of FIs more effectively as the key point of leverage for ensuring positive development impact of the funds. To this end an assessment should be made of the extent to which the funds can also invest in riskier FIs or sectors with high development potential.

- Lending to FIs should be made conditional on the expansion of thematic areas in line with the BMZ 2030 strategy, for instance to integrate issues such as climate change into existing funds.

Regarding the financial sustainability of the funds the evaluation makes the following recommendations:

- The efficient functioning and financial sustainability of the funds should be ensured in the long term, i.e. once they have been established. This should be achieved by ensuring that the funds have a sufficiently high financing volume in the long term, and extend part of their loans to the FIs in local currency and small ticket sizes.
- The long-term options for official donors to exit the funds should be defined in advance in exit strategies.
- To make better use of the potential for mobilising private capital, the risk buffer and risk appetite of private investors should be regularly reviewed.

## References

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The German Institute for Development Evaluation (DEval) is mandated by the German Federal Ministry for Economic Cooperation and Development (BMZ) to independently analyse and assess German development interventions. Evaluation reports contribute to the transparency of development results and provide policy-makers with evidence and lessons learned, based on which they can shape and improve their development policies.